



**Consumer Federation of America**



**Americans for  
Financial Reform  
Education Fund**



May 9, 2022

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

**Re: Regulatory Notice 22-08  
Complex Products and Options**

Dear Vice President and Deputy Corporate Secretary Mitchell,

On behalf of the Consumer Federation of America (CFA),<sup>1</sup> Americans for Financial Reform Education Fund,<sup>2</sup> and Better Markets,<sup>3</sup> we appreciate the opportunity to comment on the above-captioned Regulatory Notice soliciting feedback on whether the current regulatory framework for complex products and options, 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 these products.<sup>4</sup> We commend FINRA for seeking feedback on this critical retail investor protection issue.

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<sup>1</sup> The Consumer Federation of America is a non-profit association more than 250 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.

<sup>2</sup> Americans for Financial Reform Education Fund (AFREF) is a nonpartisan, nonprofit coalition of more than 200 civil rights, community-based, consumer, labor, small business, investor, faith-based, civic groups, and individual experts. AFREF fights for a fair and just financial system that contributes to shared prosperity for all families and communities.

<sup>3</sup> Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again.

<sup>4</sup> FINRA, Regulatory Notice, 22-08, Complex Products and Options, <https://bit.ly/3KXjzDs>.

In short, the current regulatory framework for self-directed investment in complex products and options is not appropriately tailored to address current concerns raised by these products. Markets have experienced significant changes in recent years, both with regard to the increased diversity of investment products in the marketplace and the new ways in which investment products are sold to retail investors. As a result, retail investors now have unfettered access to a variety of complex products and strategies that were largely unavailable to the retail market just a few years ago. While providing access to new and innovative products certainly can be beneficial to investors who fully understand those products' essential characteristics and risks, doing so also increases the likelihood that investors who don't fully understand those products' essential characteristics and risks will misuse them. This issue has taken on increased importance as the number of accounts trading in complex products and options has increased significantly in recent years.

Unfortunately, there is abundant evidence that many retail investors are misusing complex products and options based on misunderstandings of those products' essential characteristics and risks and are suffering significant harm as a result. The fault is not theirs, however. It would simply be unreasonable to expect anyone other than highly sophisticated and experienced investors to fully understand many of these products' essential characteristics and risks, given that many of these products often possess novel, intricate, and complicated features and they can and often do perform in ways that are not intuitive.<sup>5</sup>

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<sup>5</sup> Complex products can be so difficult to fully understand that even some financial professionals who recommend these products to retail investor accounts may not fully understand these products' essential characteristics and risks. Both FINRA and the SEC have expressed concerns in this regard and brought enforcement actions against professionals and firms for misusing complex products and causing harm to retail investors. *See, e.g.*, FINRA, Regulatory Notice 12-03, Heightened Supervision of Complex Products, <https://bit.ly/3P9dEic>. *See also Northern Trust Securities, Inc.* (CRD No. 7927) (June 2, 2011) (inadequate supervision of sales of collateralized mortgage obligations and certain high-volume securities trades); *Santander Securities Corporation* (BD No. 41791) (April 12, 2011) (deficiencies in structured product business and unsuitable reverse convertible sales); *UBS Financial Services, Inc.* (CRD No. 8174) (April 11, 2011) (inadequate supervision of sales of principal-protected notes, failures to provide sufficient training to representatives on these products, some of UBS' financial advisors did not understand these products, including the limitations of the "protection" features); FINRA News Release, "FINRA Sanctions Four Firms \$9.1 Million for Sales of Leveraged and Inverse Exchange-Traded Funds," May 1, 2012, <https://bit.ly/2wz7zrY>; FINRA News Release, "FINRA Orders Stifel, Nicolaus and Century Securities to Pay Fines and Restitution Totaling More Than \$1 Million for Unsuitable Sales of Leveraged and Inverse ETFs, and Related Supervisory Deficiencies," January 9, 2014, <https://bit.ly/3aq4Xen>; FINRA News Release, "FINRA Sanctions Oppenheimer & Co. \$2.9 Million for Unsuitable Sales of Non-Traditional ETFs and Related Supervisory Failures," June 8, 2016, <https://bit.ly/2xrVCUT>; ProEquities, Inc., FINRA Letter of Acceptance, Waiver and Consent ("AWC") No. 2014039418801 (Aug. 8, 2016), <https://bit.ly/33Omlac>; Citigroup Global Markets Inc., FINRA Letter of AWC No. 20090191134 (May, 1, 2012), <https://bit.ly/3dwMj6F>; *S.E.C. v. Hallas*, No 1:17-cv-2999 (S.D.N.Y. Sept. 27, 2017) (default judgement); *In the Matter of Demetrios Hallas*, S.E.C. Release No. 1358 (Feb. 22, 2019) (initial decision), Exchange Act Release No 85926 (May 23, 2019) (final decision) (involving a former registered representative of registered broker-dealers purchasing and selling leveraged ETFs and exchange-traded notes for customer accounts while knowingly or recklessly disregarding that they were unsuitable for these customers, in violation of section 17(a) of the Securities Act and section 10(b) and rule 10b-5 thereunder of the Exchange Act); *In the Matter of Morgan Stanley Smith Barney, LLC*, Investment Advisers Act Release No. 4649 (Feb. 14, 2017) (settled action)); *In the Matter of Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC*, Exchange Act Release No. 88295, Investment Advisers Act Release No. 5451 (Feb. 27, 2020) (settled action) <https://bit.ly/33RPaCY>; Press Release, SEC, "SEC Charges UBS With Supervisory Failures in Sale of Complex Products to Retail Investors," September 28, 2016, <https://bit.ly/387p7OI>. Press Release, SEC, "SEC Charges Investment Advisory Firms and Broker-Dealers in Connection with Sales of Complex Exchange-Traded Products," November 13, 2020, <https://bit.ly/3wgM5L2>. *See also* U.S. Securities and Exchange Commission, Joint Statement

Recognizing the substantial risks to retail investors of investing in complex products and options through self-directed platforms and the current lack of regulatory safeguards to ensure that only those who understand these products' essential characteristics and risks use them, we urge FINRA to update the framework for complex products and options to better protect retail investors by:

- updating existing options account approval rules to ensure that broker-dealers approve customers for options trading only if options trading is appropriate for their customers;
- applying the options account approval rules, with our suggested modifications, more broadly to other complex products that are purchased through self-directed platforms. In doing so, FINRA should continue to construe the term "complex product" flexibly to avoid a static definition that may not address the evolution of financial products and technology. This definition should capture products whose essential characteristics and risks would likely be difficult for retail investors to fully understand; and
- vigorously enforcing these options and complex products account approval rules to ensure firms comply with their regulatory obligations.

The goal of this project should be to ensure that investors who understand a complex product's essential characteristics and risks continue to have access to such a product, while investors who do not understand a complex product's essential characteristics and risks do not continue to have unfettered access to such a product, given the increased potential for these investors to suffer great financial and personal harm from the use of such a product. As key gatekeepers in the market, it is entirely appropriate for broker-dealers to have heightened obligations to ensure that their customers who do not understand complex products and options do not use them.

Importantly, this issue cannot be addressed by providing more disclosure or education to retail investors about the risks of these products. For example, after more than a decade of attempts to warn retail investors of the significant risks of leveraged and inverse exchange traded funds (ETFs), evidence suggests that investors continue to misunderstand and misuse these products, to their detriment. We see no reason to expect a different result with even more disclosure and education, for these or other complex products.

Finally, we urge FINRA to start enforcing Regulation Best Interest, particularly with regard to the recommendation and sale of complex, higher-cost products that provide greater compensation to firms and registered representatives than less complex, lower-cost reasonably available alternatives, when those less complex, lower-cost available alternatives could achieve the same objectives for their retail customers.

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Regarding Complex Financial Products and Retail Investors, October 28, 2020, <https://bit.ly/3w66MJu>; SEC Chair Gary Gensler, Statement on Complex Exchange-Traded Products, October 4, 2021, <https://bit.ly/3snNa2K>. SEC Commissioners Allison H. Lee and Caroline A. Crenshaw, Statement on Complex Exchange-Traded Products, October 4, 2021, <https://bit.ly/3KVva3AQ>; SEC Commissioner Kara M. Stein, Remarks at SEC Speaks: Increasing Product Complexity: What's at Stake?, February 23, 2018, <https://bit.ly/3N0Nw74>.

## I. Background

As the Notice highlights, markets have experienced significant changes in recent years, both with regard to the increased diversity of investment products in the marketplace and the new ways in which investment products are sold to retail investors. Whereas just a few years ago many products and strategies with novel, intricate, and complicated features were available only to sophisticated institutional investors, new products are increasingly being manufactured and made available directly to retail investors. Likewise, whereas just a few years ago retail investors typically needed to place orders for certain complex products with the assistance of financial professionals, which provided a minimal layer of professional review of their trading practices, now retail investors can buy and sell many complex products through the click of a mouse on their personal computer or the swipe of a finger on an app on their tablet or phone, without even the most minimal of review by a financial professional about the wisdom of that investment decision.

To be clear, we are not against product innovation or the use of complex products per se. On the contrary, new and innovative products have the potential to provide real benefits to investors by allowing them to attain and manage their exposure to different assets and strategies, which may improve their investing outcomes. But it's critical to recognize that while providing access to new and innovative products can be beneficial to investors who fully understand such products' features and risks, it can also increase the likelihood that investors who don't fully understand those products' features and risks will misuse them and be harmed as a result.

Two case studies provide evidence that many retail investors do not understand complex products and may be misusing them and exposing themselves to an inordinate amount of risk. The first is with regard to options trading. The second is with regard to leveraged and inverse ETFs.

- **Options**

There's been an explosion in retail investors' options trading in recent years.<sup>6</sup> The explosion can be attributed, at least in part, to Robinhood's offering convenient access to options trading on its platform. Robinhood's platform is sleek, engaging, fun to use, and includes design and user experience components that experts believe may be addictive.<sup>7</sup> These characteristics

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<sup>6</sup> See Thyagaraju Adinarayan, *Retail Trading Fever Drives U.S. Equity Option Volumes to Record Monthly High*, REUTERS, February 3, 2021, <https://bit.ly/3vWLeAt>; Steven M. Sears, *Why the Options Market Could Get Even Crazier in 2021*, BARRONS, December 17, 2020, <https://bit.ly/3vWLeAt>.

<sup>7</sup> See Cyrus Farivar, *Gambling addiction experts see familiar aspects in Robinhood app*, NBCNEWS.COM, January 30, 2021, <https://nbcnews.to/3M1RJHF>. See also Sheelah Kolhatkar, *Robinhood's Big Gamble*, THE NEW YORKER, May 10, 2021, <https://bit.ly/3sIJX3A> (The article quotes Natasha Dow Schüll, the author of "Addiction by Design: Machine Gambling in Las Vegas" and a professor in the media, culture, and communication department at N.Y.U., who stated that "Clever engineers simply repurposed many of the design features of slot machines, which were developed over decades. Green, the color of luck and of money, is found throughout Las Vegas, and Schüll said that the physical design of casinos is also mirrored in Robinhood's pursuit of a "frictionless" user experience." The article also quotes Adam Alter, a professor of marketing at N.Y.U.'s Stern School of Business, and the author of "Irresistible: The Rise of Addictive Technology and the Business of Keeping Us Hooked." He stated, "In a case of a company like Robinhood, it's not enough for them to have users on the site. You actually have to get them to hit the Buy or Sell button." He went on, "You've got to make that feel like it's inconsequential. You've got to lower all the

have attracted millions of users, many of whom have no previous investing experience, to their platform.<sup>8</sup> Many of these investors are young and have no knowledge of or experience trading options.<sup>9</sup> Many of these investors do not seem to know how options work, how they can and often do have unintuitive payoffs, or the risks that significant leverage can present to their portfolios.

There are thousands of posts on Reddit and videos on YouTube and TikTok of investors sharing their options trading stories or attempting to teach others how to trade options, primarily on Robinhood. Many of these investors are extremely young and some even acknowledge they do not know what they're doing.<sup>10</sup> Some common claims in these posts and videos are that options trading is simple, easy, and fun, and individuals can make a lot of money very quickly trading options without risking much money.

For years, Robinhood approved investors who did not have sufficient experience or knowledge about how to trade these products. According to the findings in a settled enforcement action brought by FINRA against Robinhood, Robinhood failed to exercise due diligence before approving customers to trade options.<sup>11</sup> Specifically, the firm used “approval bots” that did not take into account all information available to the firm and, as a result, approved thousands of customers for options trading who did not meet the firm’s eligibility criteria or whose accounts contained red flags that options trading was not appropriate.<sup>12</sup> These approval practices facilitated retail investors’ options trading, many of whom did not fully understand how options

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barriers resistant people might have to making financial decisions, so that you don’t even think about the money at all.”).

<sup>8</sup> According to Robinhood’s financial disclosures, the company had 17.3 million monthly active users in December 2021. *See* Press Release, Robinhood, “Robinhood Reports Fourth Quarter and Full Year 2021 Results,” January 27, 2022, <https://bit.ly/3K RK5y9>.

<sup>9</sup> *See* Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes With Devastating Results*, THE NEW YORK TIMES, July 8, 2020, <https://nyti.ms/39MXtH6>. *See also* Sheelah Kolhatkar, *Robinhood’s Big Gamble*, THE NEW YORKER, May 10, 2021, <https://bit.ly/3slJX3A> (The article quotes Benn Eifert, the manager of QVR Advisors, an options-based investment firm, who stated that the moderators of the WallStreetBets Reddit forum periodically posted information about suicide hotlines. “You have a lot of addiction issues that come along with retail trading,” Eifert said. While he thought that getting younger people interested in investing was “wonderful,” he worried that Robinhood was “making it too easy for people to take a lot of risk doing things they don’t understand.”). *See also* @TikTokInvestors, Twitter, Feb. 11, 2021, <https://bit.ly/37s0kEt> (a seemingly very young person comparing options account approvals on Robinhood (where “you only have to click a few buttons and “it takes five minutes” to get approved”) versus Fidelity (where there’s a “multi-page application that takes hours to fill out and days to get accepted”).

<sup>10</sup> *See* YouTube, Search terms: Options Trading Robinhood, <https://bit.ly/3vU9O4P> (last visited May 8, 2022); Tik Tok, Search terms: Robinhood Options, <https://bit.ly/387psks> (last visited May 8, 2022); Reddit, r/options, <https://bit.ly/3kP9YEE> (last visited May 8, 2022); Reddit, r/wallstreetbets, <https://bit.ly/3wfp4U2> (last visited May 8, 2022).

<sup>11</sup> *See* Press Release, FINRA, “FINRA Orders Record Financial Penalties Against Robinhood Financial LLC,” June 30, 2021, <https://bit.ly/3FpLL0E>. Robinhood Financial LLC, AWC No. 2020066971201 (June 30, 2021).

<sup>12</sup> *Id.*



work or the risks that they entail. As a result, many investors have lost significant sums of money<sup>13</sup> and they and their families have suffered terrible tragedies.<sup>14</sup>

- **Leveraged and Inverse ETFs**

The second case study that provides evidence that many retail investors do not understand complex products and may be misusing them and exposing themselves to an inordinate amount of risk is with regard to leveraged and inverse ETFs.<sup>15</sup> Evidence suggests that many investors are not using leveraged ETFs consistent with their stated performance objective and some of these investors may be actively misusing them. Specifically, leveraged and inverse ETFs typically are designed to achieve their stated performance objective on a daily basis. Performance of these ETFs over a period longer than one day can differ significantly from their stated daily performance objective.<sup>16</sup>

Evidence suggests, however, that many investors are holding these products longer than a day, which may suggest investors are investing in these ETFs with the expectation that leveraged ETFs may meet their stated daily performance objective over the long term as well. For example, research by the Securities Litigation and Consulting Group (SLCG) published in 2010 found that a significant number of shares of leveraged and inverse ETFs are held for several days, if not weeks, and some are even held for months.<sup>17</sup> Holding these products for longer than one day

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<sup>13</sup> See, e.g., Anonymous, *I Lost \$400,000, Almost Everything I Had, on a Single Robinhood Bet*, VICE.COM, <https://bit.ly/3PalAzx>; Shawn Langlois, *Trader says he has 'no money at risk,' then promptly loses almost 2,000%*, MARKET WATCH, January 22, 2019, <https://on.mktw.net/388z66n>; Bryant Le, *Reddit User Lost \$140,000 from HOOD Options*, December 14, 2021, <https://bit.ly/3snmOO9>; Bryant Le, *Reddit User Down \$200,000+ From Tesla Options*, December 16, 2021, <https://bit.ly/3LYxASG>; Bryant Le, *Reddit User Loses Life Savings on Palantir Options*, December 16, 2021, <https://bit.ly/3kNQgsC>; See also Svetlana Bryzgalova, Anna Pavlova, Taisiya Sikorskaya, *Retail Trading in Options and the Rise of the Big Three Wholesalers*, April 12, 2022, <https://bit.ly/3ynBznR> (finding that retail traders prefer cheaper, weekly options, the average quoted bid-ask spread for which is a whopping 12.3%, and lose money on aggregate. The inflow of retail investors also coincides with an increase in call options left suboptimally unexercised. Assuming a holding horizon of ten days, the authors estimate that the aggregate portfolio of retail investors lost \$1.14 billion from November 2019 until June 2022.); Rob Bauer et al., *Option Trading and Individual Investor Performance*, 33 J. of Banking & Fin. 731, 746 (Apr. 2009), <https://bit.ly/3ynBMYb> (“The losses investors incur on their option investments are much larger than those from equity trading. Risk and style tilts and differences in demographic and socioeconomic characteristics do not explain the poor performance of option traders relative to equity investors. Instead, we attribute the poor performance of option traders to bad market timing due to overreaction to past stock market movements.”).

<sup>14</sup> Matt Egan, *'He Would Be Alive Today': Parents Detail Son's Desperate Attempts to Contact Robinhood Before He Killed Himself*, CNN.COM, February 11, 2021, <https://cnn.it/3P5Qr06>.

<sup>15</sup> Inverse and leveraged ETPs that are not registered investment companies pose the same risks and concerns.

<sup>16</sup> See SEC and FINRA, *Investor Alerts and Bulletins: Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors*, August 1, 2009, <https://bit.ly/3LVzyUb>. SEC, Staff of the Division of Economic and Risk Analysis, *Economics Note: The Distribution of Leveraged ETF Returns*, November 2019, <https://bit.ly/37qcYUq> (finding that, held over longer periods, leveraged ETFs can have returns with complex properties, similar to those of options).

<sup>17</sup> Ilan Guedj, Guohua Li, and Craig McCann, *Leveraged ETFs, Holding Periods and Investment Shortfalls*, Securities and Litigation Consulting Group, 2010, <http://bit.ly/1Uq86ju>. The paper inferred holding periods based on multiple trading models that are used in the securities class action context based on observed trading volume. The first, a proportional trading model, assumes that each share outstanding is equally likely to trade. The second, a multiple trader model, assumes that there are at least two types of investors within each trader type with a different level of trading activity, a high-activity trader and low-activity trader.

exposes investors to substantial risk, as the returns of these products will deviate, potentially significantly, from the returns of the index or benchmark the product is intended to track.<sup>18</sup>

Two years ago, in the context of commenting on the SEC's re-proposed rules regarding funds' use of derivatives, CFA updated the SLCG's analysis for the ETFs that still existed, and we added several other leveraged and inverse ETFs that were available in the marketplace.<sup>19</sup> We used the three-month average daily trading volume, ending on March 9<sup>th</sup>, 2020 to reduce the risk that the explosion in trading volume related to the onset of COVID-19 would alter the results. We sourced our data from ETFdb.com. However, we checked with other public websites, such as Marketwatch.com and Fidelity.com, to ensure that the data were robust. While we are not claiming academic precision with our findings, like the 2010 analysis from SLCG, they show that there is still strong evidence to suggest investors are holding leveraged and inverse ETFs much longer than one day.

Based on our analysis of 12 funds, we found funds with daily share turnover ranging from approximately 1% to 29%. All funds in our sample had a majority of their shares held for longer than one day. More than half of the funds in our sample had a majority of their shares held for longer than one week. Several funds in our sample had a majority of their shares held for longer than one month. For example:

- ProShares Ultra S&P 500, which provides 2X leverage on the S&P 500 (SSO):
  - Daily share turnover of approximately 12%;
  - Approximately 87% of shares are held longer than 1 day;
  - Approximately 50% of shares are held longer than 1 week;
  - Approximately 35% of shares are held longer than 2 weeks.
- Direxion Daily S&P 500 Bull 3X, which provides 3X leverage on the S&P 500 (SPXL):
  - Daily share turnover of about 23%;
  - More than 75% of shares are held longer than 1 day;
  - Almost 60% of shares are held longer than 2 days;
  - Approximately 25% of shares are held longer than 1 week.
- ProShares Short SmallCap600, providing 1X inverse leverage on the S&P 600 (SBB):
  - Daily share turnover of approximately 3%;
  - More than 95% of shares are held longer than 1 day;
  - More than 80% of shares are held longer than 1 week;
  - Approximately 70% of shares are held longer than 2 weeks;
  - Almost 50% of shares are held longer than 1 month.
- Direxion Daily MSCI Developed Markets, which provides 3X inverse leverage to international developed markets (DPK):
  - Daily share turnover of approximately 5%;
  - Approximately 95% of shares are held longer than 1 day;
  - Approximately 75% of shares are held longer than 1 week;

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<sup>18</sup> SEC, Staff of the Division of Economic and Risk Analysis, Economics Note: The Distribution of Leveraged ETF Returns, November 2019, <https://bit.ly/37qcYUq> (finding that, held over longer periods, leveraged ETFs can have returns with complex properties, similar to those of options).

<sup>19</sup> We applied the proportional trading model given time constraints.

- Approximately 60% of shares are held longer than 2 weeks;
  - More than 35% of shares are held for longer than 1 month.
- Direxion Daily 7-10 Year Treasury Bull 3x Shares, which provides 3X leveraged exposure (TYD):
  - Daily share turnover of approximately 3%;
  - Approximately 97% of shares are held longer than 1 day;
  - More than 85% of shares are held longer than 1 week;
  - More than 75% of shares are held longer than 2 weeks;
  - Approximately 60% of shares are held longer than 1 month;
  - More than 45% of shares are held longer than 6 weeks.
- Direxion Daily 7-10 Year Treasury Bear 3x Shares, which provides 3X inverse leveraged exposure (TYO):
  - Daily share turnover of less than 1%;
  - Approximately 99% of shares are held longer than 1 day;
  - Approximately 95% of shares are held longer than 1 week;
  - More than 90% of shares are held longer than 2 weeks;
  - More than 80% of shares are held longer than 1 month;
  - More than 75% of shares are held longer than 6 weeks.
- Direxion Daily S&P Oil & Gas Exp. & Prod. Bull 3X Shares (GUSH):
  - Daily share turnover of approximately 20%;
  - More than 80% of shares are held longer than 1 day;
  - More than 65% of shares are held longer than 2 days;
  - Approximately 35% of shares are held longer than 1 week;
  - More than 10% of shares are held longer than 2 weeks.
- ProShares UltraShort Health Care, provided 2X inverse leveraged exposure (RXD):
  - Daily share turnover of approximately 5%;
  - Approximately 95% of shares are held longer than 1 day;
  - More than 75% of shares are held longer than 1 week;
  - Almost 60% of shares are held longer than 2 weeks;
  - More than 33% of shares are held longer than a month.
- Direxion Daily Gold Miners Index Bull 3X Shares (NUGT):
  - Daily share turnover of about 29%;
  - More than 70% of shares are held longer than 1 day;
  - Almost 20% of shares are held longer than 1 week.
- Direxion Daily Financial Bull 3X (FAS)
  - Daily share turnover of about 5%;
  - Approximately 95% of shares are held longer than 1 day;
  - More than 75% of shares are held longer than 1 week;
  - Approximately 60% of shares are held longer than 2 weeks;
  - More than 30% of shares are held longer than 1 month.
- Direxion Daily Financial Bear 3X (FAZ):
  - Daily share turnover of about 15%;
  - Approximately 85% of shares are held longer than 1 day;
  - More than 40% of shares are held longer than 1 week.
- Direxion Energy Bull 3X Shares (ERX):
  - Daily share turnover of about 10%;



- Approximately 90% of shares are held longer than 1 day;
- Approximately 60% of shares are held longer than 1 week;
- Between 35% and 40% of shares are held longer than 2 weeks;
- Between 10% and 16% of shares are held longer than 1 month.

These results suggest that many leveraged and inverse ETF shares are being held for periods much longer than one day. While holding a leveraged ETF for longer than one day does not prove the product is being misused—for example, it is possible that some sophisticated investors may be holding a leveraged ETF to attain a target level of exposure for less cash and monitoring and adjusting their exposure on a regular basis to preserve their target level of exposure—it is highly unlikely that all investors who hold leveraged ETFs for longer than one day are invoking this strategy, as one would need to do under these circumstances. Moreover, anecdotal evidence, discussed below, suggests that not all investors who hold leveraged ETFs for longer than one day are invoking this kind of strategy, which supports the conclusion that these products are being misused by many investors.

First, evidence suggests that many retail investors do not understand how these products work. According to a BlackRock Blog, “Our experience is that these complex provisions are not intuitive or well-understood by many users of the products.”<sup>20</sup> Yet some retail investors think that buying and holding these investments is a smart investment strategy. According to Lara Crigger of ETF.com, in a tweet she stated that she “just answered seven emails in a row asking me the same basic thing: No but seriously it’s totally okay for me to buy and hold THIS leveraged ETF, right? The answer is and always will be: NO.”<sup>21</sup> In a column discussing this issue, she implored financially unsophisticated retail investors not to use these products. “I’m begging you: Leave these products for the sophisticated traders they were meant for.”<sup>22</sup>

Second, as with options, there are thousands of posts on Reddit and videos on YouTube and TikTok of investors sharing their leveraged ETF trading stories or attempting to teach others how to use these products. Many of these investors espouse misconceptions about how these products work and the risks that they entail.<sup>23</sup> Some common themes are a misunderstanding of the daily reset and the effects of leverage decay, the mistaken belief that it is prudent to buy and hold leveraged ETFs without any need to monitor and adjust exposure, and references to long-term performance data for leveraged funds relative to their underlying indexes to imply that such outperformance is likely to continue in the future. Here are just a few examples:

#### BUYING AND HOLDING LEVERAGED ETFS

As a buy and hold investor, what’s wrong with holding leveraged ETFs like UPRO or TQQQ if you’re not concerned about volatility? I understand the concept of decay but looking at the historical charts of UPRO vs VOO and TQQQ

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<sup>20</sup> Martin Small, *Mind your P’s and F’s: Don’t confuse leveraged ETPs with ETFs*, BLACKROCK, February 7, 2018, <https://bit.ly/3byEiwq>.

<sup>21</sup> Lara Crigger (@LaraCrigger) TWITTER, March 18, 10:48 PM, <https://bit.ly/3dw7mWV>.

<sup>22</sup> Lara Crigger, *Don’t Buy & Hold Leveraged ETFs*, ETF.COM, March 18, 2020, <https://bit.ly/33ONj1y>.

<sup>23</sup> See, e.g., Tik Tok, “Leveraged ETFs,” <https://bit.ly/3yn9tJr> (last visited May 8, 2022); Reddit, “LETFs,” <https://bit.ly/3wgMRrq> (last visited May 8, 2022).

vs QQQ, leveraged ETFs have historically outperformed their non-leveraged counterparts by a large margin over the long term.<sup>24</sup>

### 3X LEVERAGED ETF FOR LONG TERM INVESTMENT?

Last year I put some money in a 3x leveraged ETFs and the results have been tremendous (roughly +130% this past year).

I know leveraged ETFs are a high risk investment but it's constantly going up and I'd feel silly cashing out missing out on a great return.

Can someone shine a light on long term investment practices when it comes to leveraged ETFs? Is not viable in the long term at all? Should I just take the money and re-invest it in a safer ETF?

I have mid-term goals (buy a house within 4 years), nothing pressing, and I'd rather be safe than sorry.<sup>25</sup>

### BEAT THE MARKET WITH LEVERAGED ETFS!

Let me preface this that I am not an expert on the stock market and don't follow my advice. But, I do think this should be a point of discussion. Leveraged ETF'S basically 2x or 3x the daily returns of an index. For this example, I'll use QQQ, QLD, and TQQQ. They follow the NASDAQ, and are 1x, 2x, and 3x.

A word of caution. These are high risk, especially in the current market environment. People will tell you that leveraged etfs are not smart because in a flat market they will underperform (you can research why), and in a bear market they will exponentially underperform for obvious reasons.

However, over a VERY long time horizon such as 10+ years, the market tends to move up, especially with technology stocks.

Here is the difference 50k invested in QQQ, QLD, and TQQQ would be from June 2010 to June 2020:

QQQ (1x) - 50k -> 291k

QLD (2x) - 50k -> 1.18M

TQQQ (3x) - 50k -> 3.05M.<sup>26</sup>

It is true that some leveraged ETFs have experienced significant outperformance relative to their underlying indexes from inception. This outperformance can be attributed to the historic bull market run that has occurred since these products came to market. It is unlikely, however, that this bull market will continue indefinitely—it may have already ended—and it is unclear how these leveraged ETFs will fare or how leveraged ETF investors will react when the bull market

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<sup>24</sup> Reddit, r/investing, Buying and Holding Leveraged ETFs, <https://bit.ly/38X9KIX> (last visited May 8, 2022).

<sup>25</sup> Reddit, r/personalfinance, 3x Leveraged ETF for long term investment, <https://bit.ly/3KPqvTe> (last visited May 8, 2022).

<sup>26</sup> The post then lays out a “simple” market timing strategy switching between these three funds that the poster says worked well during a very narrow time frame. Reddit, r/investing, Beat the market with leveraged etfs, <https://bit.ly/3LVA30v> (last visited May 8, 2022) (grammar and spelling in original).

ends and these investors lose significant sums of money very quickly. One investor's recent post suggests things won't be pretty:

I WRECKED MY RETIREMENT FUN

I took my full retirement of around \$200,000 and put it all in TQQQ and UPRO near the height of it's valuation sometime in December.

I'm down 48% (\$32,000) and have a cost basis of \$70 per share in my TQQQ account.

I'm down 28% (\$8,800) and have a cost basis of \$66 per share in my UPRO account.

Like, wtf do I do now and how long is it going to take for this to recover?<sup>27</sup>

## II. Disclosure is not sufficient to address the concerns that complex products and options raise.

The concerns that complex products and options raise cannot be addressed merely by providing more disclosure or education to retail investors about these products' risks. For example, after a decade of attempts to warn retail investors of the significant risks of leveraged and inverse ETFs, evidence suggests that investors continue to misunderstand and misuse these products, to their detriment. We see no reason to expect a different result with even more disclosure and education, for these or other complex products and options.

First, leveraged and inverse ETF product manufacturers often include prominent warnings, including on their websites and in their regulatory disclosures, about how these products operate and what their risks are.<sup>28</sup> Second, brokerage firms often include prominent warnings about how these products operate and what their risks are when investors search for or place orders for leveraged or inverse ETFs.<sup>29</sup> Third, FINRA and the SEC have put out various

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<sup>27</sup> Reddit, r/LETFs, I wrecked my retirement fun, <https://bit.ly/3smaC0e> (grammar and spelling in original) (last visited May 8, 2022).

<sup>28</sup> See ProShares, Our ETFs, Leveraged and Inverse, UPRO, <https://bit.ly/3N0ObFA> (last visited May 8, 2022); Direxion, Leveraged and Inverse ETFs, SPXL SPXS, <https://bit.ly/3vWsIZ0> (last visited May 8, 2022). In addition to the website disclosures and warnings, the funds' prospectuses, which we doubt all investors read, have clear warnings, including that, "**The Fund may not be suitable for all investors and should be used only by knowledgeable investors who understand the consequences of seeking daily leveraged (3x) investment results of the Index, including the impact of compounding on Fund performance. Investors in the Fund should actively manage and monitor their investments, as frequently as daily. An investor in the Fund could potentially lose the full value of their investment within a single day.**" (bolded in original). See ProShares, Summary Prospectus, UltraPro S&P500®, October 1, 2021.

<sup>29</sup> For example, Robinhood has a bright yellow warning sign that says "Leveraged" when an investor searches for a leveraged ETF. When the investor clicks on the warning symbol, the investor is taken to a page that provides more information about the risks of such products. Robinhood uses similar labels warning customers about ETPs that are inverse, volatility-linked, leveraged inverse, leveraged volatility, inverse volatility, and leveraged inverse volatility. See Robinhood, Help Center, Information and Labels, What are info labels, <https://bit.ly/3N11Pc0> (last visited May 8, 2022); Robinhood, Leveraged Products, <https://bit.ly/3Fq8p9p> (last visited May 8, 2022). Similarly, Fidelity provides prominent warnings when an investor places an order for a leveraged ETF and requires an investor who trades these products to self-certify that they are a sophisticated, experienced investor and their risk tolerance is high, that they can afford to lose some or all of any investment they make in a Designated Investment, and that they have sufficient resources to sustain such losses. Fidelity, Leveraged-Inverse ETF message, <https://bit.ly/3OZFYTY>

investor alerts providing helpful information about and highlighting the risks of these products.<sup>30</sup> Fourth, press articles have repeatedly warned investors not to use these products unless investors have a sophisticated understanding of how these products work and what their risks are.<sup>31</sup> Yet, as discussed above, evidence suggests that retail investors continue to misunderstand how leveraged ETFs work and use these products in ways that are inconsistent with their stated objective.

Given the fact that more than a decade of attempts to warn retail investors of the significant risks of leveraged and inverse ETFs has not adequately addressed concerns that investors are misunderstanding and misusing these products, we see no reason to expect a different result with even more disclosure and education, for these or other complex products or options.

One reason that disclosure is likely to be ineffective in the context of complex products and options is because these products often require an investor to have a high level of knowledge about novel, intricate, and complicated features in order to use them effectively. In some cases, products combine multiple of these features, making it even more difficult for even the most sophisticated of investors to fully understand how these features work together under different circumstances. In addition, these products often have unintuitive payoffs. For example, structured products are increasingly being made available to retail investors, including in the ETF format.<sup>32</sup> In order to value the product to make an informed decision about whether to purchase such a product, an investor would need to value the product's embedded derivative.<sup>33</sup> But it is beyond foolish to think that your typical retail investor is capable of engaging in this kind of PhD level analysis.<sup>34</sup>

Second, in order to provide all of the relevant information that investors would need to make an informed decision, the disclosures for many complex products would need to be incredibly long, detailed, and technical. Yet it is highly unlikely that investors will read, much less understand, such disclosures. The Options Disclosure Document (ODD) that is furnished to investors who are approved for trading options is a perfect example of the kind of disclosure that an investor would need to read and understand in order to trade options prudently.<sup>35</sup> The ODD contains basic information about options, including defined terms and exercise procedures,

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(last visited May 8, 2022). Fidelity, Designated Investments Agreement, <https://bit.ly/3wcuZ10> (last visited May 8, 2022).

<sup>30</sup> Press Release, FINRA, "FINRA, SEC Warn Retail Investors About Investing in Leveraged or Inverse ETFs," August 18, 2009, <https://bit.ly/3yhOUOK>; SEC Investor Alerts and Bulletins, Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors, August 1, 2009, <https://bit.ly/3LVzyUb>.

<sup>31</sup> See, e.g., Joe Light, *Beware Leveraged ETFs*, WALL STREET JOURNAL, May 11, 2012, <https://on.wsj.com/3vWgLSM>; Kim Iskyan, *Buyers should beware of this \$3 trillion market*, BUSINESS INSIDER, September 21, 2016, <https://bit.ly/3kPaMce>; Rick Munarriz, *These ETFs Will Kill You*, THE MOTLEY FOOL, April 6, 2017, <https://bit.ly/3sIxcR1>.

<sup>32</sup> See, e.g., Innovator ETFs, Innovator Defined Outcome ETFs™, <https://bit.ly/3y1ABZu> (last visited May 9, 2022).

<sup>33</sup> See Geng Deng, Tim Husson, and Craig McCann, Valuation of Structured Products, Securities and Litigation Consulting Group, February 3, 2014, <https://bit.ly/3wlOleS>; Geng Deng, Tim Dulaney, Tim Husson, Craig McCann, Structured Product Based Variable Annuities, September 11, 2013, <https://bit.ly/3vVXP6G>.

<sup>34</sup> See *id.* (discussing various approaches to valuing structured products, including simulation of the linked financial instrument's future values, numerical integration, decomposition, and partial differential equation approaches.).

<sup>35</sup> See FINRA Rule 2360(b)(16)(A) Approval Required.

principal risks of options positions and examples of different types of options.<sup>36</sup> The ODD states clearly in bold in the introduction, “**Readers should read and understand this document in its entirety**, since a number of the separate chapters will be relevant to every reader interested in buying or writing options.”<sup>37</sup> At 95 pages in length, however, it is unreasonable to expect that the vast majority of retail investors who are interested in trading options will read it. It is also unreasonable to assume that anyone who reads this dense and highly technical document will understand all of the information provided.

One potential response to this concern could be to dumb down complex concepts in order to be less intimidating to investors. But such an approach carries significant risks too, particularly if the effect of the information is to lull investors into having a false sense of security about those products, thereby increasing the likelihood that they use those products. Robinhood’s explanation of options suffers in this regard. For example, on their “What is an Option” page, the “Takeaway” at the top of their webpage is that:

An option is like an umbrella...It could be valuable for you, or it could end up having no value at all. The beauty with an option, and with an umbrella, is that you don’t have to use it. You bought it, now it’s your option whether to exercise it or not. You use the umbrella when it rains. You exercise the option if it’s in the money. Options expire though, umbrella’s don’t (no analogy is perfect).<sup>38</sup>

Robinhood is correct that this is not a perfect analogy. But the “Takeaway” is likely to make Robinhood investors more comfortable trading options—after all, who would want to be caught in the rain without an umbrella? The more Robinhood customers who feel comfortable trading options and who engage in options trading, the better it is for Robinhood’s bottom line.<sup>39</sup>

Recognizing that disclosure is unlikely to address the concerns that complex products and options raise, a new approach is necessary to ensure that only those investors who understand complex products’ characteristics and risks use them.

### **III. FINRA should update existing options account approval rules, including by incorporating existing guidance into rule text, to better ensure that broker-dealers approve options accounts only when options trading is appropriate for their customers.**

FINRA Rule 2360(b)(16) states that “[i]n approving a customer’s account for options trading, a member or any person associated with a member shall exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives.”<sup>40</sup> Specifically, the member must seek to obtain and consider detailed customer

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<sup>36</sup> See Characteristics and Risks of Standardized Options. Options Clearing Corporation, Characteristics and Risks of Standardized Options, March 2022, <https://bit.ly/38bLbra>.

<sup>37</sup> *Id.* at 5.

<sup>38</sup> Robinhood, What is an option?, January 6, 2021 <https://bit.ly/3N4Rxaz> (last visited May 9, 2022).

<sup>39</sup> According to the company, it received \$440 million (46% of its total \$959 million net revenue) from options trading in 2020 and \$689 million (49% of its total \$1.40 billion net revenue) from options trading in 2021. Press Release, “Robinhood Reports Fourth Quarter and Full Year 2021 Results,” January 27, 2022, <https://bit.ly/3snlPNX>.

<sup>40</sup> FINRA Rule 2360(b)(18)(B) Diligence in Opening Accounts.



information, including, among others, the customer’s knowledge, investment experience, age, financial situation and investment objectives. However, the rule text does not explicitly state what standard members should apply when assessing the information that they collect in order to determine whether to approve (or disapprove) a customer for options trading.

It is only through guidance that FINRA (formerly NASD) has clarified how members should approach their due diligence requirements when determining whether to approve accounts for options trading. Specifically, NASD Notice to Members 80-23 states that “[t]he 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.”<sup>41</sup>

More recently, FINRA issued Regulatory Notice 21-15, reminding members that the options account approval process requires members to determine whether options trading is appropriate for the customer.<sup>42</sup> FINRA reiterated its view, expressed in Notice 80-23, that the “appropriateness” standard for approving accounts to trade options is comparable to the suitability standard as used in Rule 2360(b)(19).<sup>43</sup> FINRA also reminded members that as part of this approval process, members should consider whether to approve a customer only for certain types of options transactions and not for others, based on their sophistication and investment objectives, among other things.

Given that the rule text does not explicitly state what standard members should apply when assessing the information they collect in order to determine whether to approve (or disapprove) a customer for options trading, that there is evidence that not all firms have been complying with the guidance, and FINRA recently needed to remind firms of their regulatory obligations, including those set out in guidance, we urge FINRA to incorporate the “appropriateness” standard and related guidance into the rule text itself.

Specifically, we urge FINRA to clarify in rule text that a broker-dealer would be permitted to approve an account for options trading only if it has a reasonable basis to believe that the customer has the financial knowledge and experience necessary to be reasonably expected to be capable of evaluating the risks associated with the level of options trading for

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<sup>41</sup> See Notice to Members 80-23 (June 1980) at 5 (italics added for emphasis). This NASD Notice resulted from a Report of the Special Study of the Options Markets to the Securities and Exchange Commission, which recommended, among other actions, that Self-Regulatory Organizations (SROs) amend their options account opening requirements to ensure that broker-dealers obtain and record sufficient data to support a suitability determination and require verification of such suitability information as well as supervisory review of a customer’s options account. *Id* at n. 3. See also SEC, Investor Bulletin: Opening an Options Account, March 18, 2015 (explaining that a broker will determine whether options trading is suitable for the prospective options customer.).

<sup>42</sup> FINRA Regulatory Notice 21-15, FINRA Reminds Members About Options Account Approval, Supervision, and Margin Requirements (April 2021).

<sup>43</sup> See FINRA Rule 2360(b)(19)(B) Suitability. “No member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.”



which the customer is being considered for approval and the customer is financially able to bear the risks associated with such trading privileges.<sup>44</sup> The language of the rule should make clear that a customer should be approved only for the level of options trading that is appropriate for, and consistent with, the customer's knowledge, investment experience, age, financial situation, and investment objectives.

Incorporating these standards into the rule text will better ensure that investors are not inappropriately approved to trade options. It will also benefit member firms, ensuring that they do not need to track down various guidance documents to fully understand their regulatory obligations.

**IV. FINRA should apply the options account approval rules, with the modifications suggested above, more broadly to other complex products that are purchased through self-directed platforms. In doing so, FINRA should continue to construe the term “complex product” flexibly to avoid a static definition that may not address the evolution of financial products and technology. This definition should capture products whose essential characteristics and risks would likely be difficult for retail investors to fully understand.**

Options and leveraged ETFs are only two examples of complex products available directly to retail investors that possess novel, intricate, and complicated features and that perform in ways that are not intuitive. It is simply unreasonable to expect that all retail investors using these products fully understand these products' essential characteristics and risks. Allowing broker-dealers to continue to offer unfettered access to complex products including these and others increases the likelihood that investors who don't fully understand these products' essential characteristics and risks will misuse them and suffer great financial and personal harm as a result.

Recognizing the substantial risks to retail investors of investing in complex products through self-directed platforms and without appropriate safeguards to ensure that only those investors who understand these products' essential characteristics and risks use them, FINRA should apply the options account approval rules, with the modifications suggested above, more broadly to other complex products that are purchased through self-directed platforms. As discussed below, FINRA should continue to define complex products broadly, based on whether the product's essential characteristics and risks are likely to make it difficult for retail investors to fully understand and appreciate them. FINRA should also provide a non-exhaustive list of examples of complex products to ensure broker-dealers clearly understand the types of products that they must determine are appropriate for their customers.

First, we support FINRA's continuing to define complex products flexibly based on the product's essential characteristics and risks that are likely to make it difficult for retail investors to fully understand and appreciate (including the payout structure and how the product may perform in different market and economic conditions). We agree that because new products and strategies are constantly introduced, it is most appropriate for FINRA to construe the term

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<sup>44</sup> This language tracks FINRA 2360(b)(19)(B).

“complex product” flexibly to avoid a static definition that may not address the evolution of financial products and technology.

Previous FINRA guidance identifying the characteristics that may render a product “complex” for purposes of determining whether the product should be subject to heightened supervisory and compliance procedures are a natural starting point in this regard.<sup>45</sup> As FINRA stated in that guidance, “any product with multiple features that affect its investment returns differently under various scenarios is potentially complex. This is particularly true if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return.”<sup>46</sup> The European Securities and Markets Authority (ESMA) has also published a list of elements that can make a product difficult to understand, which are generally consistent with the features that FINRA has outlined.<sup>47</sup> We encourage FINRA to incorporate those elements in its definition of complex product to the extent they are not currently captured.

Second, FINRA should continue to provide a non-exhaustive list of examples of complex products to assist firms in establishing policies and procedures that identify products that are sufficiently complex in order to determine whether such products are appropriate for their particular customers. As previous FINRA guidance stated and the Notice reiterates, this may include a security or strategy with novel, complicated or intricate derivative-like features, such as structured products with embedded optionality, inverse or leveraged (“geared”) and volatility ETPs that can employ futures contracts and other derivatives that may engage in short sales,<sup>48</sup>

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<sup>45</sup> See FINRA, Regulatory Notice 12-03, Heightened Supervision of Complex Products, <https://bit.ly/3P9dEic>.

<sup>46</sup> *Id.*

<sup>47</sup> According to ESMA, a product is likely to be considered complex if the product: is a derivative, or incorporates a derivative (a derivative is a financial instrument where the value is based on the value of another financial instrument, or of some other underlying financial asset or index, such as foreign currencies or interest rates – they are often included in a financial product to produce or enhance a certain investment strategy, as well as to hedge, or offset, certain risks); has underlying assets or indices that are not easily valued, or whose prices or values are not publicly available; has a fixed investment term with, for example, penalties in case of early withdrawal that are not clearly explained; uses multiple variables or complex mathematical formulas to determine your investment return; includes guarantees or capital protection that are conditional or partial, or that can disappear on the happening of certain events. ESMA, Investor warning, Risks of investing in complex products, February 7, 2014, <https://bit.ly/3wgjxBh>.

<sup>48</sup> It is highly unrealistic that retail investors will fully understand products that are linked to the VIX or other esoteric indexes that are based on derivatives, or products that are based on derivatives on the VIX. One recently approved set of products highlights the different levels of complexity that an investor would have to make sense of to truly understand the products’ essential features and risks. Specifically, the products are based on VIX futures, not the VIX itself. The VIX, which is itself derived from the price of options, represents a measure of the current expected volatility of the S&P 500 over the next 30 days. VIX futures contracts, on the other hand, are based on the current expectation of what the expected 30-day volatility will be at a particular time in the future (on the expiration date). *This means that the price of the product is based on the price of futures, tied to the price of options -- the current expectation of what future expected volatility will be.* (“The Index is comprised of, and the value of the Fund will be based on, VIX Futures Contracts. VIX Futures Contracts are measures of the market’s expectation of the level of VIX at certain points in the future, and as such will behave differently than current, or spot, VIX, as illustrated below. While the VIX represents a measure of the current expected volatility of the S&P 500 over the next 30 days, the prices of VIX Futures Contracts are based on the current expectation of what the expected 30-day volatility will be at a particular time in the future (on the expiration date).”). See Notice of Filing of a Proposed Rule Change to List and Trade Shares of the -1x Short VIX Futures ETF, a Series of VS Trust, Under Rule 14.11(f)(4) (Trust Issued Receipts), Sec. and Exch. Comm’n, Exch. Act Rel. No. 87992, Jan. 16, 2020, <https://bit.ly/3FqdtDI>

hedge funds and securitized products, such as asset-backed securities, interval funds, and non-traded REITs. We also agree that other types of products that have recently emerged should be considered complex, including defined outcome ETFs that offer structured retail product-type features, such as exposure to the performance of a market index or reference asset but with downside protection and an upside cap on potential gains over a specified period, and mutual funds and ETFs that offer strategies employing cryptocurrency futures.<sup>49</sup> We also believe annuities should be included, given that they often have multiple features, including investment management components, which may include various features, guarantees, riders, and payout structures, for example.<sup>50</sup>

In addition, to the extent an investor is approved to invest in a complex product but uses it in a way that is facially inconsistent with a product's stated objective, broker-dealers should be required to send warnings to the investor and seek further information from the investor about the investor's strategy. For example, if an investor holds a leveraged ETF for longer than one day, a broker-dealer should be required to send an automated warning to the investor that the investor is using the product in a way that is inconsistent with the product's stated objective. If the investor continues to hold the product and there is evidence that the investor is not actively monitoring his or her account, for example by not logging in to their account daily, the firm should seek further information from the investor in writing about the investor's strategy. To the extent the information provided suggests a lack of knowledge about how the product works and the risks that it entails, the firm should be required to reassess the investor's qualifications to use the product.

As the Notice highlights, regulators have expressed concern about complex products because the characteristics of these products can impair the ability of registered representatives and their customers to understand how the product will perform in a variety of time periods and market environments and can lead to inappropriate recommendations and sales. Given these concerns, heightened supervisory and compliance procedures are appropriate, regardless of whether the complex products are being recommended to the investor or the account is self-directed.

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("Initial Inverse VIX Proposal"); Notice of Filing of a Proposed Rule Change to List and Trade Shares of the -1x Short VIX Futures ETF, a Series of VS Trust, Under Rule 14.11(f)(4) ("Trust Issued Receipts"), Sec. and Exch. Comm'n, Exch. Act Rel. No. 89901, Sept. 17, 2020, <https://bit.ly/38ZXuab> ("Revised Inverse VIX Proposal"); Notice of Filing of a Proposed Rule Change, as Modified by Amendment No. 1, to List and Trade Shares of the 2x Long VIX Futures ETF, a Series of VS Trust, under Rule 14.11(f)(4) ("Trust Issued Receipts"), Sec. and Exch. Comm'n, Exch. Act Rel. No. 89234, July 6, 2021, <https://bit.ly/3FsijqY> ("Leveraged VIX Proposal").

<sup>49</sup> We also urge FINRA to include mutual funds and ETFs that offer strategies employing significant amounts of exposure to futures, options, or other derivatives, including managed futures funds and options-writing funds, as these funds engage in what have been traditionally considered hedge fund strategies.

<sup>50</sup> We recognize that annuities are not typically sold directly to investors in the current marketplace. However, it is possible that the market could develop in a way that offers direct access to annuities and raises the concerns raised by complex products.

## V. FINRA should enforce these sales practice rules to ensure firms comply with their regulatory obligations.

Having strong rules on the books, as we've suggested above, will only partly address the concerns that complex products raise. To fully address those concerns and to ensure firms comply with their regulatory obligations, firms must be examined for compliance with strong rules and those rules must be vigorously enforced. Said another way, even the best sales practice rules won't improve broker-dealer practices or investor outcome if those rules are not enforced.<sup>51</sup>

To the best of our knowledge, the only enforcement action FINRA has brought against a firm or registered rep for inappropriately approving self-directed investors to trade options was the recent case brought against Robinhood.<sup>52</sup> That case was brought after a young retail investor who was trading options in speculative ways committed suicide, after acknowledging he had “no clue” what he was doing.<sup>53</sup> Following this tragedy, there was congressional pressure for FINRA to do something to rectify the problem.<sup>54</sup> While we commend FINRA for investigating Robinhood's grossly inadequate options approval process and taking strong enforcement action against the company for its regulatory failures, these regulatory issues have been well known for years.

Robinhood's shoddy options approval practices further underscore the need to vigorously enforce strong sales practice rules. Firms have intense financial incentives to facilitate access to and encourage the use of products that make the firms the most money, regardless of whether those products are appropriate for investors. In the case of Robinhood, the company receives a significant percentage of its total net revenue from options trading.<sup>55</sup> It is therefore unsurprising that they would push the envelope as far as they could to promote options trading to their

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<sup>51</sup> In the context of the SEC's proposed rule regarding funds' use of derivatives, which included a sales practice rule component for the sale of leveraged and inverse ETFs, we stated that the Commission had totally failed to provide any evidence that its proposed regulatory approach would protect retail investors against the risks of inappropriately using leveraged and inverse vehicles. Further, we stated that the Commission needed to do more to determine whether its proposal would achieve its regulatory goal of meaningfully reducing the inappropriate use of leveraged and inverse vehicles by retail investors. If evidence suggested the proposed rule would not meaningfully reduce inappropriate use of these products, we urged the Commission to propose a more effective approach. *See* Letter from Micah Hauptman, to the SEC, Funds' Use of Derivatives Re-proposal, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, March 30, 2020, <https://bit.ly/3yDSNxN>. Similarly, should FINRA consider adopting our proposed approach, we urge FINRA to provide evidence and analysis showing that this approach would meaningfully reduce the inappropriate use of complex products. Importantly, however, FINRA does not have the same obligations with regard to economic analysis under either the Exchange Act or the Administrative Procedure Act as the SEC when promulgating rules.

<sup>52</sup> *See* Press Release, FINRA, “FINRA Orders Record Financial Penalties Against Robinhood Financial LLC,” June 30, 2021, <https://bit.ly/3FpLLOE>. Robinhood Financial LLC, AWC No. 2020066971201, June 30, 2021.

<sup>53</sup> Sergei Klebnikov and Antoine Gara, *20-Year-Old Robinhood Customer Dies By Suicide After Seeing A \$730,000 Negative Balance*, FORBES, June 17, 2020, <https://bit.ly/3FsilPL>.

<sup>54</sup> Caitlin Reilly, *Death draws lawmakers' scrutiny to Robinhood's trading app*, ROLL CALL, July 28, 2020, <https://bit.ly/3skRz6w>. As I stated at the time, “The question isn't whether there are relevant rules that apply to this situation, the question is whether these rules are being followed and being enforced.”)

<sup>55</sup> According to the company, it received \$440 million (46% of its total \$959 million net revenue) from options trading in 2020 and \$689 million (49% of its total \$1.40 billion net revenue) from options trading in 2021. Press Release, “Robinhood Reports Fourth Quarter and Full Year 2021 Results,” January 27, 2022, <https://bit.ly/3snlPNX>.

customers, including young and inexperienced investors, who had no or very limited knowledge about options.<sup>56</sup> To neutralize these incentives from influencing firms' policies, procedures, and practices, the threat of enforcement for violation of these rules needs to be real and the financial costs relating to violations of these rules need to be meaningful.

**VI. FINRA must start enforcing Regulation Best Interest, particularly with regard to the recommendation and sale of complex, higher-cost products that provide greater compensation to firms and registered representatives than less complex, lower-cost reasonably available alternatives, when those less complex, lower-cost available alternatives could achieve the same objectives for their retail customers.**

We are now almost two years after the implementation of Regulation Best Interest (Reg. BI) and not a single enforcement action has been brought for violation of the standard of conduct by the SEC, FINRA, or state regulators. Ample time has been provided for firms and registered representatives to understand their regulatory obligations and come into compliance. Now, regulators must prove they are serious that "best interest" isn't a mere slogan and that it is a substantially stronger standard than the FINRA suitability rule that it replaced.

The recommendation and sale of complex products should be a primary focus for initial regulatory enforcement of Reg. BI because complex products are likely to implicate various aspects of the rule.<sup>57</sup> First, the recommendation and sale of complex products implicate Reg. BI's Care Obligation.<sup>58</sup> This obligation requires a broker-dealer exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks, rewards, and costs associated with the recommendation. The broker-dealer must then consider those risks, rewards, and costs in light of the customer's investment profile and have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest. A broker-dealer should consider reasonable alternatives, if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation.

Reg. BI's Adopting Release makes clear that the "reasonable-basis" component of the Care Obligation is especially important when broker-dealers recommend securities and investment strategies that are complex or risky securities.<sup>59</sup> The Release further makes clear that the level of reasonable diligence that is required will rise with the complexity and risks associated with the security or strategy.<sup>60</sup> In addition, the Release states that broker-dealers that

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<sup>56</sup> See Yun Li, *Options trading activity hits record powered by retail investors, but most are playing a losing game*, CNBC.COM, December 22, 2021, <https://cnb.cx/3snz141> ("The Robinhood investor is the most novice of the cohorts of retail investors," said Paul Rowady, director of research for Alphacution Research Conservatory. "The question is how do I influence new, often very young first-time investors using an application that's frictionless and highly gamified? How do I get them to try options where based on the payment for order flows, these fees are a very lucrative component of their revenue model.").

<sup>57</sup> SEC Final Rule, Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031, June 5, 2019, <http://bit.ly/2mMO75u>.

<sup>58</sup> *Id.* at 14-15.

<sup>59</sup> *Id.* at 263-264.

<sup>60</sup> *Id.* at 264, n. 598.

recommend complex or costly products should first consider whether less complex or costly products could achieve the same objectives for their retail customers.<sup>61</sup> The Release cites to the FINRA Regulatory Notice 12-03, which provided firms and registered representatives with guidance regarding the heightened supervision of complex product sales.<sup>62</sup>

Second, the recommendation and sale of complex products implicate Reg. BI's Conflict of Interest Obligation. This obligation requires firms to, among other things, establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a registered representative to place the interest of the firm or representative ahead of the interest of the retail customer.<sup>63</sup> In other words, firms cannot encourage and reward recommendations that are not in the retail customer's best interest.

Third, the recommendation and sale of complex products implicate Reg. BI's Compliance Obligation. This obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole.<sup>64</sup>

Unfortunately, evidence suggests that many firms may not be complying with their Care, Conflict of Interest, or Compliance Obligations with regard to the recommendation and sale of complex products. For example, a recent North American Securities Administrators Association (NASAA) report provided evidence that firms continue to recommend complex, costly, and risky products and that they are not seriously considering costs or reasonably available alternatives with their customers when they recommend these products.<sup>65</sup> Moreover, many firms are not taking meaningful steps to mitigate conflicts of interest. On the contrary, they are continuing to provide a variety of financial incentives to recommend complex products over reasonably available alternatives. As a result, it's not clear whether or the extent to which firms have made any meaningful enhancements from the previous FINRA suitability framework.

To the extent firms recommend complex products that provide greater compensation to firms and registered representatives than less complex, less costly reasonably available alternatives, when those less complex, less costly available alternatives could achieve the same objectives for their retail customers, that would appear to be a prima facie violation of the standard. Such recommendations suggest that the firm and representative are not seriously considering costs or reasonably available alternatives that would be a better match for the customer. Such recommendations also suggest that the firm and representative are making the recommendation based on the compensation they are receiving, not what's best for their customers.

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<sup>61</sup> *Id.* at 284.

<sup>62</sup> *Id.* at 263-264.

<sup>63</sup> *Id.* at 15.

<sup>64</sup> *Id.* at 16.

<sup>65</sup> NASAA, Report and Findings of NASAA's Regulation Best Interest Implementation Committee, National Examination Initiative Phase II (A), November 2021, <https://bit.ly/3yIIIKS>.



In short, these practices suggest that the firm and representative are not making recommendations in the best interest of their retail customers, are putting their interests ahead of their customers, firms are encouraging and rewarding representatives for making recommendations that are not in customers' best interest, and firms do not have reasonably designed policies and procedures to comply with the rule.

If Reg. BI is to have any meaning or credibility with investors, it must be enforced vigorously. Firms must understand that recommending products that pay them and their representatives more than reasonably available alternatives, regardless of whether those recommended products are the best match for their customers, won't pass muster under this new standard. Firms must see the threat of enforcement for violation of these rules as real and the financial costs relating to violations of these rules as meaningful. If "best interest" continues to be nothing more than a regulatory and marketing slogan, investors will lose trust and confidence in firms and their representatives and we will need to consider much more aggressive regulatory solutions to address the problem of conflicted and low-quality advice and recommendations.

## Conclusion

We commend FINRA for publishing this Notice. As discussed above, the current regulatory framework for self-directed investment in complex products and options is not appropriately tailored to address current concerns raised by these products. We believe FINRA can update this framework to better protect investors. As key gatekeepers in the market, it is entirely appropriate for broker-dealers to have heightened obligations to ensure that their customers who do not understand complex products' essential characteristics and risks do not use them.

We understand some members of the industry, including product manufacturers that make a lot of money selling their products to investors who do not fully understand how their products work, have an interest in preserving the status quo. After all, if these product manufacturers could no longer get their products into the hands of retail investors who don't know how to use them, they would lose a significant portion of their revenue. It should therefore come as no surprise that members of the industry are engaging in a grass-tops misinformation campaign to try to scare investors into believing that FINRA is trying to restrict investors' right to invest in a long list of public securities.<sup>66</sup> For example, they are running Facebook and Twitter ads that read: "YOUR FREEDOM TO INVEST IS AT RISK. TELL REGULATORS: HANDS OFF MY INVESTMENTS."<sup>67</sup> They are calling this Notice a "radical" and "unprecedented" threat to individuals' "right to invest in many of today's most popular funds."<sup>68</sup> These ads are, perhaps intentionally, tapping into anti-government fervor. Nowhere do these ads mention that FINRA is a private corporation that acts as a self-regulatory organization or that there is clear

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<sup>66</sup> See ProShares Trust, Supplement dated April 25, 2022 to the Prospectuses for the Leveraged and Inverse ETFs each dated October 1, 2021, <https://bit.ly/395hoAs>. See also Let Everyone Invest, Your Ability To Freely Invest May Be At Risk, <https://www.leteveryoneinvest.com/> (last visited May 7, 2022). The first product on the "list of investments that may be at risk" is target date funds, which we don't believe anyone is seriously considering restricting. Providing such prominence to a product that is commonly purchased by retail investors, including in their retirement accounts, appears to be part of a cynical attempt to foment outrage in response to this Notice.

<sup>67</sup> Screenshots on file with author.

<sup>68</sup> *Id.*

precedent for FINRA to apply heightened obligations to broker-dealers when approving customer accounts for trading certain complex products, as is the case with options trading.

Because of this grass-tops campaign, FINRA is likely receiving a significant number of comments from retail investors opposing this Notice. We believe that if these investors were properly educated about the issues concerning complex products rather than being made scared and angry, they would view this regulatory project as a worthy endeavor—one that ensures that those investors who understand a complex product’s essential characteristics and risks continue to have access to such a product, while those investors who do not understand a complex product’s essential characteristics and risks do not continue to have unfettered access to such a product, given the increased potential for these investors to suffer great financial and personal harm. Accordingly, we urge FINRA to forge on with this critical retail investor protection project.

Respectfully submitted,

A handwritten signature in cursive script that reads "Micah Hauptman".

Micah Hauptman  
Director of Investor Protection  
Consumer Federation of America