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Invested in America

May 9, 2022

Via E-Mail to pubcom@finra.org

Jennifer Piorko Mitchell
FINRA, Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 22-08, Complex Products and Options

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on Notice 22-08 (the "Notice").[2] The Notice raises regulatory concerns about retail investors who trade complex products and/or options without adequately understanding their risks, and solicits comments on whether additional regulatory requirements should be imposed to address those concerns. We understand that FINRA plans to coordinate its response to this request with the SEC's development of its regulatory approach to this topic.[3] We respectfully submit the following comments and recommendations for your consideration.[4]

Part I addresses the current regulatory regime for options and complex products. Part II addresses the best interest standard applicable to brokerage accounts where financial professionals may recommend options and/or complex products to retail customers. Part III addresses what we view as the central focus of the Notice, that is, transactions in options and complex products by retail investors through self-directed platforms, or otherwise on a self-directed, non-recommended basis. We examine

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] Notice 22-08, Complex Products and Options (Mar. 8, 2022), https://www.finra.org/rules-guidance/notices/22-08.

[3] SEC Chair Gary Gensler, Statement on Complex Exchange-Traded Products (Oct. 4, 2021), https://www.sec.gov/news/public-statement/gensler-statement-complex-exchange-traded-products-100421 (directing SEC staff to study this area and recommend changes, if appropriate).

[4] The Asset Management Group of SIFMA is submitting an additional comment letter under separate cover to express the views of the asset management community.

the existing regulatory landscape, and whether enhanced firm practices may be appropriate for self-directed transactions. Finally, Part IV highlights an aspect of FINRA Rule 2360 (Options) where both broker-dealers and their customers would benefit from rule modernization.

Executive Summary of Recommendations

We appreciate the concern that some retail investors who trade complex products and/or options may not fully understand their risks. Many retail investors, however, do understand these products and their value in managing risk; providing the desired level of leverage, exposure, and diversification; and achieving investment objectives, among other things. We are concerned that prospective new regulatory requirements that have the effect of restricting access to these products would deprive retail investors of these products' significant benefits.[5]

Regardless, our overarching goal is to be responsive to the Notice by providing constructive feedback. To that end, our response incorporates the following recommendations:

- To the extent FINRA proposes to modify, expand, or impose new regulatory requirements on complex products generally, the SEC and FINRA should define the term "complex product" consistently, objectively, and more narrowly, and apply that definition in advance to any new product designated as "complex" through the traditional notice and comment rulemaking process.

- With respect to *recommended* transactions and complex products, FINRA should acknowledge that Reg BI, together with FINRA options rules and guidance, and complex products-related guidance, provide sufficient protection for retail investors.

- The SEC should not extend Reg BI to *self-directed* transactions by retail customers in options or complex products.

- FINRA should continue to provide firms with the flexibility and leeway under FINRA rules to establish their own appropriate option strategy categorizations and respective eligibility requirements (e.g., knowledge, experience, investment objectives) for each category, based on the particular broker-dealer's client base, systemic controls and safeguards, risk-based supervisory systems, and options product and strategies offerings.

- FINRA should continue to allow firms to set a deadline for customers to make a final option exercise decision prior to 5:30 pm ET.

- Prior to taking any regulatory action with respect to options accounts, FINRA should first complete its targeted examinations of firms' options accounts and thereafter, consider publishing a regulatory notice to share its examination findings.

[5] We urge FINRA to appropriately weigh and address this same concern which is currently being voiced directly by hundreds of retail investors who invest in these products today. *See* Retail Investor Comments on Notice 22-08, https://www.finra.org/rules-guidance/notices/22-08#comments.

- FINRA guidance should encourage member firms: (i) to make freely and readily available to self-directed retail investors a variety of content, guide, and educational materials about complex products generally, and about the specific complex products offered by the firm; (ii) to use the tools available to them to educate their self-directed customers about complex products in a variety of ways; and (iii) to consider providing the customer with a supplemental risk warning prior to permitting the customer to transact in a complex product.

- FINRA guidance should encourage firms to adopt a layered approach for disclosing the potential risks of trading options (similar to that suggested by the SEC in Form CRS).

- FINRA should consider amending Rule 2360(b)(11), in light of the recent OCC policy change regarding ODD amendments, to reaffirm and clarify our industry's understanding that member firms are required to deliver the amended aspects of the ODD *only*, and/or a summary of the changes, and are *not* required to redeliver the full document, as amended.

Part I:
The Current Regulatory Regime for Options and Complex Products is Robust.

A. Options. Our current regulatory regime includes the following options-specific rules, disclosure, guidance, education, examination and enforcement:

- Options Rules. FINRA Rule 2360 (Options) and Rule 2220 (Options Communications).[6]

- Options Disclosure. Options Disclosure Documents ("ODD") (Mar. 2022).[7]

- Regulatory Guidance for Firms. Notice 21-15, Options Account Approval, Supervision and Margin (Apr. 9, 2021).[8]

- Education for Investors. Options A-Z: The Basics to The Greeks (regarding options terminology) (Jun. 2015).[9] Trading Options: Understanding Assignments (Dec. 2020).[10] Investor Bulletin: An Introduction to Options (Mar. 2015).[11] Investor Bulletin: Opening an Options Account (Mar. 2015).[12]

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[6] https://www.finra.org/rules-guidance/rulebooks/finra-rules/2360; https://www.finra.org/rules-guidance/rulebooks/finra-rules/2220.

[7] Characteristics and Risks of Standardized Options, https://www.theocc.com/Company-Information/Documents-and-Archives/Options-Disclosure-Document.

[8] https://www.finra.org/rules-guidance/notices/21-15.

[9] https://www.finra.org/investors/insights/options-z-basics-greeks.

[10] https://www.finra.org/investors/insights/trading-options-understanding-assignment.

[11] https://www.sec.gov/oiea/investor-alerts-bulletins/ib_introductionoptions.html.

[12] https://www.sec.gov/oiea/investor-alerts-bulletins/ib_openingoptionsaccount.html.

- Examinations – Targeted Exams of Options Accounts. FINRA is currently conducting targeted exams to review firms' practices relating to options account opening, supervision, communications, and diligence.[13]

- Enforcement. FINRA actively enforces options rules and obligations and routinely sanctions firms and their financial advisors for unsuitable recommendations and deficient risk disclosures.[14]

B. Complex Products.

1. Definition. FINRA maintains a dynamic definition of a complex product in order to accommodate the evolution of new financial products. Generally speaking, FINRA defines a complex product as "a product with features that may make it difficult for a retail investor to understand the essential characteristics of the product and its risk…."[15] FINRA has identified a fairly extensive number of products and securities as "complex" in both the Notice[16] and in other publications over the years, including the following:

> interval funds; closed-end funds; global real estate funds; opportunistic, tactical, multi-strategy funds; funds using derivatives for hedging or leverage; funds using cryptocurrency futures; defined outcome funds; geared funds; commodity funds; exchange-traded notes; principal protected notes; market-linked CDs; structured notes; variable annuities; asset-backed securities; investment trusts investing in cryptocurrency; currency funds; leveraged loan funds; funds selling short; start-up company (IPO) funds; funds investing in unlisted securities; distressed debt funds; absolute return funds; funds of hedge funds; volatility-linked funds; non-traded REITs; business development companies; reverse convertible notes; range accrual notes; target date funds; high yield bond funds; floating-rate loan funds; nontraditional index funds (smart beta; quant; custom index; ESG); emerging market funds; unconstrained bond funds; insurance-linked securities.

Recommendation: To the extent FINRA proposes to modify, expand, or impose new regulatory requirements on complex products generally (which, as we explain in Part III.D. *infra*, we do not believe is necessary), then the term "complex product" should be more narrowly, objectively, and carefully defined. FINRA's current definition is too vague and overinclusive. If new prospective regulations were to be applied to complex products, then the SEC and FINRA would need to *not only* consistently define the term, *but also* apply that regulatorily defined term at the outset to specify which products are complex in order to provide the industry with fair notice and opportunity to adjust to and address newly identified complex products, and to comply with any relevant regulatory requirements. Otherwise, it

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[13] FINRA Targeted Examination Letter on Option Account Opening, Supervision and Related Areas (Aug. 2021), https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/targeted-examination-letter-option-account-opening-and-supervision.

[14] *See, e.g.*, Notice at nn. 28 – 30 and accompanying text.

[15] *Id.* at p. 3.

[16] *Id.* at p. 3 – 4.

would create an untenable situation where different firms may apply different standards to the term. It could also lead to a situation where regulators make a hindsight determination that a product is "complex" after the product has already been on-boarded by firms and recommended to retail investors and/or purchased by retail investors on a self-directed basis, where the firm has not complied with any regulatory requirements applicable to the product. Accordingly, we recommend that the SEC and FINRA follow the traditional notice and comment rulemaking process prior to defining any new product as "complex."

2. Current Regulatory Regime. Our current regulatory regime includes the following complex product-specific rules, guidance, education, examination and enforcement:

- Heightened Supervision. Pursuant to Notice 12-03, broker-dealers must implement heightened supervisory and compliance procedures in order to recommend complex products to retail investors.[17]

- Investment Company Act of 1940 ("Investment Company Act"). Certain complex products, such as exchange-traded funds ("ETFs"), closed-end funds, and interval funds are registered investment companies that are subject to the Investment Company Act and rules thereunder. These rules protect retail investors through limitations on a fund's ability to incur leverage, imposing certain requirements on governing boards and chief compliance officers, imposing certain prohibitions on affiliated transactions, and requiring periodic reporting to investors.[18]

- Product-Specific Guidance for firms. FINRA has issued extensive product-specific guidance for firms on a variety of complex products including the following:

  - hedge funds[19]
  - non-conventional instruments[20]
  - equity-indexed annuities[21]
  - structured products[22]
  - "geared" ETFs[23]

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[17] Notice 12-03, Heightened Supervision of Complex Products (Jan. 2012), https://www.finra.org/rules-guidance/notices/12-03.

[18] Other complex products, however, including without limitation exchange-traded notes, commodity pools, and structured notes, are structured differently and are not subject to the Investment Company Act.

[19] Notice 03-07 (Feb. 2003) (obligations when selling hedge funds), https://www.finra.org/rules-guidance/notices/03-07.

[20] Notice 03-71 (Nov. 2003) (obligations when selling non-conventional investments), https://www.finra.org/rules-guidance/notices/03-71.

[21] Notice 05-50 (Aug. 2005) (supervising sales of unregistered equity-indexed annuities), https://www.finra.org/rules-guidance/notices/05-50.

[22] Notice 05-59 (Sep. 2005) (guidance concerning the sale of structured products), https://www.finra.org/rules-guidance/notices/05-59.

[23] Notice 09-31 (Jun. 2009) (obligations relating to leveraged and inverse exchange-traded funds), https://www.finra.org/rules-guidance/notices/09-31.

- principal protected notes[24]
- reverse convertibles[25]
- commodity futures-linked securities[26]
- volatility-linked exchange-traded products ("ETPs")[27]
- oil-linked ETPs[28]

- Product Specific Education for Investors. FINRA has issued extensive product-specific education for investors on a variety of complex products including the following:

  - volatility-linked ETPs[29]
  - "geared" ETPs"[30]
  - alternative funds[31]
  - exchange-traded notes[32]
  - structured notes with principal protection[33]
  - reverse convertibles[34]

- New Product Review Guidance. FINRA has also issued best practices guidance for firms to assess new products proposed for sale.[35] This guidance encourages firms to consider the complexity of a new product, whether its complexity would impair investor understanding of the product, and how complexity would affect the marketing and sale of the product. It also encourages firms to consider whether less complex products could achieve the same

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[24] Notice 09-73 (Dec. 2009) (obligations relating to principal-protected notes), https://www.finra.org/rules-guidance/notices/09-73.

[25] Notice 10-09 (Feb. 2010) (obligations with reverse exchangeable securities), https://www.finra.org/rules-guidance/notices/10-09.

[26] Notice 10-51 (Oct. 2010) (obligations for commodity futures-linked securities), https://www.finra.org/rules-guidance/notices/10-51.

[27] Notice 17-32 (Oct. 2017) (volatility-linked exchange-traded products), https://www.finra.org/rules-guidance/notices/17-32.

[28] Notice 20-14 (May 2020) (oil-linked exchange-traded products), https://www.finra.org/rules-guidance/notices/20-14.

[29] FINRA Investor Insight: Know Before You Invest: Volatility-Linked Exchange-Traded Products (Oct. 2017), https://www.finra.org/investors/insights/volatility-linked-exchange-traded-products.

[30] FINRA Investor Insight: The Lowdown on Leveraged and Inverse Exchange-Traded Products (Nov. 2016), https://www.finra.org/investors/insights/lowdown-leveraged-and-inverse-exchange-traded-products.

[31] Investor Alert: Alternative Funds Are Not Your Typical Mutual Funds (Jun. 2013), https://www.finra.org/investors/alerts/alternative-funds-are-not-your-typical-mutual-funds.

[32] Investor Alert: Exchange-Traded Notes – Avoid Unpleasant Surprises (Jul. 2012), https://www.finra.org/investors/alerts/exchange-traded-notes-avoid-unpleasant-surprises.

[33] Investor Alert: Structured Notes with Principal Protection (Jun. 2011), https://www.finra.org/investors/alerts/structured-notes-principal-protection-note-terms-your-investment.

[34] Investor Alert: Reverse Convertibles: Complex Investment Vehicles (Jul. 2011), https://www.finra.org/investors/alerts/reverse-convertibles-complex-investment-vehicles.

[35] Notice 05-26 (Apr. 2005) (best practice for reviewing new products), https://www.finra.org/rules-guidance/notices/05-26.

objectives for investors, and further encourages post-approval follow-up and review for complex products.[36]

- Examination. FINRA regularly focuses on firms' practices around complex products and employs a risk-based dynamic approach to identify potential problematic activity.[37]

- Enforcement. FINRA regularly brings enforcement actions involving complex products against firms for issues such as unsuitable recommendations and failure to supervise.[38]

Part II:
The Best Interest Standard Applicable to Recommended Options and Complex Products Transactions Fully Protects Retail Investors.

The best interest standard of conduct for broker-dealers under Regulation Best Interest ("Reg BI") applies to any recommendation of an account, transaction, or investment strategy to a retail customer.[39] Under Reg BI, when recommending the opening of an options account, a trade in options, or an investment strategy involving options, the financial advisor must *not only* understand all relevant risks and features him/herself *but also* have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that customer's investment profile and the potential risks, rewards and costs associated with the recommendation. FINRA's options rules also include specific suitability requirements when recommending options, including a reasonable belief that the customer has the knowledge and experience to evaluate the risks involved and the financial ability to bear these risks. Thus, with respect to broker-dealer advised options accounts, transactions and investment strategies, Reg BI, together with the previously discussed FINRA options rules and guidance, is fully sufficient to address retail investor protection concerns.

As with options, Reg BI applies to transactions in complex products where the transaction is recommended to a retail customer by a broker-dealer.[40] Under Reg BI, a broker-dealer cannot establish a reasonable basis to recommend complex products to retail customers without understanding the terms, features and risks of these products.[41] In addition, the broker-dealer must have a reasonable basis to believe that the recommendation of the particular complex product is in the best interests of at least *some* retail customers.[42] Again, as with options, under Reg BI, when recommending a complex product, the financial advisor must *not only* understand all relevant risks and features him/herself *but also* have a reasonable basis to believe that the recommendation is in the best interest of a *particular* retail customer

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[36] *Id.*

[37] 2022 Report on FINRA's Examination and Risk Monitoring Program (Feb. 9, 2022), https://www.finra.org/rules-guidance/guidance/reports/2022-finras-examination-and-risk-monitoring-program.

[38] Notice at nn. 12 – 15 and accompanying text.

[39] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (Jun. 5, 2019) [84 FR 33318 (Jul. 12, 2019)] (Reg BI Adopting Release"), https://www.sec.gov/rules/final/2019/34-86031.pdf.

[40] *Id.*

[41] *Id.* at nn. 593 – 597.

[42] Reg BI, Section 240.15l(a)(2)(ii)(A).

based on that customer's investment profile and the potential risks, rewards and costs associated with the recommendation.

FINRA also requires broker-dealers to implement heightened supervisory and compliance procedures in order to recommend complex products to retail investors.[43] Thus, with respect to recommended transactions in complex products, Reg BI, together with complex products-related guidance, is also fully sufficient to protect retail investors and ensure they understand the unique characteristics and risks of a recommended complex product.

Recommendation: For all the foregoing reasons, for *recommended* transactions in options and complex products, FINRA should acknowledge that Reg BI, together with FINRA options rules and guidance, and complex products-related guidance, provides sufficient protection for retail investors.[44]

Reg BI's application is strictly limited to *recommended* securities and investment strategies, including account types. Reg BI does not extend to self-directed transactions (discussed in Part III below). When the SEC promulgated Reg BI in 2019, it reached a reasoned determination that Reg BI should apply only to recommendations, and not to "self-directed or otherwise unsolicited transactions by a retail customer, whether or not she also receives separate recommendations from the broker-dealer."[45] That determination was based upon the SEC's findings that: the existing recommendation-based framework has worked well for broker-dealers for decades; it is understood by and provides necessary clarity for broker-dealers; and thus, the SEC should continue this approach under Reg BI.[46] We see no reason to deviate from this approach today.

Recommendation: Given that FINRA is coordinating its efforts with the SEC's own prospective regulation in this area, and consistent with the reasoning articulated in the Reg BI Adopting Release, we would strongly oppose and recommend against the SEC extending Reg BI to self-directed transactions by retail customers in options or complex products.

Part III:
Self-Directed Transactions in Options and Complex Products Are Sufficiently Regulated Today.

As stated above, the central focus of the Notice appears to be self-directed transactions in options and complex products by retail investors. FINRA notes that the number of accounts trading in options and complex products has increased significantly in recent years. FINRA also notes that the current rules were adopted at a time when most retail investors accessed options and complex products through a financial professional, rather than through self-directed platforms. Ultimately, FINRA's apparent concern is that self-directed retail investors (without the benefit of financial advice from a financial

[43] Notice 12-03, Heightened Supervision of Complex Products (Jan. 2012), https://www.finra.org/rules-guidance/notices/12-03.

[44] Likewise, the fiduciary standard for investment advisers under the Investment Advisers Act of 1940 provides sufficient protection for retail investors.

[45] Reg BI Adopting Release at p. 77.

[46] *Id.* at p. 81.

professional of a broker-dealer or registered investment adviser)[47] may trade options and/or complex products without adequately understanding the relevant risks involved.[48]

A. The Factual Predicate to Justify Additional Regulation of Self-Directed Transactions Has Not Been Established.

Self-directed platforms and transactions have certainly facilitated and contributed to an increased level of trading activity in options and complex products by retail investors. However, we view greater access and participation in the capital markets by retail investors as a generally positive development – one that should be encouraged. While we appreciate the regulatory concern that some retail investors may not fully appreciate the risks associated with options and/or complex products, as we stated at the outset, we also recognize that many retail investors can and do appreciate the risks, and that options[49] and/or complex products may be an appropriate and attractive component of their investment strategy and portfolio.

With respect to self-directed options transactions, many firms long ago implemented options access controls with option "levels" ranging from simpler, less risky options and strategies to more complex and risky options and strategies. Coupled with education and other reference materials as helpful aids, these option level controls allow new self-directed customers to gain actual experience trading options in a live trading environment over time that is limited to simpler, less risky option types (e.g., covered call writing) prior to being able to access more complex and risky options.

Moreover, we have not found, nor are we aware of FINRA having publicly identified, widespread and substantial evidence that self-directed retail investors misunderstand the risks, rewards, or costs of options or complex products. Finally, none of the enforcement actions cited in the Notice suggest any issue or concern with respect to options or complex product transactions by self-directed retail investors. FINRA should perform a proper economic and cost-benefit analysis to support any new prospective restrictions on, or regulation of, self-directed trading in options or complex products. At a minimum, such analysis should identify and weigh: the alleged harm to retail investors from having the access to options and complex products that they enjoy today; the harm to retail investors from restricting or denying such access (e.g., an uneven playing field for investment or trading opportunities between retail investors and other professional/institutional investors); the cost and burden on broker-

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[47] For retail investors who work with a financial professional who is associated with a registered investment adviser, and not a broker-dealer, the broker-dealer's services are often limited to (i) opening brokerage accounts for such investors; (ii) introducing those investors to a qualified custodian as defined in Rule 206(4)-2 under the Advisers Act or a clearing or carrying broker-dealer; and (iii) as instructed by the investment adviser, transmitting orders to buy and sell securities for those investors to such qualified custodian, or clearing or carrying broker-dealer. In these cases, current regulations provide sufficient protection to retail investors transacting in options and complex products, particularly in light of the added layer of oversight provided by the registered investment adviser. The SEC reached a similar conclusion when it excluded broker-dealers meeting these criteria from Form CRS requirements. *See* FAQs on Form CRS, "Qualified Custodians," and "Qualified Custodians, Clearing or Carrying Broker-Dealers – Introduced Accounts of Registered Investment Advisers' Clients," https://www.sec.gov/investment/form-crs-faq.

[48] Notice at pp. 3 and 5.

[49] The Notice, for example, highlights the following benefits to retail customers of options investing: "enhancing returns, limiting losses, or improving diversification;" "to hedge current positions and for income generation;" and "to speculate on the future price of a stock—whether up or down—and be able to do so by committing less funds up front than in buying or selling the underlying stock." Notice at pp. 1 and 5.

dealers of implementing such restrictions and/or limiting their options and complex product offerings as a result of such restrictions; and the effects on competition and capital formation.

B. Prescriptive Regulations Would Ultimately Restrict or Eliminate Retail Investors' Access to Options and Complex Products.

Notwithstanding the absence of a factual predicate for imposing additional regulation on self-directed transactions in options and complex products, the Notice suggests a number of prescriptive requirements that might be imposed on broker-dealers including, for example:

- requiring firms to conduct conversations with retail customers to vet whether they may trade options.[50]
- requiring periodic reassessments of the retail customer's account for appropriateness to trade options or complex products.[51]
- requiring retail customers to demonstrate their understanding of options and complex products by passing a competency exam or some other form of "knowledge check."[52]
- requiring firms to conduct heightened supervision of self-directed options accounts.[53]
- restricting retail customer access to complex products, based upon criteria such as net worth or other categories.[54]

These prospective requirements represent an unnecessary departure from our nearly 90-year-old disclosure-based regulatory regime, which gives investors the freedom of choice to seek investment advice from a financial professional or to independently make their own investment decisions.[55] FINRA should avoid substituting its judgment for that of self-directed investors in a manner that hinders or precludes their access to options strategies and complex products. Under our current regime, investor choice, democratization of investment opportunities, and appropriate controls (including disclosure and, in the case of options, approval criteria and need for margin for certain transactions) strike the appropriate balance between investment opportunities and investor protection.

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[50] Options Question 2.b.

[51] Options Question 2.c.; Complex Products Question 7.d.

[52] Options Question 2.f.; Complex Products Question 7.c. Prospective competency exams are unlikely to be effective because they are unlikely to accurately assess an individual retail investor's knowledge level – that is, unless the exams were lengthy, comprehensive, and detailed – akin to a Series 7 exam for retail investors, which would be unduly burdensome on retail investors and have a chilling effect on their investment in the subject product(s). Needless to say, such exams would also be susceptible to cheating, for example, by having a third party take the exam in the retail investor's place, or by having someone post the firm's exam answers online.

[53] Options Question 2.f.

[54] Complex Products Question 2.

[55] *See* SEC Chair Gensler, Speech, *A Century with a Gold Standard* (May 6, 2022), https://www.sec.gov/news/speech/gensler-acfmr-20220506?utm_medium=email&utm_source=govdelivery ("Markets don't stand still. Our disclosure and transparency rules can't stand still, either. Thus, over the generations, the Commission often has updated disclosure and transparency regimes. Going back to the 1930s, we have a disclosure-based regime, not a merit-based one. The core bargain is that investors get to decide which risks to take, as long as public companies provide full and fair disclosure and are truthful in those disclosures.")

The prescriptive requirements listed above would also, in many cases, unfairly transfer regulatory and/or legal risk from the self-directed retail investor to the broker-dealer. The net effect of these types of requirements would be to disincentivize broker-dealers with self-directed platforms, or who allow self-directed trading, from offering these securities (whether due to the prescriptive requirement's vagueness, cost, burden, legal risks, or impracticality of implementation), and to restrict or prevent self-directed retail investors (particularly less affluent customers or customers without a trading background) from accessing these securities, neither of which would be a good policy outcome.

C. Self-Directed Options Accounts are Sufficiently Regulated Today.

FINRA's options rules impose investor protection-related, account opening approval requirements and ongoing specific supervisory review requirements on both advised and self-directed options accounts.[56] In order to approve the opening of an options account, the firm must conduct due diligence on, and collect information about, the customer to support a determination that options trading is appropriate for the customer. Specifically, the firm must seek to obtain and consider detailed customer information, including, among other things, the customer's knowledge, investment experience, age, financial situation and investment objectives.[57] In terms of supervisory review, the firm must also review the compatibility of options transactions with investment objectives and the types of transactions for which the account was approved.[58]

Notice 21-15 details the extensive requirements applicable to broker-dealers for options account approval, supervision and margin.[59] Notice 21-15 explains that firms' approval process must consider the appropriateness of the full range of options trading being approved for the customer, or whether to approve a customer only for certain types of options transactions and not for others. Notice 21-15 also explains that firms must furnish the customer with the ODD disclosure, which describes the features, different types, and risks associated with options. Given the extensive guidance in Notice 21-15 and other relevant materials, our existing ruleset is more than sufficient to ensure that retail investors in self-directed options accounts adequately understand the risks associated with options. Because our current regulatory regime comprehensively addresses options, we do not believe that additional options regulation is necessary or warranted at this time.

Moreover, many firms have already implemented practices that exceed what is required under the current rule set, such as providing educational resources that help retail investors understand the risker aspects of options, such as assignment risk; providing interactive strategy screeners that help retail investors select the right strategy for them; and restricting marketing of options to customers who are not approved for options. These types of practices, among others, demonstrate firms' commitment to self-regulation and acting in the best interest of their retail customers without the strictures of prescriptive rules.

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[56] Rule 2360(b)(16) and (b)(20).

[57] Rule 2360(b)(16) (B)(i). Information considered in approving an account for options must be reflected in the records of the account. Rule 2360(b)(16)(B)(v).

[58] Notice at. p. 7.

[59] Notice 21-15, Option Account Approval, Supervision and Margin (Apr. 9, 2021), https://www.finra.org/rules-guidance/notices/21-15.

1. Options Levels. The Notice observes that many firms have also developed a system of option "levels" ranging from less risk options and strategies to more risky options strategies, based on the customer's risk tolerance, investment experience, and upon the customer opening a margin account. The Notice queries whether specific new regulations and standards should be applied to options levels.[60]

Recommendation: We recommend against imposing a rigid regulatory structure of options levels. Firms should continue to have the flexibility and leeway under FINRA rules to establish appropriate option strategy categorizations and respective eligibility requirements (e.g., knowledge, experience, investment objectives) for each category, based on the particular broker-dealer's client base, systemic controls and safeguards, risk-based supervisory systems, and options product and strategies offerings.

2. 5:30 pm ET Deadline for Expiring Option. FINRA's existing options rules give option holders until 5:30 pm ET to make a final decision whether or not to exercise an expiring option, but also allows firms to set a deadline for customers to make exercise decisions prior to 5:30 pm ET. The Notice queries whether all firms should be required to give investors to 5:30 pm ET to make a final exercise decision.[61]

Recommendation: Firms should not be required to give investors to 5:30 pm ET to make a final exercise decision. Firms should continue to be allowed to set a deadline for customers prior to 5:30 pm ET. As a practical matter, firms could not reasonably be expected to process a volume of exercise instructions all at once, and so require a window prior to 5:30pm ET within which to process them.

3. FINRA's Targeted Examination of Options Accounts. As discussed above, FINRA is currently conducting targeted examinations of firms' practices relating to options account opening, supervision, communications, and diligence.

Recommendation: Prior to taking any regulatory action with respect to options accounts, we recommend that FINRA first complete its targeted examinations of member firms' options accounts. Thereafter, we recommend that FINRA consider publishing a regulatory notice to share its examination findings with members, including best practices observed, as well as areas where firms could make improvements. Doing so would provide a roadmap for firms to consider enhancing their options systems and procedures in order to address the findings in the notice.

D. Self-Directed Complex Product Transactions are Sufficiently Regulated Today.

As discussed above, broker-dealer firms are expected to follow FINRA guidance for assessing complex products offered by the firm. Firms are expected to consider the complexity of a product and whether it would impair investors' understanding of it.[62] Needless to say, most complex products have unique features and risks, requiring a product-by-product approach to assess whether the product may be in the best interest of at least some retail customers and whether retail customers are able to understand the product's unique characteristics and risks.

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[60] Options Question 2.a.

[61] Options Question 2.j.

[62] Notice 05-26.

Accordingly, as new complex products have been introduced and/or offered by firms, FINRA has in nearly each instance issued both product-specific guidance for firms, and product-specific education for retail customers, on each of those new products.[63] In many cases (e.g., with registered investment companies such as ETFs, closed-end funds, and interval funds, as well as with non-traded REITs), the SEC reviews the registration statement for the complex product.[64] For other products such as hedge funds and private equity funds, investors are provided disclosure of material risks through a private placement memorandum ("PPM"), and are required to execute subscription agreements in which the investor acknowledges receipt and review of the PPM, as well as an understanding of the risks associated with the complex product, among other things. We believe that FINRA's product specific regulatory guidance for firms and investor education materials, and in certain cases the SEC registration process, together, have adequately ensured that retail customers understand the unique characteristics and risks of the complex products covered by such guidance, education and risk disclosure.

1. Options-Type Regulation of Complex Products is Unnecessary and Inappropriate.

The Notice poses questions about prospective new complex product regulation that seem to suggest an interest in foisting on complex products a regulatory regime similar to that applicable to options. We believe that is unnecessary and would be inappropriate. Unlike complex products, options require a specific account type and more importantly, certain options strategies present a risk of unlimited loss (not limited to the investment, as with most complex products).

Moreover, the complex products regulatory framework discussed above already provides many controls governing the offer and sale of such products. For example, for publicly offered securities of corporate issuers (e.g., structured notes), prospectus disclosure and delivery requirements under the Securities Act; for investment companies, fiduciary obligations applicable to investment managers of those products under the Investment Advisers Act of 1940; for complex products issued by public companies, ongoing SEC reporting obligations by such companies under the Securities Exchange Act of 1934; for certain unregistered pooled investment vehicles that are privately placed (e.g., hedge funds and private equity funds), "accredited investor" requirements under Regulation D under the Securities Act and "qualified purchaser" requirements under the Investment Company Act; and for various bank-issued structured notes, "accredited investor" requirements under OCC regulations.

Thus, imposing an options-type regulatory regime on complex products would be *not only* unnecessary, *but also* burdensome and costly, as firms would need to develop and maintain a separate complex-product-by-complex-product due diligence process for each different complex product that is currently on its platform, and as each new complex product is on-boarded in the future. It would certainly be difficult to implement uniformly across complex products with varying features, complicate the trading process, frustrate retail customers, and in many cases deprive retail customers of the ability to choose the complex products that they want to buy. For these reasons, we do not believe it makes practical sense to create a new, options-like, rule-based, patchwork tiering of different levels of retail customers for each different complex product offered by the firm.

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[63] *See supra* footnotes 19 – 34 and accompanying text.

[64] Certain complex products that are registered investment companies must register under the Securities Act of 1933, as amended (the "Securities Act") and the Investment Company Act using Form N-2 or Form N-1A. As part of the registration process, the SEC staff reviews and comments on the registration statement, including in respect of the complex product's articulated objective, strategies, and risk disclosures, and whether such information is communicated in a manner consistent with the SEC staff's "Plain English" directive.

2. Firms Should Provide Sufficient Educational Resources About Complex Products.

We do not believe that new regulations are necessary for complex products – particularly ones that are modeled after the options rules. We do, however, recognize the risks and complexities of these products and believe that firms should provide sufficient educational resources to retail customers who transact in complex products on a self-directed basis.

Recommendation: FINRA guidance should encourage member firms to make freely and readily available to retail investors a variety of content, guide, and educational materials about complex products generally, and about the specific complex products offered by the firm; and to use the tools available to them to educate their self-directed customers about complex products in a variety of ways. For example, in addition to providing clients with the disclosure material for the complex product where applicable (e.g., prospectus or PPM), firms could create an education "hub" where customers can learn about the different types of complex products offered by the firm and their features and risks. FINRA guidance could also encourage firms to consider providing the customer with a supplemental risk warning prior to permitting the customer to transact in a complex product.

Part IV:
FINRA's Options Disclosure Regime Should be Modernized for the Benefit of Retail Investors and Broker-Dealers Alike.

As part of FINRA's review of its options rules, we respectfully request that FINRA revisit and modernize the options disclosure regime. Currently, FINRA Rule 2360(b)(11) requires delivery of:

> the current ODD to each customer at or prior to the time such customer's account is approved for trading options issued by The Options Clearing Corporation, other than an OCC Cleared OTC Option. Thereafter, a copy of each amendment to the ODD shall be distributed to each customer to whom the member previously delivered the ODD not later than the time a confirmation of a transaction in the category of options to which the amendment pertains is delivered to such customer.

The ODD is currently 93 pages long.[65] Given this length, it is questionable whether many retail investors actually take the time to read it and if so, whether such retail investors are able to sufficiently digest it. If FINRA's concern is that retail investors may not understand the potential risks of trading options, then the ODD is arguably the least effective way to educate them about such risks.

The SEC has stressed the benefits of "layering" disclosures to retail customers in the Form CRS, whereby retail customers are given the most pertinent information first, with readily available resources to find out more.

Recommendation: FINRA guidance should encourage firms to consider adopting a layered approach for disclosing the potential risks of trading options (similar to that encouraged by the SEC in Form CRS).

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[65] *See* ODD (Mar. 2022), https://www.theocc.com/getmedia/a151a9ae-d784-4a15-bdeb-23a029f50b70/riskstoc.pdf.

Recently, the Options Clearing Corp. ("OCC") changed its practice of amending the ODD through supplements and announced on its website that "all future changes to the ODD will be incorporated into an updated version of the document rather than through the issuance of separate supplements."[66] The OCC stated, "Firms are reminded that new versions of the ODD may be issued at various times as needed to address new products or industry changes."[67] In the past several months, the OCC has already issued two new versions.

Recommendation: FINRA should consider amending Rule 2360(b)(11), in light of the recent OCC policy change regarding ODD amendments, to reaffirm and clarify our industry's understanding that member firms are required to deliver the amended aspects of the ODD *only*, and/or a summary of the changes, and are *not* required to redeliver the full document, as amended.

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If you have any questions or would like to further discuss these issues, please contact the undersigned.

Sincerely,

Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: Meredith Cordisco, Associate General Counsel, Office of General Counsel, FINRA
Danny Mileto, Vice President, FINRA Market Regulation
Kathryn Moore, Senior Director & Counsel, FINRA Market Regulation
Division of Trading and Markets, Office of Chief Counsel

[66] Characteristics and Risks of Standardized Options, https://www.theocc.com/Company-Information/Documents-and-Archives/Options-Disclosure-Document.

[67] *Id.*