

**Recommendation of the SEC Investor Advisory Committee
regarding the Protection of Self-Directed Investors when Trading Complex Products
and Utilizing Complex Strategies
June 6, 2024**

On December 7, 2023, the SEC’s Investor Advisory Committee hosted a panel discussion entitled, “Examining the use of Complex Investment Products and Strategies by Self-Directed Investors – Is the Current Approach Working?” The Committee heard from the following panelists:

- Professor Elizabeth Goldman, Clinical Professor of Law, and Director, Securities Arbitration Clinic, Benjamin N. Cardozo School of Law;
- Michael Garawski, Associate General Counsel, Regulatory Practice and Policy, Financial Industry Regulatory Authority (FINRA);
- Kevin Carroll, Deputy General Counsel, Litigation and Private Client (Legal), Securities Industry and Financial Markets Association (SIFMA); and
- Micah Hauptman, Director of Investor Protection, Consumer Federation of America.

The panelists discussed the use of complex investment products and strategies by self-directed investors with a focus on whether investors are being protected adequately by the account approval process and disclosures required by the existing regulatory structure.

Self-directed investing, that is, investing without the advice of a financial professional, started in the mid-70s with the elimination of fixed commissions and the creation of discount brokerage firms.¹ In the late 90s, many of these firms moved online.² Over time, the barriers to entry lessened. Commissions declined until they reached zero in many instances. Account minimums also declined, opening the opportunity to invest to an entirely new class of investors.

As trading moved online in the late 90s, then SEC Chairman Arthur Levitt raised concerns about the influx of new and inexperienced investors trading online inconsistently with their goals and risk tolerances.³ He recognized that as firms grow, their ability to provide effective customer service must keep pace. He emphasized that firms have an obligation of best execution, regardless of how the trade has been placed. He also raised concerns about the clarity of communications and the accuracy of advertising aimed at this new group of investors.

Shortly thereafter, the United States Government Accountability Office (the “GAO”), studied the same question we are asking today. In a report from May 2000, the GAO examined how online broker-dealers address investor protection issues related to margin, privacy of information, risk

¹ See Christine Lazaro, Teresa J. Verges, *The Obligations and Regulatory Challenges of Online Broker-Dealers and Trading Platforms*, 29 PIABA B.J. 25 (2022).

² See Arthur Levitt, Chair, Sec. Exch. Comm’n, *Remarks to the National Press Club, Plain Talk About On-Line Investing* (May 4, 1999), http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1990/1999_0429_LevittDraftT.pdf.

³ *Id.*

disclosures, best execution, suitability, and advertising.⁴ The GAO re-examined these issues a year later, in July 2001.⁵ In reviewing information about investor complaints to the SEC, the GAO concluded that many online investors may not understand the risks they are taking or the rules and procedures for trading.⁶

In the 20 years since these concerns were raised by the SEC Chairman and the GAO, online investing has evolved, but many of the same concerns still exist. With reduced barriers to entry, more individuals are opening accounts and trading. One report estimates that more than 10 million new online brokerage accounts were opened in 2020.⁷ In a joint study conducted by FINRA and NORC at the University of Chicago, two-thirds of investors who opened accounts in 2020 were new investors.⁸ These new investors were younger, had lower incomes, and were more racially diverse than experienced investors who opened accounts at that time.

In 2022, FINRA followed up with the investors identified in the 2020 study.⁹ When asked what information they use to make investment decisions, a greater number now relied on financial professionals. However, that number is still low – only a third indicated they relied on financial professionals. That means a majority of new investors continue to be self-directed. This large group of investors are routinely making important investing decisions without the benefit of a financial professional.

There is evidence that these investors are not consistently given quality information by the industry to make decisions. For example, in its report on its Examination and Risk Monitoring Program from 2023, FINRA asked whether firms utilizing mobile apps are clearly disclosing applicable risks and adequately explaining other features such as margin or options accounts at account opening.¹⁰ In FINRA's examinations of brokerage firms, it found that some brokerage firms were sending margin call warnings to customers whose account balances were not approaching, or were below, minimum maintenance requirements; were falsely informing customers that their accounts were not enabled to trade on margin, when the accounts were, in fact, margin enabled; and were misstating the risk of loss associated with certain options transactions.¹¹ In 2024, FINRA asked whether firms utilizing mobile apps were including appropriate risk disclosures at account opening;

⁴ See U.S. GAO, *On-Line Trading: Better Investor Protection Information Needed on Brokers' Web Sites* (May 9, 2000), <https://www.gao.gov/products/ggd-00-43>.

⁵ See U.S. GAO, *On-Line Trading: Investor Protections Have Improved but Continued Attention Is Needed* (July 20, 2001), <https://www.gao.gov/products/gao-01-858>.

⁶ *Id.*

⁷ See Lazaro & Verges, *supra* note 1.

⁸ See FINRA Investor Education Foundation and NORC Report, *Investing 2020: New Accounts and the People Who Opened Them* (Feb. 2021), https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them_1_0.pdf.

⁹ See Adam Bloomfield, Angela Fontes, Robert Ganem, Kathryn Meagher, Gary Mottola, Brian Mulford, and Olivia Valdes, *Where Are They Now? Following Up With the New Investors of 2020* (Mar. 2023), <https://www.finrafoundation.org/sites/finrafoundation/files/Where-Are-They-Now-Following%20Up-With-the-New-Investors-of-2020.pdf>.

¹⁰ See FINRA, *2023 Report on FINRA's Examination and Risk Monitoring Program* (Jan. 10, 2023), <https://www.finra.org/rules-guidance/guidance/reports/2023-finras-examination-and-risk-monitoring-program>.

¹¹ *Id.*

whether information was identified in ways easily understandable based on the customer’s experience level, and whether information provided constitutes a recommendation under Regulation BI.¹² FINRA examinations also have found that some brokerage firms were providing false, misleading, and inaccurate information in their mobile apps.¹³ For example, there were examples where some brokerage firms had failed “to fully explain and clearly and prominently disclose risks, where required by a specific rule or needed to balance promotional claims, associated with options trading, the use of margin and crypto assets.”¹⁴

This is especially troubling when the customer is not speaking with a financial professional, who may be in a position to identify the false or misleading information. Rather, customers are left to figure out this information on their own.

We see further awareness of the need to better serve these investors in FINRA’s recent examination of its rules governing complex products and options in Regulatory Notice 22-08.¹⁵ Specifically, FINRA asked whether the current regulatory framework, 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 complex products and options.

Two of the panelists who participated in the Committee’s discussion in December 2023 represented firms that had filed comment letters in response to FINRA’s Regulatory Notice.¹⁶ In its comment letter, SIFMA sought continued flexibility and leeway for firms “to establish their own appropriate option strategy categorizations and respective eligibility requirements (e.g., knowledge, experience, investment objectives) for each category, based on the particular broker-dealer’s client base, systemic controls and safeguards, risk-based supervisory systems, and options product and strategies offerings.” SIFMA also suggested FINRA encourage brokerage firms to provide educational materials about complex products to customers and consider supplemental risk warnings prior to trading complex products. Consumer Federation of America’s comment letter called for an update to existing options account approval rules to ensure approval only occurs when appropriate, and for FINRA to adopt these rules more broadly with respect to other complex products purchased through self-directed platforms.

¹² FINRA, *2024 FINRA Annual Regulatory Oversight Report* (Jan. 9, 2024), <https://www.finra.org/rules-guidance/guidance/reports/2024-finra-annual-regulatory-oversight-report>.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ See FINRA Regulatory Notice 22-08, *FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements* (Mar. 8, 2022), <https://www.finra.org/rules-guidance/notices/22-08>.

¹⁶ See SIFMA’s Comment Letter in Response to Regulatory Notice 22-08 (May 9, 2022) (“SIFMA Comment”), https://www.finra.org/sites/default/files/NoticeComment/SIFMA_Kevin%20M%20Carroll_5.9.2022_comment%20re%20complex%20products%20FINAL%20%285.9.2022%29.pdf; and Comment Letter on behalf of Consumer Federation of America, Americans for Financial Reform Education Fund, and Better Markets in Response to Regulatory Notice 22-08 (May 9, 2022) (“CFA Comment”), https://www.finra.org/sites/default/files/NoticeComment/CFA_Micah%20Hauptman_5.9.2022_Final%20Comment%20Re%20FINRA%20Complex%20Products%20Notice.pdf.

In order to better protect self-directed investors who are trading online and on trading apps, the Investor Advisory Committee makes the following recommendations to enhance the current regulatory framework, which will be discussed in further detail below:

- I. The SEC and FINRA should clarify and supplement the account approval process when self-directed customers wish to trade complex products or utilize complex strategies:¹⁷
 - a. FINRA should amend its rule governing the approval of options accounts to explicitly state that the determination required in approving an options account is comparable to the best interest standard under Regulation BI;
 - b. The SEC or FINRA should define the term, “complex product,” and adopt similar account approval rules for any product that meets the definition;
 - c. The SEC or FINRA should publicize best practices for firms to utilize when offering complex products and strategies;
- II. The SEC or FINRA should require increased disclosure and/or interactions when self-directed customers wish to trade complex products and utilize complex strategies, such as enhanced risk disclosures at the time a trade is placed;
- III. The SEC and FINRA should continue to initiate enforcement actions when brokerage firms do not meet the diligence standards when approving options accounts under the current rules; and
- IV. The SEC and FINRA should increase education focused on self-directed investors who wish to trade complex products or utilize complex strategies.

I. The SEC and FINRA should clarify and supplement the account approval process when self-directed customers wish to trade complex products.

- a. *FINRA should amend its rule governing the approval of options accounts to explicitly state that the determination required in approving an options account is comparable to the best interest standard under Regulation BI.*

FINRA Rule 2360(b)(16) requires that a brokerage firm approve a customer’s account to trade options. In doing so, the brokerage firm must “exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives.” The rule requires the brokerage firm to obtain the customer’s investment objective, employment status, estimated annual income, net worth, and liquid net worth, marital status, and age.¹⁸ However, beyond this instruction to obtain this information, the rule itself does not indicate how the brokerage firm should assess the information.

As early as 1980, FINRA has told firms, “The requirement that all public customers must be specifically approved for options is intended to assure that the firm has exercised due diligence to determine that options transactions are appropriate for the customer in light of his investment objectives and financial situation, and that the customer has been made aware of the risks of

¹⁷ Here and below, the term “complex strategies” includes the use of margin in conjunction with a complex product.

¹⁸ FINRA Rule 2360(b)(16)(B)(i).

options transactions.”¹⁹ In guidance, FINRA has stated that it views the options trading approval standard as “comparable to a suitability standard.”²⁰ Additionally, the SEC has told investors, “Based on the information you provide, your broker will determine whether options trading is suitable for you and, if so, what types of options trading may occur in your account.”²¹

From both the SEC’s and FINRA’s guidance, it is clear the options approval process is one that historically has required a suitability assessment. However, the rule itself does not make this explicit. Moreover, the Committee believes it is appropriate that the standard utilized in determining whether options trading is appropriate for a customer should now be the standard set forth in Regulation BI, one that assesses whether the account type is in the customer’s best interest. Accordingly, the Committee recommends that FINRA amend Rule 2360 to explicitly state that when approving an account for options trading, the brokerage firm must determine that the level of options trading approved is in the client’s best interest.

b. The SEC or FINRA should define the term, “complex product,” and adopt similar account approval rules for any product that meets the definition.

The concerns raised with respect to options trading exist with respect to other types of complex products. For example, Consumer Federation of America has raised concerns that investors do not understand the essential characteristics and risks of leveraged ETFs.²²

FINRA has described a “complex product” as “a product with features that may make it difficult for a retail investor to understand the essential characteristics of the product and its risks (including the payout structure and how the product may perform in different market and economic conditions). A product that combines features of multiple products and strategies also may be complex (e.g., leveraged or inverse exchange-traded products (ETPs) – collectively, “geared” ETPs – that can employ futures contracts and other derivatives or may engage in short sales; structured products with embedded optionality; interval funds; non-traded REITs).”²³

Accordingly, either the SEC or FINRA should require that firms assess whether a product falls within the definition. For any product that is consistent with definition, the SEC or FINRA should adopt account approval rules that require brokerage firms to obtain the essential facts relative to the

¹⁹ FINRA Notice to Members 80-23 (June 1980). FINRA has explained that these requirements were the result of recommendations made within the Report of the Special Study of the Options Markets to the Securities and Exchange Commission (the “Special Study”) (December 22, 1978) and SEC Plan for Implementing of Recommendations of the Special Study (February 22, 1979). According to FINRA, The Special Study included a recommendation “that 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.” FINRA Regulatory Notice 21-15, *FINRA Reminds Members About Options Account Approval, Supervision, and Margin Requirements* (Apr. 9, 2021), <https://www.finra.org/rules-guidance/notices/21-15>.

²⁰ See FINRA Regulatory Notice 22-08; FINRA Regulatory Notice 21-15.

²¹ SEC, *Investor Bulletin: Opening an Options Account* (Mar. 18, 2015), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_openingoptionsaccount.

²² See CFA Comment, *supra* note 16.

²³ FINRA Regulatory Notice 22-08.

customer, their financial situation, and investment objectives, and then assess whether trading such complex products is in the customer's best interest.

- c. *The SEC or FINRA should publicize best practices for firms to utilize when offering complex products and strategies.*

It may be useful for brokerage firms to have some guidance as to best practices when offering complex products and strategies. FINRA has issued such guidance in the past with respect to other topics. For example, in 2007, FINRA highlighted industry practices that were designed to better serve senior investors.²⁴ Additionally, the SEC has provided guidance with respect to implementing Regulation BI.²⁵

Firms may benefit from similar guidance with respect to new investors trading in self-directed accounts. Accordingly, the Committee recommends that the SEC or FINRA publish guidance for brokerage firms that sets forth industry best practices designed to better serve self-directed investors who wish to trade complex products and utilize complex strategies.

II. The SEC or FINRA should require increased disclosure and/or interactions when self-directed customers wish to trade complex products and utilize complex strategies, such as enhanced risk disclosures at the time a trade is placed.

Today, self-directed investors can place trades with the click of button on their phones. The ease with which trades may be placed raises concerns that investors may not fully appreciate the risks of the trade or may otherwise make mistakes in placing the trade.

One way to address this concern is to increase the disclosure and/or interaction present when a trade is placed. This friction would serve to slow down the process between the placement of the order by the investor and the order execution. For example, the brokerage firm may include an "Are you sure?" prompt that sets forth the basic risks and characteristics of the trade that must be accepted before the trade is placed. As another example, the brokerage firm may include a prompt notifying the customer that the trade may utilize margin. This would be the equivalent of a warning label that must be acknowledged for the investor to proceed with the trade.

III. The SEC and FINRA should continue to initiate enforcement actions when brokerage firms do not meet the diligence standards when approving options accounts under the current rules.

In 2021, FINRA assessed its largest financial penalty to date against Robinhood Financial LLC.²⁶ According to FINRA, Robinhood had failed to exercise due diligence before approving options

²⁴ See FINRA Regulatory Notice 07-43, *FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers* (Sept. 10, 2007), <https://www.finra.org/rules-guidance/notices/07-43>.

²⁵ See SEC, *Regulation Best Interest, A Small Entity Compliance Guide*, <https://www.sec.gov/info/smallbus/secg/regulation-best-interest>.

²⁶ See FINRA, *Firm Ordered to pay Approximately \$70 Million for Systemic Supervisory Failures and Significant Harm Suffered by Millions of Customers* (June 30, 2021), <https://www.finra.org/media-center/newsreleases/2021/finra-orders-record-financial-penalties-against-robinhood-financial>.

accounts.²⁷ Robinhood had used computer algorithms to review and approve options accounts. The computer algorithms approved options trading based on inconsistent or illogical information, approved accounts with low risk tolerances for trading options, and only considered the most recent information provided by a customer, even when inconsistent with information provided minutes earlier.²⁸

This appears to be the only enforcement action for inappropriately approving self-directed investors to trade options. For the rules to be meaningful, they must be rigorously enforced. Accordingly, the Committee recommends that the SEC and FINRA initiate enforcement actions when firms do not ensure that options trading is appropriate for customers before approving their accounts for options trading.

IV. The SEC and FINRA should increase education focused on self-directed investors who wish to trade complex products or utilize complex strategies.

In December 2023, the Committee also hosted a panel discussion focused on “Practical Applications for Enhancing Financial Literacy.” Separately, the Committee is making a recommendation with respect to enhancing financial literacy.

The Committee adopts and reinforces those recommendations here, with an additional recommendation that investor education specifically focus on self-directed investors trading complex products and utilizing complex strategies.

The Committee also supports the recommendation made by SIFMA to FINRA, that “firms could create an education “hub” where customers can learn about the different types of complex products offered by the firm and their features and risks.”²⁹ Firms may also offer education on complex strategies and the risks associated with utilizing margin in conjunction with complex products. Education should be readily accessible and easily understandable.

Additionally, the Committee recommends that brokerage firms consider incorporating educational materials provided by the regulators. For example, the Options Clearing Corporation hosts a Learning Center on its website, which includes articles, a podcast, and modular educational videos.³⁰ Brokerage firms should consider creating similar content across a variety of modalities, or simply link to the OCC’s Learning Center. The SEC, FINRA, and NASAA also make investor educational materials available.³¹ These materials would be better disseminated to investors if the brokerage firms shared the links themselves.

²⁷ *Id.*

²⁸ See FINRA, *Robinhood Financial LLC Letter of Acceptance, Waiver, and Consent* (June 2021), <https://www.finra.org/sites/default/files/2021-06/robinhood-financial-awc-063021.pdf>.

²⁹ See SIFMA Comment, *supra* note 16.

³⁰ OCC Learning, <https://www.optionseducation.org/theoptionseducationcenter/occ-learning>.

³¹ SEC Investor Education, <https://www.sec.gov/education/investor-education>; FINRA For Investors, <https://www.finra.org/investors#/>; NASAA Investor Education, <https://www.nasaa.org/investor-education/>.