

May 9, 2022

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

RE: Regulatory Notice 22-08-Complex Products and Options

Charles Schwab & Co., Inc. ("Schwab")<sup>1</sup> and TD Ameritrade, Inc. ("TDA" and, collectively with Schwab, "the Firm") appreciate the opportunity to respond to FINRA's request for comment on Regulatory Notice 22-08 (the "Notice") regarding complex products and options. The Firm acknowledges the regulatory concerns raised in the Notice and is committed to the investor protection goals outlined therein.

The Firm agrees with FINRA that it is important for investors to understand the key features and risks, benefits and terminology associated with complex products and options should they choose to trade them. The Notice highlights particular concern for the risks posed to self-directed investors who access these products without the involvement of a professional financial intermediary. While the growth of self-directed investing has contributed to the growth in the trading volumes of these types of products, the Firm believes that, except as described below, the current regulatory regime, along with easy-to-understand product information, education, and clear disclosures provides self-directed investors with the resources they need to take advantage of the benefits these products offer while also understanding the key features and risks of these products.

As discussed in the Notice, FINRA has promulgated a comprehensive set of options and other product specific rules, supported by an extensive history of regulatory guidance, examination, and enforcement. While FINRA's options rules are effective and are important to protect investors who seek and understand the potential risks and rewards of options exposure, it is the Firm's view that a similar

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<sup>1</sup> Charles Schwab & Co., Inc., (member SIPC) is the broker-dealer subsidiary of The Charles Schwab Corporation (NYSE: SCHW), a leading provider of financial services, with 33.6 million active brokerage accounts, 2.2 million corporate retirement plan participants, 1.6 million banking accounts, and approximately \$7.86 trillion in client assets. Through its operating subsidiaries, the company provides a full range of wealth management, securities brokerage, banking, asset management, custody, and financial advisory services to individual investors and independent investment advisors. Its broker-dealer subsidiaries, Charles Schwab & Co., Inc., TD Ameritrade, Inc., and TD Ameritrade Clearing, Inc., (members SIPC, <https://www.sipc.org>), and their affiliates offer a complete range of investment services and products including an extensive selection of mutual funds; financial planning and investment advice; retirement plan and equity compensation plan services; referrals to independent, fee-based investment advisors; and custodial, operational and trading support for independent, fee-based investment advisors through Schwab Advisor Services.

May 9, 2022

regulatory regime is not necessary for complex products and as discussed below, such rules could potentially impact the access that self-directed investors have to these products today. While FINRA notes, some of the current rules were adopted at a time when the amount of self-directed investing and volume of trading in these products were far below current levels, this current regime of guidance, examination and enforcement has generally ensured that member firms have evolved their approach to the risks associated with these products to meet the changing investor landscape. Accordingly, except as noted below, the Firm believes that the current regulatory framework is appropriately designed to effectively meet the goals and concerns outlined in this Notice for both investors who receive advice from an investment professional and those who choose to invest on their own.

Under Securities and Exchange Commission (SEC) Regulation Best Interest (Reg BI), broker-dealers and their associated persons are required to act in the best interest of retail investors when making securities, strategy, rollover, or other account recommendations. This includes understanding the potential risks, rewards, and costs in light of the investor's investment profile and having a reasonable basis to believe the recommendation is in the investor's best interest. Similarly, FINRA Rule 2111 imposes general suitability obligations when a member firm or its associated persons makes certain recommendations. The obligations noted above clearly apply to recommended transactions in both options and complex products, and as discussed in the Notice, in the absence of a recommendation, neither Reg BI nor FINRA Rule 2111 apply when a retail investor invests entirely on their own accord in complex products through a self-directed account. In addition to Reg BI, options related activities are governed by specific FINRA rules and both options and complex products have been the subject of substantial FINRA guidance over the years. Taken holistically, it is the Firm's view that recommended transactions in options and complex products are sufficiently covered by the existing SEC and FINRA regulatory regime and that regime should not be applied to self-directed transactions in these products. As such, the Firm's comments will primarily be focused on the Notice's potential impact for self-directed investors should FINRA choose to pursue rulemaking in these areas.

The Firm believes that the potential new requirements suggested by some of the questions contained in the Notice could inadvertently and unnecessarily limit self-directed investors' access to certain products. For example, if member firms believe that such potential restrictions are impractical and burdensome to implement, they then may choose not to offer certain products to self-directed investors. The resulting impact for these investors could create a disadvantage to investment opportunities and/or unfavorable investment outcomes, along with the inability to limit losses or improve diversification. This could lead to a domino effect, by which millions of self-directed investors could be excluded from participating in the capital markets due to unnecessary barriers to entry and a belief that they are incapable of independently assessing the risks associated with more complex investment strategies without assistance from an investment professional. As the enforcement actions highlighted in the Notice show, assistance from an investment professional does not always ensure a favorable outcome for investors. The Firm urges FINRA to thoroughly consider these potential consequences as it contemplates the need for additional rulemaking around these products.

May 9, 2022

As is the case with the Notice, the Firm has separated its response into two sections, the first addressing complex products, the second, options.

### **Complex Products**

Over the past several years, FINRA has adopted rules and provided member firms and investors with guidance designed to address the risks associated with complex products. In addition, results from FINRA's sales practice examinations have provided member firms with valuable insight into activities that have negatively impacted investor protection. The Firm has used this information to implement what it believes to be effective practices, and policies and procedures which we believe provide both our registered representatives and our self-directed clients with the information needed to make informed risk-based investment decisions.

The Firm continually reviews and updates as necessary the steps it takes to educate its registered representatives and self-directed clients on the benefits, features and risks associated with complex products. The Firm provides relevant plain language product, educational and disclosure information to both registered representatives and self-directed clients to promote an understanding of the features, benefits, and risks of these products, with the goal of enabling clients to make informed, risk-based investment decisions, whether relying on an investment professional to make a recommendation or making their own decision.

Through the Firm's two client facing websites, self-directed clients have access to product information and educational articles and videos describing how certain complex products work and their associated benefits and risks. Available articles cover such topics as leveraged and inverse products, buffered ETFs, crypto currencies, commodity mutual funds and ETFs and interval funds. Investors are also provided with risk-related information when researching or trading certain complex products that may include indicators identifying certain products as having leveraged or inverse attributes, links to regulatory investor alerts, access to product prospectuses, point of sale disclosures and or, in some cases, an acknowledgment by the investor that they understand the risks associated with a particular product.

While the Firm believes that it is important for investors to understand the risks associated with complex products, it does not believe that a testing process or an account approval process similar to the options model are necessary for complex products and that such an approach would prove to be cumbersome for both investors and member firms. The Firm's view is that given the resources, self-directed investors are capable of making the determination as to whether they understand how a complex product works, are aware of associated risks, and whether they are appropriate to meet their specific objectives and financial needs.

May 9, 2022

As noted below, the industry has a robust regulatory regime that has been largely effective in mitigating risks for options investors. While this regime works well for options, the Firm does not believe it is appropriate to do a “lift and shift” of these requirements to address FINRA’s concerns related to complex products. For example, the risk to an investor in buying a call option (loss of premium paid) is very different than selling a put. There are typically many different series of options contracts for each underlying security or index, each with different strike prices, market values and durations until expiration. Furthermore, advanced options strategies may require extensive experience and knowledge that not everyone possesses. The complexities and challenges of implementing many options trading strategies can go well beyond anything presented by the majority of complex products, thus requiring a more robust regulatory regime.

Absent a specific definition, the Firm has taken a principles-based approach and defined complex products in a manner which it believes is consistent with previous FINRA guidance. The Firm considers securities or investment strategies with multiple features that affect investment returns differently under various scenarios to be potentially complex, particularly if it would be unreasonable to expect an average retail investor to recognize the existence of these features and to understand the basic manner in which these features interact to produce an investment return. Additionally, the Firm may consider a product to be complex if it believes the average retail investor probably would not understand how its features will interact under different market conditions, and how that interaction may affect potential risk and return.

While this approach has allowed the Firm to continuously evaluate new products based upon their specific attributes, market dynamics, and regulatory considerations, the Firm believes FINRA’s dynamic definition of complex products is overly broad and overinclusive and that the industry and investors would be better served with a more narrow and objective definition. The Firm believes that prospective rulemaking (subject to the standard rulemaking process), including the creation of an industry-standard classification system, would help ensure a consistent approach across the industry and allow member firms to update their practices as new products are introduced and prior to making them available to self-directed investors. Since many products are not exclusive to a single member firm, a narrower definition would allow member firms to provide consistent educational information and risk disclosures and investors would potentially have a consistent experience regardless of where they conduct their investment activity. In the absence of a narrow and objective definition that member firms can easily understand and consistently apply, the interpretation of what constitutes a complex product would continue to be arbitrary and could lead to investor confusion, rather than achieving its intended investor protection objectives. Such a definition would also allow for consistent examinations and enforcement as it relates to the sale of these products.

The Firm believes that a consistently applied complex product definition, coupled with clear effective education and disclosure, can enable self-directed clients to make informed investment decisions that meet their needs without the need for expansive rulemaking, such as account level approval or pre-trade approval, or mandatory investor testing prior to trading complex products. As noted above, if such requirements were implemented, the Firm could envision a scenario whereby member firms

May 9, 2022

decide not to offer complex products to self-directed investors, thus limiting the availability of important tools which have the potential to allow these investors to hedge risk, increase investor returns and diversify portfolios.

### **Options**

As discussed in the Notice there is an established regulatory framework governing retail options trading, much of which in our view addresses the concerns highlighted in the Notice's questions regarding options. The cornerstone of this framework is FINRA Rule 2360 which details member firms' requirements and obligations when approving accounts for options trading and requires that firms deliver a copy of the Options Disclosure Document ("ODD") to each client prior to approving the client's account for options trading. Importantly, FINRA has also noted in Regulatory Notice 21-15 that, under FINRA 2360, firms should encourage the client to read not only the ODD, but also other educational materials that may help them improve their understanding of the risks and characteristics of options trading. In addition, FINRA Rule 2220, along with the general communications standards of FINRA Rule 2210, outlines the obligations of firms when disseminating options related communications and directly addresses the communication related concerns raised in the Notice.

While the Firm understands the potential concerns for FINRA emanating from the increase in numbers of self-directed investors trading options, we firmly believe that the current regulatory framework has proven to be well suited to ensuring that investors engaging in options transactions have adequate knowledge and understanding of the product including associated risks. The framework has led to the development of many practices in the industry that effectively mitigate the potential risk that self-directed clients are not appropriately prepared to participate in the options market. For example, the Firm employs a system of options trading levels informed by the requirements of Rule 2360 to assist us in conducting our due diligence and appropriateness determinations. The Firm has also implemented controls to protect against clients' circumvention of our established requirements for options approvals. These include a look back period designed to prevent any client who has been denied approval at a given options approval level from applying again for that level or higher for six months. We also review instances where a client has provided information that may be illogical or require further scrutiny. For example, we look for younger investors representing they have significant options trading experience.

Additionally, the Firm continues to monitor client options trading once clients are approved. This includes a trading surveillance program designed to mitigate the risk of significant financial harm to clients and to assist us in identifying client accounts posing potential suitability concerns. Moreover, the Firm has created other processes to identify at-risk positions, potential concentration risk, and other situations that may pose risk to clients, and has implemented controls to assist in managing client option expiration risk and mitigate risk from other unique situations such as the trading of non-standard options.

May 9, 2022

The Firm takes seriously the obligation to encourage our clients to educate themselves before and after applying or being approved for options trading. We have long invested, and continue to invest, in robust education and analytical resources to enable our clients to make better informed decisions when trading options and believe such resources are a key factor in meeting the client protection goals espoused in the Notice. Resources offered by the Firm include articles, on-demand video content, live webcasts and teams dedicated to options trading available to educate clients on options and options strategies including the risks associated with them.

Lastly, at the Firm all options communications are subject to our communications standards and review policies and procedures. This includes a requirement that all options communications are reviewed and approved by both a Compliance and a business Registered Options Principal, that approvals determine whether appropriate disclosures have been included, and that other important factors such as intended audience have been considered.

Given the overall effectiveness of robust practices such as those described above which we have developed and employed under the current regulatory framework of rules, guidance, examination and enforcement, the Firm does not believe there is any demonstrated need for significant new rulemaking regarding options practices. Current due diligence requirements are sufficient to require that firms have a reasonable process to review and evaluate clients and provides firms with flexibility to set experience and financial requirements for each level which allows the industry to adjust eligibility standards as market conditions and client behaviors evolve.

We would further caution against the heightened supervisory requirements suggested by several questions in the Notice, particularly with regard to self-directed accounts. We find that self-directed investors are very clear in their desire to access the options market. Many of the concepts advocated in the Notice such as requiring a conversation prior to options trading approval or heightened and more frequent supervisory reviews of self-directed options accounts, could deny clients timely market access or could be both too paternalistic and burdensome for firms to implement. Ultimately this could become a barrier to entry for otherwise qualified clients to access the options market. While these investors might appreciate the inherent protective motivation behind some of these concepts, they would also expect that regulators impose no undue burden on their ability to access that market in a timely manner. Moreover, Firms do not have the same insight into a self-directed client's investment approach or reasoning as they might have in the case of recommended accounts, and it would be difficult to design a one-size-fits-all supervisory solution to address the self-directed client segment. The Firm believes the more effective approach is to employ reasonable supervisory and monitoring processes like those discussed above, while also providing clients with robust educational and other assistive resources including properly trained service support representatives, as well as introduction to advised solutions should the client need or want that level of assistance.

May 9, 2022

Finally, the Firm believes that current options communications standards under FINRA Rules 2210 and 2220 are sufficient to mitigate the risks posed by the general and targeted options communications referenced in the Notice. Current rules allow firms to design review, approval and dissemination processes for options communications that meet their business model and client needs, while controlling for content that is misleading, unsuitable for a particular audience, or otherwise problematic. Accordingly, such additional regulation around option communications is unwarranted.

While we do find the current regulatory framework to be effective, the Firm would be supportive of select best practices or enhancements that would address some of the proposals contained in the Notice. For example, the Firm would support the addition of a standardized “key risk” document into the account opening workflow as a best practice. However, the Firm believes a better approach would be to create a summary of the risks and characteristics contained in the Options Disclosure Documents. Such a summary might be more useful as that document has grown to be quite comprehensive. In addition, the Firm is aware of the proposal in SIFMA’s response to the Notice that the ODD delivery requirements contained in Rule 2360 be modernized including provisions that Firms need only deliver the relevant amendments in a summary of material changes rather than re-issuing the entire document when those amendments are made. We believe such a change would benefit both firms and clients and are supportive of that proposal. The Firm also appreciates the potential benefit of the ongoing reassessment of a client’s suitability as discussed in the Notice. Nonetheless, again we believe FINRA should not issue prescriptive requirements, rather offer best practices maintaining the flexibility firms will need to accomplish the client protection related goals of such an assessment in a way that is practical for a firm’s particular size and business model. Finally, the Firm is a strong proponent of the value of investor education both before and after the client has been approved for options trading but would caution against the imposition of strict requirements for the use of educational resources. Instead, we believe that these concepts may again be most effectively included in a best practices framework providing firms the freedom to structure their educational offering as best fits their business model and overall risk management approach.

### **Conclusion**

The Firm appreciates FINRA’s commitment to protecting retail investors and shares its goal of ensuring that investors (both those who receive advice from an investment professional and those who choose to invest on their own) fully understand the risks and benefits of complex products and options prior to making an investment decision. The Firm reiterates its belief that the current framework of rules, guidance, examinations, and enforcement along with the availability of product, educational and disclosure information has been largely effective in providing investors with the resources needed to understand the features, benefits and risks of these products and has enabled them to make informed, risk-based investment decisions. However, the Firm believes that FINRA’s dynamic definition of complex products is overly broad and overinclusive and that the industry and investors would be better served with a more narrow and objective definition.



May 9, 2022

The Firm appreciates the opportunity to comment on the Notice and thanks FINRA for its consideration of the views expressed herein. Finally, the Firm would welcome the opportunity to meet with FINRA to discuss our comments and potential rulemaking that could enable consistent industry practices and enhance investor understanding of the benefits and risks associated with complex products and options.

If you have any questions regarding our comments, please contact the undersigned.

Sincerely,

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