James J. Angel, Ph.D., CFP®, CFA
Associate Professor of Finance
Georgetown University[1]
McDonough School of Business
Washington DC 20057
angelj@georgetown.edu
+1 (202) 687-3765
Twitter: @GuFinProf

May 6, 2022

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506
pubcom@finra.org

Re: Regulatory Notice 22-08, Complex Financial Products

Dear FINRA:

I commend you for taking on this important yet difficult task. Complex financial products bring up two important regulatory considerations: Investor protection, and systemic risk. While systemic risk is extremely important, I will focus on investor protection in this letter. The best way to protect investors is to make sure they understand what they are doing. This can be done by having them pass a short quiz before trading each category of financial instruments.

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else. Over the years I have served as a Visiting Academic Fellow at the NASD, served on the boards of the EDGX and EDGA exchanges, served as Chair of the Nasdaq Economic Advisory Board, and performed consulting work for brokerage firms, stock exchanges, market makers, and law firms. I've also visited over 75 stock and derivative exchanges around the world. As a finance professor, I practice what I preach in terms of diversification and own modest holdings in most public companies, including brokers, asset managers, market makers, and exchanges.

It is not in society's or the industry's best interest to blow up investors.

Our economy depends upon the willingness of people to invest their money in productive enterprises. Without investors, there would be no investment and our economy would wither away. Yet all of these investments bear substantial risk, so we need investors who are willing to take on investment risks.

Our economy also benefits substantially from risk transfer tools. Derivatives are efficient mechanisms for transferring a particular risk from one party that does not want it to one that does. The riskiness of these products is not a bug, but a feature. Like other useful tools such as chainsaws, they can do great good but also can cause damage to the careless and unlucky.

It is not in the interest of society or the industry to let investors blow themselves up, especially novice ones. Investors whose first investment experience is a big loss are likely to believe that the financial markets are rigged and unfair. They may exit the market and thus deprive our economy of badly needed growth capital while they call for punitive actions against the financial industry. For this reason, it is in the public interest to provide some safeguards that would reduce the risk of extremely bad outcomes for unsophisticated investors. However, these safeguards must be appropriate, effective, and not overly burdensome. So what actually makes sense?

There is general agreement that we need to protect investors from the fraudsters who would sell bogus financial instruments as well as the manipulators who would disrupt fair and orderly markets. There is much more controversy over the degree to which regulators should protect investors from their own ignorance or recklessness. Regulators by their nature tend to be risk averse: If a product is successful and everyone is happy, nobody thanks the regulators who approved it. If a product delivers losses, unhappy investors complain that they were bamboozled and blame the regulators for letting it happen.

One approach that does not make sense is to just ban certain financial products or categories of financial products as "too risky." Such draconian measures deprive the majority of investors from access to potentially worthwhile investments and risk transfer opportunities while depriving issuers of badly needed growth capital. Excessive regulatory risk aversion is not good for investors or society. We should never forget that when Apple went public, the Commonwealth of Massachusetts did not permit its residents to buy Apple stock.

All financial products are complex and risky.

All financial products have risk. Government bonds are generally considered "safe", but they bear substantial inflation and interest-rate risk. For example, the November 15, 2050 1.625% US Treasury bond is now trading at 70, having lost nearly 30% of its value in less than two years of existence. A naive investor who thinks a 30-year Treasury is as "safe" as a 30-day T-bill would be in for a rude surprise.

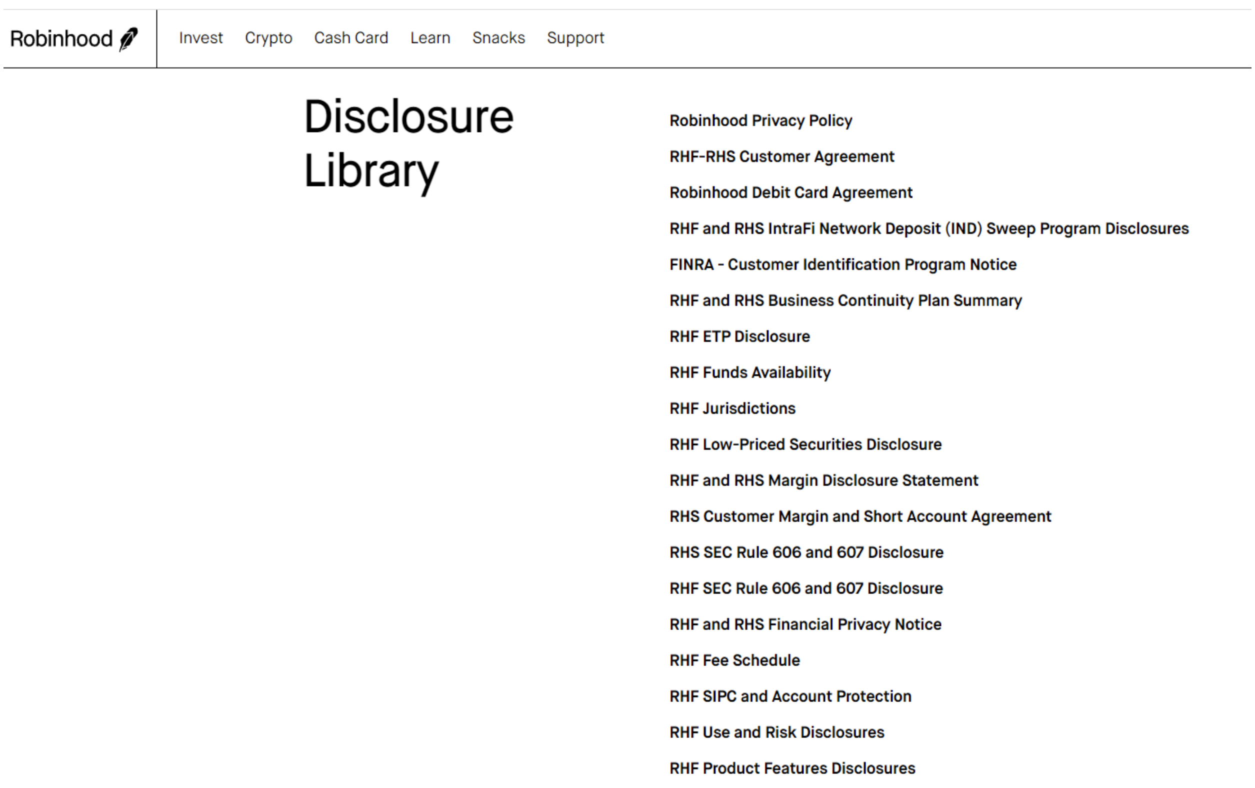
Common stocks are among the most complex products around. Most public corporations are complex enterprises. Their future cash flows are extremely uncertain, and their financial statements are filled with complex disclosures. However, this risk does not mean that we should prevent investors from investing in them. Indeed, our economy requires investment in these productive operations. We need to make sure that investors are educated on the rewards and risks of various investment products.

<u>The real issue is whether investors understand the risks of their investment strategy.</u>

Currently, broker dealers provide access to various product categories based on customer request. They consider customer-provided KYC information regarding investment objectives, wealth, and investment experience. These are crude and ineffective proxies for whether the customers understand the products they wish to trade or have the risk bearing ability to weather losses.

<u>Existing "disclosures" don't communicate.</u>

Brokers are already required to disclose many things. Here is a partial list from one popular broker. Most brokers have similar thickets of boilerplate. Few investors have read all of these, let alone understood them.



Unfortunately, these disclosures are generally written by lawyers for lawyers, and are difficult for mortals to comprehend. For example, the required 95-page Characteristics and Risks of Standardized Options starts out with:

> This document relates solely to options issued by The Options Clearing Corporation (OCC), and all references to "options" in this document are applicable only to such options. As of the date of this document, options are traded on the United States markets listed prior to the Table of Contents. In the future, options may be traded on other markets within or outside the United States. The markets on which options are traded at any given time are referred to in this document as the "options markets." Options described in this document are those approved for trading on the options markets but may not be actively trading at any given time.
>
> OCC is a registered clearing agency, and each U.S. options market is a national securities exchange that is subject to regulation by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934.
>
> What is an option? An **option** is the right to buy or sell a specified amount or value of a particular underlying interest at a fixed exercise price by exercising the option before its specified expiration date. An option that gives the right to **buy** is a **call** option, and an option that gives a right to **sell** is a **put** option. Calls and puts are distinct types of options, and buying or selling of one type does not involve the other. Certain special kinds of options may give a right to receive a cash payment if certain criteria are met.

If you put the first page of this 95-page document through a readability checker, you get a Gunning Fog Index 15.8, which is "too hard for most people to read."[2]

Flesch Reading Ease score: 42.5 (text scale)
Flesch Reading Ease scored your text: difficult to read.
[f] | [a] | [r]

Gunning Fog: 15.8 (text scale)
Gunning Fog scored your text: difficult to read.
[f] | [a] | [r]

> The ideal score for readability with the Fog index is 7 or 8. Anything above 12 is too hard for most people to read. For instance, The Bible, Shakespeare and Mark Twain have Fog Indexes of around 6. The leading magazines, like Time, Newsweek, and the Wall Street Journal average around 11.

Flesch-Ki
Grade lev
[f] | [a] |

[2] https://readabilityformulas.com/freetests/six-readability-formulas.php

We need to make sure that investors demonstrate comprehension.

Again, it is not in the best interest of society or the industry to let the noobs blow themselves up. The short-term revenue to be gained at the expense of a lifelong investor is not worth it. Just prohibiting people from trading is not the solution. The solution is to make sure that investors know what they are doing.

Brokers should administer a simple on-line quiz before granting trading permissions.

There is only one way to make sure that investors comprehend what they are doing: test them. This need not be an arduous or difficult process. For each category of financial instruments, require that the person take and pass a short quiz about that category. When a person requests permission from their broker to trade a particular class of instruments on the broker's web site, the web site would give them a short multiple choice quiz about that asset class. Each quiz would have between five and ten questions. The quiz would give immediate feedback for each question in order to educate the investors who miss questions. An investor who fails could retake the quiz the next day.

The categories requiring testing could include

- Equities
- Fixed income products
- Mutual funds
- Exchange-Traded Products (ETPs)
- Margin
- Short selling
- Inverse and leveraged ETPs
- IPOs
- Options (long)
- Options (short)
- Futures
- Cryptos

Let FINRA design the quizzes and the brokers administer them.

FINRA is very good at designing tests. FINRA should design the quizzes for each category in order to have consistency across the industry. However, it makes sense that the brokers should administer the quizzes to reduce administrative complexity and burden on investors: If a customer wants to trade a particular product, the web site asks a few basic questions. If the customer passes, they can trade that product immediately. For a knowledgeable investor, this should take no more than ten minutes and thus not be a burden on the customer or the firm.

If the customer fails, they can be directed to an online tutorial, either on the broker's own web site, or another one (perhaps FINRA's?) that would teach the investor what they need to know for that particular product class.

Once is enough.

Once a customer has passed the quiz for a particular product, there is no need to bother them or the broker to make them take it again.

Grandfather existing users.

In order to reduce the implementation challenge, customers who are already using existing products should be exempt from the testing requirement.

Respectfully submitted,

James J. Angel, Ph.D., CFP®, CFA
Georgetown University