

May 9, 2022

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

Re: FINRA Regulatory Notice 22-08; Complex Products and Options; FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements

The Security Traders Association¹ (“STA”) appreciates the opportunity to provide comments in response to the aforementioned Request for Comment (the “Request”)² published by FINRA. STA is an organization comprised of individuals who are involved in the trading of financial securities in the U.S and Canada. Our members are employed at retail brokerage firms, agency only broker dealers, asset owners and managers, market makers, liquidity providers and exchanges.

The Request reminds FINRA members of their current regulatory obligations, including the application of Regulation Best Interest (Reg BI) when broker-dealers and their associated persons make securities recommendations, and recommendations of investment strategies involving securities, to retail customers, and seeks comment on: (1) effective practices that members have developed for complex products and options, particularly when retail investors are involved; and (2) whether the current regulatory framework, which was adopted at a time when the majority of individuals accessed financial products through financial professionals rather than through self-directed platforms, is appropriately tailored to address current concerns raised by complex products and options.

The Request describes that while many complex products serve a role in our financial markets, they also may raise a number of regulatory and investor protection concerns. Complex products could potentially create system-wide risks by operating in unanticipated ways when markets experience volatility or stress conditions. Similar to transactions in complex products, buying or selling options can be risky for retail investors who trade options without understanding their vocabulary, strategies and risks. Like the concerns associated with complex products, these concerns may be heightened when retail investors make self-directed decisions through online platforms without the assistance of a financial professional.

¹ STA is a trade organization founded in 1934 for individual professionals in the securities industry. STA is comprised of 24 affiliate organizations in North America with individual members who are engaged in the buying, selling and trading of securities. STA is committed to promoting goodwill and fostering high standards of integrity in accord with the Association’s founding principle, Dictum Meum Pactum – “My Word is My Bond.” For more information, visit <https://securitytraders.org/>.

² <https://www.finra.org/rules-guidance/notices/22-08>

STA supports FINRA for publishing the Request as we believe that as markets evolve it is critical for regulators to stay apprised on how to best protect the interests of investors.

The majority of STA's remarks will be in response to those requests for comments pertaining to options trading via self-directed brokerage accounts.

FINRA states in the Request that three (3) themes are arising in targeted examinations of its member firms regarding options trading in self-directed brokerage accounts:

1. Account Opening

FINRA observation

Initial observations indicate potential gaps in identification of red flags in customer representations of trading experience, where members' policies require minimum levels of experience for advanced level option accounts.

STA observation

It is difficult for STA to provide meaningful input in the area of Account Openings as the Request fails to define or identify examples of "red flags". Based on the specific questions raised in the Request, we assume that FINRA is seeking input in areas such as suitability and verification of information provided to the broker dealer by the investor. On the former, brokerage firms have a duty to ensure that investors on their platform are provided adequate disclosures, including the risks and regulations of options trading. On the latter, broker dealers should be able to rely on the information provided to them by self-directed investors in the absence of any conflicting information the broker dealer may possess.

2. Disclosure Practices

FINRA observation

Most members rely only on the delivery of "Characteristics and Risks of Standardized Options" (also known as the Options Disclosure Document or ODD) issued by the Options Clearing Corporation (OCC) to provide customers with information related to the risks of trading options, but there is a wide range of practices by members in the provision of educational materials in addition to the ODD specific to risks surrounding complex options transactions and the mechanics of options expiration.

STA observation

Providing educational resources is an area where brokerage firms compete for investors. Therefore, we do not disagree with FINRA's observation that there is a wide range of practices by members. We also do not generally believe that the existence of a wide range of practices is necessarily a red flag. Some brokerage firms invest more heavily than others in this area, as it is a contributing factor in the overall client experience. For example, some brokerages provide self-directed investors with a means to self-evaluate their level of financial literacy, even though they are under no regulatory obligation to do so.

Additionally, educational services are not stagnant. When some broker dealers observe a specific area where self-directed investors require additional education, we find that they respond. For example, in our February 17, 2021, letter to the House Committee on Financial Services, we wrote.

Given the events surrounding GME, we believe more needs to be done towards educating investors and that the report by the regulators could be useful in identifying specific areas. For example, it is important for investors to understand the risks of trading on margin and the transaction rules for cash account established under Regulation T.³ As regulators conduct their investigations, their findings would help the industry understand if additional education in this area is needed. We also believe the industry will respond accordingly in the area of education and investors will be well served.⁴

It is our view that the market for education on options trading provided by brokerage firms is robust, albeit not equal. Self-directed investors have ample choices of brokerage firms to choose from if they are not satisfied with the educational services of their existing provider.

3. Options Exercise Procedures.

FINRA observation

FINRA staff also initially noted varying practices concerning cut-off times for customers to submit options exercise instructions. Specifically, FINRA's options rule provides that option holders have until 5:30 p.m. Eastern Time (ET) on the business day of expiration to make a final decision to exercise or not exercise an expiring option. The rule also provides that members may set a time earlier than 5:30 p.m. ET by which customers must submit exercise instructions. In practice, FINRA found that members have set various early cut-off times and the communication of such cut-off times is not clear or consistently applied. A customer's lack of knowledge of a member's cut-off time for submission of contrary exercise decisions on expiration day may greatly impact the customer's ability to profit from moves in the underlying security on which an option is based, due to after-market activity in those underlying instruments, or the ability to make an informed investment decision such as hedging against potentially significant losses.

STA observation

STA agrees with FINRA's observation that members set various early cut-off times. In addition, we believe there are occurrences when investors may be unaware of their broker's policy. However, we are uncertain if such occurrences are systemic in nature or the result of poor communications from broker dealers. If FINRA has data which can help quantify the frequency of such occurrences and identify if they involve multiple broker-dealers or just a few, then STA would be able to provide more efficient feedback. In the meantime, we recommend 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

Potential Future Rulemaking

Need for Data

Should FINRA pursue rulemaking in areas where the Request seeks comment, we believe more data than what is found in the Request needs to be provided in order for the industry to offer effective comments. Given FINRA's unique standing within the industry, it possesses qualitative and quantitative data on options trading across markets. FINRA should, where possible, provide examples of common or systemic failures, so the industry can provide meaningful input on how to eradicate them.

³ <https://www.ecfr.gov/current/title-12/chapter-II/subchapter-A/part-220?toc=1>

⁴ [February 17, 2021 STA Letter to the Honorable Maxine Waters, Chair and the Honorable Patrick McHenry, Ranking Members House Committee on Financial Services](#)

Limitations

If new rulemaking is to be considered, it needs to do so under a realization that protecting all self-directed investors from all harm, at both the regulatory and broker dealer levels, has limitations. It is our view that there will always be individual self-directed investors who either intentionally ignore readily available opportunities to educate and self-evaluate themselves about a financial product or will circumvent processes put in place for their protection. These realities are not an excuse for a regulator or broker dealer to obscure their investor protection responsibilities; however, they need to be realized in any potential rulemaking.

Merit Based vs Disclosure Based Regulation

Federal securities laws require that issuers and intermediaries disclose the risks associated with securities products. This guiding principle, which is disclosure-based as opposed to merit-based, enables investors rather than the government, to make informed judgments about whether to purchase a particular financial product. It is our view that while the Request does not specifically seek comment on whether complex products or options trading should be exposed to some form of regulatory merit-based oversight, many of the obligations it seeks input would represent unreasonable obligations on broker-dealers with self-directed investors. The result of certain onerous requirements would be similar to a merit-based regulator who denies the availability of certain investment products to certain investors.

Conclusion

The democratization of the markets – which is an overwhelmingly positive, but not new, development – has been at the core of many conversations recently. Key drivers for the democratization of the U.S. markets include: low explicit and implicit costs; investment products; and a regulatory regime which protects investors, contributes to the overall integrity of the markets, and provides investor choice. The combination of these factors can be seen throughout the history of the U.S. markets. STA looks forward to working with FINRA on matters pertaining the Request.



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