May 8, 2022

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

Re: Effective Practices and Rule Enhancements regarding Complex Products and Options
[Regulatory Notice 22-08]

Dear Ms. Mitchell:

I am pleased to provide these comments regarding Regulatory Notice 22-08 relating to Effective Practices and Rule Enhancements regarding Complex Products and Options.[1]

Introduction

FINRA is increasingly interpreting its "investor protection" mission in an inadvisable manner that constitutes creeping "merit review" and is inconsistent with both the disclosure principles of federal securities law and its own stated purposes. The focus of FINRA's guidance, examinations and rules should be to ensure adequate disclosure by FINRA members to investors and to police fraud and conflicts of interest. FINRA should not engage in merit review, substitute its investment judgement for that of investors or harm investor choice or investor returns.

The Purpose of FINRA

In its Articles of Incorporation, the purpose of FINRA is stated, in relevant part as follows:

> 1) To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, **to promote therein high standards of commercial honor, and to encourage and promote among members observance of federal and state securities laws**;
> (3) To adopt, administer, and enforce rules of fair practice and rules **to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors**;[2]
> (emphasis added)

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[1] "FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements," Financial Industry Regulatory Authority March 8, 2022 https://www.finra.org/rules-guidance/notices/22-08#notice and https://www.finra.org/sites/default/files/2022-03/Regulatory-Notice-22-08.pdf.

[2] "Restated Certificate of Incorporation of Financial Industry Regulatory Authority, Inc." https://www.finra.org/rules-guidance/rulebooks/corporate-organization/restated-certificate-incorporation-financial.

Investor Protection

"Investor protection," therefore, is a explicit part of FINRA's mission. The same is true, of course, of the Securities and Exchange Commission.[3] However, it is quite clear that many existing regulations, guidance documents or examination practices, usually imposed in the name of investor protection by the Commission and by FINRA, actually *harm* investors by increasing costs and reducing investor returns. Equally importantly, they are increasingly creating an investment environment where the freedom of choice of ordinary "retail" investors is purposefully circumscribed and only wealthy or institutional investors can access more sophisticated product that often involve higher returns or limit risk. FINRA rules and practices certainly go beyond those necessary to achieve (1) "high standards of commercial honor," (2) "to encourage and promote among members observance of federal and state securities laws," (3) "to prevent fraudulent and manipulative acts and practices, and (4) "to promote just and equitable principles of trade for the protection of investors." In fact, they often conflict with these aims.

A main problem is that the term "investor protection" is a very ambiguous term that can cover, at least, four basic ideas. The first is protecting investors from fraud or misrepresentation. This is a fundamental function of government and of FINRA (which as a national securities association is delegated regulatory authority under section 15A of the Securities Exchange Act).[4] The second is providing investors with adequate information to make informed investment decisions. Although a legitimate function of the securities laws,[5] this requires policymakers to carefully balance the costs (which are typically underestimated by regulators and policymakers) and benefits (which are typically overestimated by regulators and policymakers) of mandatory disclosure.[6] Moreover,

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[3] "The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." U.S. Securities and Exchange Commission, "What We Do: Introduction," http://www.sec.gov/about/whatwedo.shtml#intro. The statutory charge is "[w]henever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." See §3(f) of the Securities Exchange Act of 1934 and §2(b) of the Securities Act of 1933.

[4] 15 U.S. Code § 78o–3.

[5] The reasons for this are that:

> (1) the issuer is in the best position to accurately and cost-effectively produce information about the issuer;
> (2) information disclosure promotes better allocation of scarce capital resources or has other positive externalities;
> (3) the cost of capital may decline because investors will demand a lower risk premium;
> (4) disclosure makes it easier for shareholders to monitor management; and
> (5) disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.

See David R. Burton, "Securities Disclosure Reform," Chapter 5, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf or David R. Burton, "Securities Disclosure Reform," Heritage Foundation Backgrounder No. 3178, February 13, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3178.pdf for a more detailed discussion.

[6] "Some Limits and Drawbacks of MD," section in Luca Enriques and Sergio Gilotta, "Disclosure and Financial Market Regulation," in *The Oxford Handbook on Financial Regulation*, edited by Eilís Ferran, Niamh Moloney, and Jennifer Payne (Oxford: Oxford University Press, 2015) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423768; Omri Ben- Shahar and Carl E. Schneider, "The Failure of Mandated Discourse," *University of Pennsylvania Law Review*, Vol. 159 (2011), pp. 647–749, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2066&context=journal_articles.

more disclosure is not always better because it enables issuers to obfuscate by drowning investors in barely relevant and immaterial information. The third is protecting investors from investments or business risks that regulators deem imprudent or ill-advised. This is *not* an appropriate function of government or those delegated regulatory authority by government and can be highly counter-productive. The fourth is protecting investor freedom of choice or investor liberty and, thereby, allowing investors to achieve higher returns and greater liquidity. This primarily requires regulators to exercise restraint, or eliminate existing regulatory barriers, both in the regulation of primary offerings by issuers and of secondary market sales by investors to other investors. In practice, this aspect of investor protection is almost entirely ignored by state and federal regulators and by FINRA. FINRA needs to incorporate the latter two aspects of "investor protection" into its thinking as it proceeds in this area.

Disclosure Requirements

Disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find relevant information.[7] The average number of pages in annual reports devoted to footnotes and "Management's Discussion and Analysis" has quadrupled.[8] The number of words in corporate annual 10-Ks increased from 29,996 in 1997 to 41,911 in 2014.[9] This has undoubtedly become an even bigger problem over the past eight years. And calls for even more disclosure relating to even more subjects will notably exacerbate the problem if implemented. Very few investors, whether professional or retail, are willing to wade through lengthy disclosure documents, often running hundreds of pages of dense legalese, available on the SEC's EDGAR database[10] or multitudinous state blue sky filings in the forlorn hope that they will find something material to their investment decision that is not available elsewhere in shorter, more focused, more accessible materials. Many of these more accessible materials are, of course, synopses of both the mandated disclosure documents (usually Forms 10-K, 10-Q, or 8-K3) and other voluntarily disclosed information, such as shareholder annual reports or materials provided to securities analysts by companies. But the fact that the vast majority of investors rely on these summary materials strongly implies that the legal requirements exceed what most investors find material to their investment decisions.

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[7] Troy A. Paredes, "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation," *Washington University Law Quarterly*, Vol. 81 (2003), pp. 417–485, https://openscholarship.wustl.edu/cgi/viewcontent.cgi?article=1287&context=law_lawreview and Troy A. Paredes, "Remarks at The SEC Speaks in 2013," U.S. Securities and Exchange Commission, February 22, 2013, http://www.sec.gov/News/Speech/Detail/Speech/1365171492408#.Ut2WJbROmM8. See also Keith F. Higgins, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting," U.S. Securities and Exchange Commission, April 11, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370541479332#.VItSmXt4zYg.

[8] Ernst & Young, "Now is the Time to Address Disclosure Overload," *To the Point*, No. 2012-18, June 21, 2012, https://www.lexissecuritiesmosaic.com/gateway/sec/speech/%24FILE_TothePoint_BB2367_DisclosureOverload_21June2012.pdf.

[9] Vipal Monga and Emily Chasan, "The 109,894-Word Annual Report: As Regulators Require More Disclosures, 10-Ks Reach Epic Lengths: How Much Is Too Much?" *The Wall Street Journal*, June 1, 2015 https://www.wsj.com/articles/BL-CFOB-8071

[10] U.S. Securities and Exchange Commission, "[Electronic Data Gathering, Analysis, and Retrieval] EDGAR, Search Tools," https://www.sec.gov/edgar/search-and-access#.

The same problem arises in required broker-dealer disclosures to investors. FINRA needs to be much more careful and creative in the disclosure requirements it places on broker-dealers with respect to investors. More is not always better. Clarity and focus on the most material matters should be central to FINRA's efforts. In the real world, burying investors in an avalanche of legalese simply defeats the purpose of disclosure. Such disclosures will not be read by the vast majority of investors no matter what their degree of sophistication. Disclosure documents and oral disclosures and explanations should *explain* not obfuscate the risks and potential returns associated with an investment rather than serve as a lawyers and accountants full employment device.

Merit Review

Securities regulation should not, even in principle, adopt a regulatory regime that is designed to protect all investors from every conceivable ill. Even in the case of fraud, there needs to be a balancing of costs and benefits. Securities law should deter and punish fraud but, given human nature, it can never entirely eliminate fraud. The only way to be certain that there would be no fraud would be to make business impossible. In other words, the socially optimal level of fraud is not zero.[11] While fraud imposes significant costs on the person who is defrauded, preventing fraud also has significant costs (both to government and, more significantly quantitatively, to law-abiding firms or investors) At some point the costs of fraud prevention exceed the benefits, however defined.[12] It is up to policymakers to assess this balance and make appropriate judgments in light of the evidence.

About three-fifths of the states conduct what is called "merit review."[13] Under merit review, state regulators decide whether a securities offering is too risky or too unfair to be offered within their

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[11] Gary S. Becker, "Crime and Punishment: An Economic Approach," in Gary S. Becker and William M. Landes, eds., *Essays in the Economics of Crime and Punishment* (New York: Columbia University Press, 1974), http://www.nber.org/chapters/c3625.pdf and Richard A. Posner, "An Economic Theory of the Criminal Law," *Columbia Law Review*, Vol. 85 (1985), pp. 1193–1231, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2827&context=journal_articles.

[12] This discussion omits several subsidiary issues, including the relative efficacy of civil and criminal penalties, the degree of deterrence that is socially optimal, and measurement issues. For a review of some of these issues, see Keith N. Hylton, "The Theory of Penalties and the Economics of Criminal Law," *Review of Law and Economics*, Vol. 1, No. 2 (2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=337460.

[13] For a dated but detailed look at blue sky laws, see U.S. Securities and Exchange Commission, "Report on the Uniformity of State Regulatory Requirements for Offerings of Securities that Are Not 'Covered Securities,'" Securities and Exchange Commission October 11, 1997, http://www.sec.gov/news/studies/uniformy.htm#seci . For a critique of blue sky laws, see Rutheford B. Campbell Jr., "Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses," *Washburn Law Journal*, Vol. 50 (Spring 2011), p. 573, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934825. ("In retrospect, there can be little doubt that the failure of Congress to preempt state authority over the registration of securities was a significant blunder."); Rutheford B. Campbell Jr., "The Case for Federal Pre-Emption of State Blue Sky Laws," Chapter 6, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf. See also Roberta S. Karmel, "Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?" *Brooklyn Law Review*, Vol. 53 (1987), pp. 105–125. The North American Securities Administrators Association, in its "Application for Coordinated Review of Regulation A Offering," delineates between merit review and disclosure jurisdictions. There are 49 participating jurisdictions, including Puerto Rico, the U.S. Virgin Islands, and the District of Columbia. Of the states, 28 are merit review states, 16 are disclosure states, and two (New Jersey and West Virginia) are "disclosure" states that "reserve the right" to make "substantive comments." Four states do not, at this time, participate, North American Securities

state, effectively substituting their investment judgment for that of investors. Merit review is wrong in principle. It is very unlikely that regulators make better investment decisions than investors. Lastly, merit review is expensive and it delays offerings considerably.[14]

There is an increasing effort by the Commission and by FINRA to impose merit review requirements at the federal level.[15] These steps are generally unwarranted. In practice, they limit investor choice and create a bifurcated market where only institutional or wealthy investors can gain access to more sophisticated products that have higher returns or lower risks. It is the job of FINRA to make sure its members adequately disclose the nature of an investment. It is not the job of FINRA to effectively bar ordinary investors from such investments.

Materiality

The concept of materiality has been described as "the cornerstone" of the disclosure system established by the federal securities laws.[16] The Supreme Court has held that information or facts (or omitted information or facts) are material if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote or make an investment decision.[17] The Court has also indicated that information is material if there is a substantial likelihood that disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available.[18]

Administrators Association, http://www.nasaa.org/wp-content/uploads/2014/05/Coordinated-Review-Application-Sec-3b.pdf.

[14] Rutheford B. Campbell Jr., "The Insidious Remnants of State Rules Respecting Capital Formation," Washington University Law Quarterly, Vol. 78 (2000), pp. 407–434, https://openscholarship.wustl.edu/law_lawreview/vol78/iss2/4/; Henry G. Manne and James S. Mofsky, "What Price Blue Sky: State Securities Laws Work Against Private and Public Interest Alike," in *The Collected Works of Henry G. Manne*, Vol. 3 (Liberty Fund, 1996); Therese H. Maynard, "The Future of California's Blue Sky Law," *Loyola of Los Angeles Law Review*, Vol. 30 (1997), pp. 1531–1556, http://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=2067&context=llr; Mark A. Sargent, "A Future for Blue Sky," *University of Cincinnati Law Review*, Vol. 62 (1993), pp. 471–512; James S. Mofsky and Robert D. Tollison, "Demerit in Merit Regulation," *Marquette Law Review*, Vol. 60 (1977), pp. 367–378; James S. Mofsky, *Blue Sky Restrictions On New Business Promotions* (Matthew Bender & Company, 1971); and John P. A. Bell and Stephen W. Arky, "Blue Sky Restrictions on New Business Promotions," *The Business Lawyer*, Vol. 27, No. 1 (November 1971), pp. 361–365. See also discussion of merit review in David R. Burton, "Securities Disclosure Reform," Chapter 5, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf

[15] For some FINRA steps down this road, see Regulatory Notice 09-31 (June 2009), Regulatory Notice 09-73 (December 2009), Regulatory Notice 10-51 (October 2010), Regulatory Notice 10-09 (February 2010), Regulatory Notice 17-32 (October 2017), Regulatory Notice 20-14 (May 2020), and Regulatory Notice 21-15 (April 2021), among others.

[16] SEC Concept Release on Business and Financial Disclosure Required by Regulation S-K, April 13, 2016 at p. 33 https://www.sec.gov/rules/concept/2016/33-10064.pdf; "Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission," Committee Print 95-29, House Committee on Interstate and Foreign Commerce, 95th Congress, 1st Session, November 3, 1977 http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1977_1103_AdvisoryDisclosure.pdf.

[17] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Basic Inc. vs. Levinson*, 485 U.S. 224 (1988)

[18] *Matrixx Initiatives, Inc. v. Siracusano*, 131 U.S. 1309 (2011).

There is no definition of material or materiality in the Securities Act or the Securities Exchange Act although the term “material” is used in both many times. The Commission has defined the term “material” in its regulations and changed its definition over years, often to conform to Supreme Court holdings. The current definition found in 17 CFR § 240.12b-2 is:

> Material. The term “material,” when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.

These definitions are fine as far as they go but they are quite general and provide little practical guidance to issuers or broker-dealers. There is a spirited debate about whether “principles-based” or more “prescriptive,” bright-line rules should govern disclosure by issuers of material information. The Commission’s rules presently balance these two approaches. Other issues related to materiality have also generated a robust debate. Congress should, but has not yet, defined materiality and clarified these issues.

FINRA needs to make sure that it requires broker-dealers to provide only *material* information to investors and prevent broker-dealers from burying investors in reams of immaterial and unimportant information. The information provided should *explain*, not serve as a risk management or risk exposure reduction exercise by the broker-dealer’s lawyers.

Limiting choice

FINRA needs to become much more cognizant of the fact that its rules limit access to complex or sophisticated products to institutional or wealthy investors to the detriment of ordinary investors. There appears to be almost no recognition on the part of FINRA that this is the opposite of investor protection. This is particularly true of products that enable retirees to purchase structured products that limit losses while enabling participation in equity markets.

Conflict policy

It is appropriate for FINRA to police conflicts of interest. Broker-dealers may act in a manner that is in their interest to the detriment of their customers, particularly when large commissions or fees are on the line.

Systemic Risk

On page five of the Notice, FINRA makes the following “observation”:

> In addition, as SEC Chair Gensler has recently suggested, complex products can potentially create system-wide risks by operating in unanticipated ways when markets experience volatility or stress conditions.

This purports to be a summary of a statement by SEC Chair Gensler when in point of fact it is no such thing. The footnote references a summary of the “Preliminary Recommendations of ETP

Panel Regarding COVID-19 Volatility: Exchange-Traded Products Asset" by the Management Advisory Committee.[19] Moreover, the recommendations do not focus on systemic risks.[20]

"Systemic risk" is a throwaway argument increasingly used by those seeking to justify still more regulation of financial markets. In general, there is absolutely no reason to believe that regulators are better at analyzing systemic risk than market participants. In fact, there is ample reason to believe that government is the progenitor of most of the systemic risk in the system. Specifically, in the case of this Regulatory Notice, the idea that a few retail investors investing in complex products poses some kind of systemic risk is simply false. They are quantitatively very small and there is no reason to believe that this small group of investors will (1) move markets to an appreciable degree or (2) be on the same side of the market.

Sincerely,

David R. Burton
Senior Fellow in Economic Policy
The Heritage Foundation

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[19] "Preliminary Recommendations of ETP Panel Regarding COVID-19 Volatility: Exchange-Traded Products Asset" by the Management Advisory Committee, September 16, 2020 https://www.sec.gov/files/prelim-recommendations-to-amac-on-etps.pdf.

[20] Ibid. "Accordingly, we offer the following six recommendations that the SEC and, in some cases, FINRA should undertake to promote fair, orderly, and efficient markets for the benefit of investors:

- The SEC should investigate the divergences that some ETPs experienced between their market prices and NAVs and issue a report on the cause of these divergences.
- The SEC should hold a roundtable to assess whether marketwide circuit breakers or other aspects of equity market structure should be optimized to reduce the potential for market disruption during periods of extraordinary market volatility.
- The SEC should consider whether investors would benefit from an ETP classification system that provides information about the structures and risks of ETPs at the point of order entry.
- The SEC and FINRA should analyze whether TRACE dissemination requirements should be calibrated to enhance transparency.
- The SEC and FINRA should analyze whether TRACE should be enhanced to include bid-offer information for corporate bonds and whether TRACE should disseminate bid-offer information in real-time to market participants.
- The SEC should conduct a thorough review of fixed income market structure to assess whether other changes would encourage the evolution of market characteristics in the hopes of enhancing transparency, liquidity, and price discovery."