PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION
1225 West Main Street, Suite 126 | Norman, OK 73069
Toll Free (888) 621-7484 | Fax (405) 360-2063
www.piaba.org

May 9, 2022

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

Re: Regulatory Notice 22-08 (Comment on Sales Practice Obligations for Complex Products and Options)

Dear Ms. Piorko Mitchell:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews (like the instant one) in order to protect the rights and fair treatment of the investing public.

Regulatory Notice 22-08 requests comments regarding complex products and options. PIABA submits this comment because the bar association believes strongly that member firms' obligations for the supervision of sales of complex products and options should be strengthened. Notice 22-08 acknowledges a significant increase in the sales of these products, which should warrant closer attention.

This is not the first time that FINRA and its predecessor, the NASD, has raised concerns about complex products. In fact, since Notice 22-08 was published, FINRA also published Notice 22-11, regarding sales of mutual funds that use complex products and options within its portfolio (known as "alt funds"). FINRA also addressed the issues raised with complex products in numerous other notices, including:

a) Notice 12-03 – Heightened Supervision of Complex Products;
b) Notice 10-09 – Reverse Exchangeable Securities (Reverse Convertibles);
c) Notice 09-73 – Principal Protected Notes;
d) Notice 05-59 – Structured Products;
e) Notice 05-26 – Best Practices for Reviewing New Products;
f) Notice 03-71 – Non-Conventional Investments.

Likewise, issues related to these products are frequently raised in FINRA's Report on its Examination and Risk Monitoring Program, and previously in its annual Regulatory and Examination Priorities Letters. Despite nearly 20 years of guidance regarding complex products, the release of Notice 22-08 reveals that FINRA still has significant concerns about sales practices regarding these products.

FINRA should require heightened supervision regarding the sales of complex products and options. These products are often represented, at the point of sale, as being tools to help mitigate market risks. Instead, some of these products can exacerbate risks. A few examples should be noted:

a) In February 2018, the LJM Preservation and Growth Fund lost over 80% of its value within two days, possibly the biggest two-day drop for a mutual fund ever. This fund was overconcentrated in risky leveraged options, a far cry from its namesake "preservation" objective;
b) The Lehman Brothers Principal Protected Notes were marketed as being safe and conservative but lost most of their value after Lehman Brothers collapsed in 2008. The internal holdings of these notes were laden with complex structured products that did not withstand the market volatility of 2008; and
c) The Oppenheimer Champion Income Fund lost significant value in 2008. Despite being labeled as a "bond" fund, it had substantial exposure to commercial mortgage backed securities, done so using substantial leverage in derivatives and total return swaps. This product also lost significant value, much more than other "bond" funds.

There are numerous other examples of similar complex products. It is clear that complex products like the three discussed above can wreak havoc on investors' portfolios in a relatively short period of time. This should be met with extra vigilance by FINRA.

Leveraged and Inverse ETFs

While Notice 22-08 details the numerous Regulatory Notices that FINRA has published addressing specific complex products, it is clear that further and more substantial regulatory actions are needed, particularly in complex products previously addressed by FINRA. Some of the products that FINRA should monitor closely are leveraged and inverse ETFs.

For example, in June 2009, FINRA published Regulatory Notice 09-31, Non-Traditional ETFs, which focused on leveraged and inverse exchange traded funds. Notice 09-31 described how "[m]ost leveraged and inverse ETFs 'reset' daily" and therefore "[d]ue to the effect of compounding, their performance over longer periods of time can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time." [1]

Notice 09-31 then cited two examples of situations in which leveraged ETFs declined in value, even though the underlying indexes they tracked increased in value, including one situation in which the Russell 1000 Financial Services Index gained "around 8 percent," while "an ETF seeking to deliver three times the daily return" of that index fell 53 percent.[2]

Given these clear dangers associated with holding leveraged ETPs for more than a single day, Notice 09-31 concluded that, "inverse and leveraged ETFs typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets." FINRA also reminded firms that part of a member's suitability obligation requires the member to "fully understand the products and transactions they recommend," and that "[w]ith respect to leveraged and inverse ETFs, this means that a firm must understand the terms and features of

[1] FINRA, Regulatory Notice 09-31 (2009).
[2] *Id.*

the funds, including how they are designed to perform, how they achieve that objective, and the impact that market volatility, the ETF's use of leverage, and the customer's intended holding period will have on their performance."[3]

Despite FINRA's clear identification of the significant problem with investments in leveraged and inverse ETFs longer than a day and its clear warning to member firms, our members continue to see investors who have been victimized by inappropriate longer-term holding of positions in these complex products. FINRA's guidance and reminders concerning leveraged and inverse ETFs delivered in Notice 09-31 was insufficient by itself to stop these sales practice violations.

As Notice 09-31 detailed, and the issuers' own prospectuses make clear, leveraged and inverse exchange traded products ("ETPs) that are designed to reset daily should not be held for longer than a single trading day. Given this, FINRA should requite member firms to carefully scrutinize the holding of leveraged and inverse ETP positions beyond one trading day. Such scrutiny should include a written explanation from the registered representative who recommended the ETP; documented supervisory review of all such transactions, including the registered representative's written explanation; and affirmative, direct communication between firm supervisory personnel and individual investors making such investments to ensure that the individual investor understands the characteristics of leveraged and inverse ETPs that make holding them for longer than a single day inadvisable. FINRA should consider adopting a new rule within the 2300 series to explicitly address the sales practice and supervision concerns associated with these products.

In short, the current regulatory framework is not appropriately tailored to address the specific concerns and significant risk that complex products, such as leveraged and inverse ETPs pose. FINRA needs to closely examine and carefully draft new regulatory requirements that address these specific risks and fulfill the investor protection mandate of the securities laws.

Options Trading

PIABA is also concerned with the dramatic rise of options trading, which poses serious risks for retail investors who do not understand the characteristics of options and risks related to the product. Most recently, FINRA fined Berthel, Fisher & Co. Financial Services, Inc. for failing to supervise unsuitable options trading activity for a senior citizen.[4]

These same concerns are heightened when retail investors are accessing these products through self-directed platforms. PIABA believes that investor protection guardrails need to be strengthened to adequately address the risks posed by options trading through a self-directed platform.

Broker-dealers have adopted self-assessments as part of their approval process for opening a customer's self-directed account to trade options. While the self-assessment may meet FINRA's minimum due diligence requirements, the information collected by broker-dealers is not reasonably designed to sufficiently ascertain a retail investor's understanding of options trading or their understanding of the characteristics and risks related to options trading. For example, the self-assessments do not address whether the investor understands the risk and consequences of margin calls, or the risk of potentially unlimited losses for certain options trading. To further protect retail investors from future market volatility, PIABA believes that firms should solicit and keep a record of the amount an investor is able to and willing to put at risk.

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[3] *Id.*

[4] In re: Berthel, Fisher & Co. Financial Services, Inc., Financial Industry Regulatory Authority Letter of Acceptance, Waiver, and Consent, No. 2018057425202 (Apr. 26, 2022).

Perhaps worse still, our members are seeing an uptick in small RIA firms using complex options strategies that the advisers themselves do not understand. These RIA firms typically use FINRA member firms to execute their strategies. The brokerage firms disclaim any responsibility for the trading, placing that responsibility on the RIA. However, investors do not understand that they are dealing with two separate entities, each of which have limited responsibilities and obligations.

Consistent with applicable fiduciary duties and Regulation Best Interest conduct standards, PIABA believes that, once a member firm has approved options trading for an account, the firm should also have an ongoing duty to monitor a customer's options trading strategy. Suitability is a constantly changing variable and the firm has a duty to continuously update the suitability profile as additional financial information becomes available. As part of any subsequent suitability assessment, the firm must reassess if the existing options trading strategy and products being used remain suitable for the investor. Therefore, a firm would have to prevent a customer from engaging in an overall risky trading strategy if it contradicts the customer's evolving suitability profile. This is especially true when the firm has reason to know that the customer does not fully understand the risks of the options trades.

In summary, PIABA supports any measure that strengthens investor protection and imposes stricter requirements regarding the sales of complex products and options.

Very truly yours,

Michael Edmiston
President, PIABA