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May 6, 2022

Via Email To pubcom@finra.org
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street NW
Washington, D.C. 20006-1505

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

Dear Ms. Mitchell:

The St. John's University School of Law Securities Arbitration Clinic (the "Clinic") would like to thank you for the opportunity to comment on this Regulatory Notice regarding complex products and options. The Clinic is a curricular offering where students represent public investors of limited means in disputes against their investment brokers.[1] In addition to representing aggrieved investors, the Clinic is committed to investor education and protection.

The Clinic has represented investors who have been harmed from investments in various complex products including but not limited to non-traded REITs, non-traded BDCs, structured notes, steepeners, and buffered notes. Additionally, the Clinic regularly receives calls from investors who have lost substantial sums of money engaging in options trading in a self-directed account because they do not understand the risks they are exposed to with the trading. Accordingly, the Clinic is uniquely

[1] For more information, please see http://www.stjohns.edu/law/securities-arbitration-clinic.

situated to address the issues of protecting investors in connection with complex products and options.

Many of our clients have little to no prior investment experience, and they are retirees or senior investors rolling most or all of their retirement funds into their investment accounts, making them particularly vulnerable to bad practices. Additionally, the nature of the origin of the broker-client relationship does not promote vigilance among these investors as they choose brokers they believe they can "trust." In our role, we have seen countless clients place their full trust in their brokers, believing that they are acting in their best interest. Many clients have been referred to the broker from a friend or family member, have a personal relationship with their broker prior to investing, or are charmed by brokers into a working friendship. These brokers end up exercising enormous control over their clients' finances. These investors need greater protections than the rules presently apply, protections which reflect the realities of the broker-customer relationship.

The Clinic will address its concerns with complex products and options separately for two reasons. The issues for each are focused on different investor – brokerage firms relationships, and tend to impact different constituencies of investors. For example, the issues we see with complex products tend to be focused on senior investors dealing with a human broker, while the issues with options tend to impact younger investors engaged in self-directed trading through an app or website.

A. Complex Products

FINRA has several rules in place that focus on protecting senior investors. For example, Rule 4512 requires firms to make reasonable efforts to obtain contact information for a trusted contact person.[2] Additionally, Rule 2165 permits a firm to place a temporary hold on a disbursement of funds or securities from the account of a "specified adult" customer when the firm reasonably believes that financial exploitation has occurred or is going to occur.[3] While these rules address the risks relating to possible financial exploitation of an investor by a third party, they fail to provide protection when the broker is the one recommending harmful complex investments, often to benefit themselves.

Additionally, FINRA provides a toll-free Securities Helpline for Seniors to provide older investors with a supportive place to get assistance from knowledgeable FINRA staff related to concerns they have with their brokerage accounts and

[2] FINRA Rule 4512.
[3] FINRA Rule 2165.

investments.[4] FINRA has taken the additional step of "analyzing Helpline call data to identify patterns or trends that inform [its] regulatory outreach and programs."[5] This helpline is a good resource. But it is typically a resource after the fact, specifically, after misconduct occurred. It often does not prevent misconduct from occurring in the first instance. In the Clinic, we regularly receive calls from senior investors who were taken advantage of but who did not understand that the broker may have given them improper advice.

In 2008, the SEC, NASAA, and FINRA jointly issued a report setting forth best practices used by firms to address senior issues.[6] While the Regulator Report did not focus specifically on complex products, the Regulator Report stated that some firms established processes that included, reviewing products for appropriateness for senior investors; establishing age-based restrictions on certain products or product features; and developing procedures to address potential elder financial abuse or diminished capacity. Some firms also adopted additional procedures with respect to communications, including increasing the frequency of contact; documenting conversations internally; and sending follow up communications to the clients to document conversations. Some firms have also developed trainings designed specifically to address senior-specific issues. However, the Regulator Report set forth guidance, not rules. More than a decade later, there are firms that are not doing any of these things. Accordingly, the Clinic believes that FINRA should codify certain of the best practices outlined in the Regulator Report.

FINRA takes an expansive view of complex products, viewing products that possess "multiple features" that could interact to affect returns, features that would confuse an average retail investor, as potentially complex.[7] Complex products increase risk for retail investors because "complexity adds a further dimension to the investment decision process beyond the fundamentals of market forces."[8] Examples of complex products include asset-backed securities, range accrual notes, and leveraged or inverse ETFs.[9] As noted above, the Clinic has represented investors who have been a number of different types of complex products. While FINRA has encouraged heightened supervision from firms that offer these kinds of products, the Clinic believes FINRA can and should require more.

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[4] FINRA, *Key Topics for Senior Investors*, https://www.finra.org/rules-guidance/key-topics/senior-investors.
[5] FINRA, *Report on the FINRA Securities Helpline for Seniors* (Dec. 2015), https://www.finra.org/sites/default/files/Securities_Helpline_for_Seniors_Report.pdf.
[6] SEC, FINRA, NASAA, *Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors* (Sept. 22, 2008) (the "Regulator Report"), https://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf.
[7] FINRA Regulatory Notice 12-03 (Jan. 2012), https://www.finra.org/rules-guidance/notices/12-03.
[8] *Id.*
[9] *Id.*

Our clients rely on their brokers to present them with investment options that will meet their goals. Many of our clients have multiple investment objectives including income, liquidity, and preservation of principal. However, we have seen brokers recommend complex products that pay high income with no consideration paid to the risks to principal or liquidity. For example, we have seen non-traded REITs and BDCs presented to investors as safe, high income opportunities. The brokers do not discuss the risks, sometimes because they had not previously materialized. However, the risks were always there, and it is unreasonable to believe that a retiree would want their retirement funds tied up in a product that can easily become illiquid, can lose principal, and whose income can be suspended. Often, our clients are sacrificing at least one of their investment objectives (such as protecting their principal or securing liquidity) by investing in complex products without even knowing it.

Moreover, with respect to complex products specifically, we have found that many brokers continue to conflate the "qualification" standards with the "suitability" and "best interest" standards. An investor may qualify for a certain type of investment because they have a certain level of income or net worth, but that does not mean that investment is suitable for or in the investor's best interests. If the client subsequently complains about the investment, the broker and the firm point to the investment paperwork and the representations therein that the investor qualified for the investment, and that they understood the risks of the investment. However, having an investor sign a document does not relieve the broker of their suitability or best interest obligations. Moreover, as mentioned above, our clients rely on their brokers to give them appropriate advice. They are not second guessing the advice they receive from their brokers and are not scrutinizing the paperwork their broker has presented to them to sign.

The way the United Kingdom has approached the regulation of complex products is informative. The United Kingdom's Financial Conduct Authority has implemented restrictions and prohibitions on the "distribution of certain complex investment products."[10] The United Kingdom's strategy is centered on addressing the harm from consumer investing in high-risk investments that do not match their risk tolerance, which can lead to unexpected and significant losses.[11] For example, when a firm is "dealing in or arranging a deal in a mutual society share with or for a retail client in the United Kingdom where the retail client is to enter into the deal as a buyer"[12] the firm is required to give the buyer the following warning: "The investment to which this

[10] FCA Conduct of Business Sourcebook, Ch. 22.
[11] Financial Conduct Authority, *Strengthening our financial promotion rules for high risk investments, including cryptoassets* (Jan. 2022), https://www.fca.org.uk/publication/consultation/cp22-2.pdf.
[12] FCA Rule 22.2.1 (1).

communication relates is a share. Direct investment in shares can be high risk and is very different to investment in deposit accounts or other savings products."[13] The warning goes on to say, among other things, that "the entire amount you invest is at risk." The firm must receive written confirmation from the retail client that they have read the warning prior to the commitment to purchase the mutual society share. Further, absent an exemption, the firm is required to assess whether the investment is appropriate for the prospective buyer. Going one step further, firms cannot sell contingent convertible instruments to retail investors in the United Kingdom absent an exemption. Similarly, firms cannot "sell a cryptoasset derivative or a cryptoasset exchange traded note to a retail client."[14] For certain complex products, firms are prohibited from "market[ing], publish[ing], provid[ing] or communicat[ing] in any other way any communication or information in a durable medium or on a webpage or website to a retail client, or in such a way that it is likely to be received by a retail client."[15]

FINRA should follow the United Kingdom's lead in strengthening the rules governing complex products. From our experience, investors often do not understand the complex products that brokers recommend to them. Promotional materials are often inadequate and misleading, causing the investors to more heavily rely on the representations of their brokers. In addition to better enforcement to ensure recommendations are appropriate for investors in the first place, FINRA should consider also implementing stringent risk warnings to be delivered when complex products are recommended and banning inducements to invest in these types of products.

FINRA should also consider implementing an account approval process for complex products, similar to the one used for options trading, which will be discussed in further detail below. Presently, firms are not required to have any special approval process before recommending complex products. For example, if an investor's investment objectives include preservation of principal and liquidity, the account should not be approved to invest in complex products. Moreover, firms should be required to review the associated risk tolerance designated for the account and ensure that it is appropriate in light of the investment objective selected. For example, an account with an investment objective of preservation of principal should never have a moderate or aggressive risk tolerance.

FINRA should also expand its product specific rules. FINRA has adopted rules

[13] FCA Rule 22.2.2.
[14] FCA Rule 22.6.5.
[15] FCA Rule 22.5.6.

with respect to certain products such as variable annuities, DPPs, and options.[16] These rules go beyond the obligations of suitability and best interest. For example, the DPP rule requires that the firm assess whether the investor has a net worth sufficient to sustain the inherent risks of the investment.[17] The variable annuity rule requires that the firm ensure all aspects of the annuity and any included riders are suitable for the investor.[18] The options rule requires that the firm determine that the investor is capable of assessing the risks of the transactions.[19] FINRA should consider expanding the existing rules to ensure that for any complex products, the firm has assessed the investor's ability to understand and assess the specific risks of the product, the firm has ensured the investor's financial wherewithal to sustain any risks present, and that the firm has ensured all aspects of the product are suitable for the investor.

Additionally, FINRA should determine whether there are products that should not be sold to senior investors under any circumstances. For example, as set forth in the Regulator Report, some firms have prohibited the purchase of certain variable life insurance products for investors above a certain age.[20] Some firms have limited or prohibited the purchase of certain structured products based on the investor's life stage and risk profile.[21] However, FINRA has stated that despite the general risks senior investors face, "[t]his does not mean . . . that any particular product, per se, is unsuitable for older investors."[22] Considering the heightened risks posed by complex products including with respect to principal and liquidity, it may be worth revisiting this position in this specific context.

Of course, FINRA cannot prevent all firm and broker misconduct. However, FINRA can do more to help senior investors be better equipped to respond when something does go wrong. For example, FINRA acknowledges that firms can "educate their clients to contact a supervisor or compliance officer when they have concerns or questions about the conduct of their registered representative."[23] However, again, this is a mere suggestion rather than a requirement. Firms should be required to provide information to investors about the relevant supervisory persons within a branch. FINRA should also consider requiring firms to provide their senior clients with the FINRA Securities Helpline for Seniors at the start of their investment relationship, and periodically thereafter.

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[16] *See e.g.* FINRA Rules 2310, 2330, and 2360.
[17] FINRA Rule 2310(b)(2)(B)(i).
[18] FINRA Rule 2330(b)(1)(A).
[19] FINRA Rule 2360(b)(19)(B).
[20] *See* the Regulator Report, *supra* note 6 at 15.
[21] *Id.*
[22] FINRA Regulatory Notice 07-43 (Sept. 2007), https://www.finra.org/rules-guidance/notices/07-43.
[23] Report on the FINRA Securities Helpline for Seniors, *supra* note 5 at 3.

Finally, FINRA can do more to ensure that smaller senior investors have access to competent representation if something should go wrong. Investor advocacy clinics interface with far more investors than we can assist. Presently, there are only 10 such clinics.[24] There is only one such clinic in Florida, and no clinics in 44 of the 50 states. In 2018, the SEC's Investor Advocacy Committee recommended that FINRA consider utilizing fines and penalties to provide financial support to investor advocacy clinics.[25] To ensure that investors who are harmed from misconduct have a viable path to recovery, we urge FINRA to adopt the IAC's recommendation and provide funding for law schools to start and maintain investor advocacy clinics.

B. Options

In the Clinic, we largely see complex products being purchased through brokers. However, the risks associated with complex products and options trading are not limited to an investor's interaction with a human broker. The Clinic receives numerous intake calls from investors relating to options trading in self-directed accounts. Even sophisticated investors (including those who have been in the market for years) can be susceptible to the confusion of the market mechanisms of trading options.

All of the investor advocacy clinics have seen a rise in calls from investors who have engaged in options trading. The current regulatory scheme fails to adequately protect investors, especially with the rise of online trading. As we have seen, investors are regularly approved for options trading with almost no knowledge or understanding of the risks associated with such trading. For example, FINRA found in June 2021 that one firm failed to exercise the required due diligence before approving its customers for options trading.[26] There was little to no oversight by the firm's options principals, as required by FINRA.[27] Instead, the firm relied on computer algorithms known as "options account approval bots" to approve the accounts.[28]

The FINRA rules can be improved by incorporating prior guidance into the language of the rules. Presently, to approve a customer for options trading, a firm "shall

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[24] *See* FINRA, *How to Find an Attorney*, https://www.finra.org/arbitration-mediation/how-find-attorney.
[25] Recommendation of the Investor Advisory Committee, Financial Support for Law School Clinics that Support Investors (Mar. 8, 2018), https://www.sec.gov/spotlight/investor-advisory-committee-2012/law-clinics-recommendation.pdf.
[26] *See* FINRA, *FINRA Orders Record Financial Penalties Against Robinhood Financial LLC* (June 30, 2021), https://www.finra.org/media-center/newsreleases/2021/finra-orders-record-financial-penalties-against-robinhood-financial.
[27] *Id.* "As a result, Robinhood approved thousands of customers for options trading who either did not satisfy the firm's eligibility criteria or whose accounts contained red flags indicating that options trading may not have been appropriate for them."
[28] *Id.*

exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives."[29] However, the rule does not specify how the firm should assess the information they collect in order to decide whether to approve a customer for options trading. FINRA's recent notice reminding firms about their obligations when approving options accounts points to a Notice to Members from 1980 which appears to not even be available on FINRA's website.[30] That notice apparently tells firms:

> The requirement that all public customers must be specifically approved for options is intended to assure that the firm has exercised due diligence to determine that options transactions are appropriate for the customer in light of his investment objectives and financial situation, and that the customer has been made aware of the risks of options transactions. For these reasons, firms are required to seek to obtain specified minimum information concerning the customer's financial background and investment experience, and to provide the customer with a current OCC prospectus.[31]

FINRA has stated that it views the options approval standard as one comparable to the suitability standard.[32] While FINRA has made firms aware of this prior guidance, if it expects firms to adhere to it, it should be explicitly incorporated into the language of the rule itself.

Additionally, FINRA should consider whether additional requirements are appropriate when a firm is determining whether to approve an account for options trading. For example, FINRA could adopt minimum financial thresholds that are similar to those to qualify as an accredited investor for private placements. According to Rule 501(a), a natural person may qualify as an accredited investor if they have a net worth exceeding $1 million, or income exceeding $200,000.[33] While these thresholds are outdated, they represent one indicator of an investor's ability to withstand investment risk.

However, financial thresholds do not address whether an investor is capable of assessing the risks associated with options trading. Presently, it appears that assessment is done wholly on the basis of self-reported investment experience and knowledge.[34] FINRA may consider requiring that investors pass a standardized test to qualify for self-

[29] FINRA Rule 2360(b)(16)(A).
[30] FINRA Regulatory Notice 21-15 (Apr. 2021), https://www.finra.org/rules-guidance/notices/21-15.
[31] *Id.* at note 7.
[32] *Id.*
[33] 17 C.F.R. 230.501(a). *See also* 17 C.F.R. 230.506(c).
[34] FINRA Rule 2360(b)(16)(B)(i).

directed options trading. Such a test would create a bright line, relatively easy to enforce standard for approval of an account for options trading. The Clinic cautions FINRA to adequately study such an option because there are access issues that arise with any standardized test. Research has shown that standardized tests exhibit implicit bias,[35] and the result of the test may not accurately reflect an individual's knowledge. Accordingly, FINRA would have to ensure that the test is not unfairly disadvantaging any particular communities of investors or preventing knowledgeable investors from engaging in informed trading.

In addition to greater scrutiny with respect to the account approval process, the Clinic recommends that FINRA consider other ways investors may be protected when engaging in options trading, especially when doing so in an on-line or in-app trading platform. For example, to better protect investors once an account is approved, firms could implement speed bumps after an options trade is placed but before it is executed, especially if the trade is of an unusual size or type. The purpose of the speed bumps would be to slow down or impose some time lags between the placement of the order by the investor and the order execution. For options traders, this may entail the firm including a pop-up message that confirms that a trade will be made and give the investor an opportunity to reflect on their decision. This can be done through an "Are you sure?" prompt at the end of the process that must be actively confirmed by the investor. Another option would be to implement an automatic time delay that prevents the trade from executing (going through) for a short period of time. The appropriate time can range from a few seconds to minutes, depending on the size of the trade, the risk associated with the trade, or its uniqueness. The goal would be to interrupt an investor's impulsivity, convey the significance of the trade, and ensure that no error has been made when the investor entered the trade.

Additionally, FINRA may consider requiring that firms specify potential risk at the time an options trade is placed and provide an investor with the ability to click through for additional information. One firm has already implemented an "info label" system for certain trades with the purpose of helping users make "informed investing decisions."[36] The purpose of these labels is to "help [users] take note of certain securities that may introduce more investment risk."[37] However, for such a notification to be effective, it must be prominent, and accurately and fully describe the attendant risks in plain English. Further, examples that quantify the financial risks associated with the trade will be more meaningful than the more generic warning that an investor may lose

[35] *See e.g*. Crouch, M. et al, *Rethinking Standardized Testing From an Access, Equity and Achievement Perspective: Has Anything Changed for African American Students?* 5 Journal of Research Initiatives (2021) (focusing on standardized testing for grades K-12).
[36] Robinhood, *What are info labels*, https://robinhood.com/us/en/support/articles/info-labels/ (last visited Apr. 22, 2022).
[37] *Id*.

some or all of their investment.

One way to protect investors, especially when they are engaged in self-directed trading, is to provide educational materials to maximize informed investing. However, current educational material is too dense, too long, and has low visibility that prevents the material from maximizing its reach. For example, the Characteristics and Risks of Standardized Options published by the Options Clearing Corp. is almost 100 pages long.[38] It is unlikely most investors will read the brochure. FINRA should consider requiring that relevant information be broken out into shorter, "bite-size" pieces, that may be presented either in print or through video or interactive graphics.

To the extent information is presented electronically, the information may be presented in modules, which incorporate check points before the user can move onto the next module. These check points can help assure comprehension, and prevent mindless listening, scrolling, or clicking. Print material should likewise be broken down. When the information is complex, the educational material should not be too long or dense so as not to hinder comprehension. We suggest limiting the length of print materials and utilizing simple charts, graphics, and examples when possible. As an example, the current Option Strategies Quick Guide is far more accessible that the Characteristics and Risks of Standardized Options.[39] It is not a perfect document, but the presentation of the information is much easier for an investor to follow.

To the extent information will be presented by video, they should be limited to no longer than sixty seconds. This is about the length of time that most people will show interest in a subject when they have little, or no, prior knowledge of the matter. These clips could be released in series and should be released across multiple social media platforms to maximize their reach. This may work particularly well for the younger generations of investors who have grown accustomed to consuming short video content on platforms such as TikTok, Instagram, or Snapchat.

Finally, FINRA should require firms to utilize standardized educational material that has been produced by the regulators, including by the FINRA Foundation, the SEC, NASAA, and the state securities regulators. This will ensure that the material is objective, accurate, and consistent. However, the regulators should consider the above suggestions with regard to the presentation of the information to increase the likelihood of it being read or watched and understood.

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[38] Options Clearing Corp., *Characteristic and Risks of Standardized Options* (Mar. 2022), https://www.theocc.com/getmedia/a151a9ae-d784-4a15-bdeb-23a029f50b70/riskstoc.pdf.
[39] The Options Industry Council, *Options Strategies Quick Guide*, https://www.optionseducation.org/referencelibrary/brochures-literature/page-assets/options-strategies-quick-guide.aspx.

In conclusion, the Clinic encourages FINRA to consider a broad range of options to better protect investors, both when dealing with a broker and when engaged in self-directed trading. The Clinic also encourages FINRA to work with other regulators to develop more accessible educational materials, and then to require firms to make such materials available to investors.

Thank you for the opportunity to comment on these important issues.

Respectfully submitted,

/s/

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