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Morningstar Comments on Regulatory Notice 24-13

Ladies and Gentlemen:

Morningstar welcomes the opportunity to comment on FINRA's request for comments on the effectiveness and efficiency of its requirements relating to day trading. Morningstar's mission is to empower investor success while not sacrificing investor protection. Morningstar has conducted research on investor behavior, and we bring our expertise to bear on the questions in the FINRA request.

In 2021, Morningstar conducted a study investigating investing behavior to help individual investors and their ecosystem avoid common behavioral biases in response to the SEC's Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices.[1] This study provides numerous insights that shed light on the limitations of the definition of the promotion of day trading outlined in FINRA Rule 2130.

In this letter, we answer a few of FINRA's questions and provide our recommendations for future proposed rules.

Executive Summary

To assist FINRA in achieving its objectives, we offer the following comments and recommendations:

- Expand the definition of the promotion of day trading to account for digital "nudges" such as push notifications informing investors of hot stocks or even market volatility.
- In margin accounts, a trade can count toward a customer's pattern day-trading designation regardless of whether the trade uses a margin. Expanding the definition of the promotion of day trading to include defaulting trading accounts to margin accounts could be an effective way to mitigate impulsive day-trading habits.

[1] Szapiro, A. Sethi, J., & Wendel, S. 2021. "RE: Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices." Comment Letter on Digital Engagement Practices. Morningstar. https://www.sec.gov/comments/s7-10-21/s71021-9316157-260072.pdf. (Comment Letter on Digital Engagement Practices)

- Currently, risk disclosures are mainly required when day trading is promoted or when a customer opens an account. We emphasize that more effective disclosures in changing investor behavior are those presented clearly and "just in time" as such disclosures provide easy-to-understand information right when an investor needs it most. We recommend FINRA consider specific just-in-time disclosures regarding day trading when an individual trades multiple times in one day as a method for curbing excessive risky activity. If FINRA proposed just-in-time disclosure requirements for comment, then commenters may be able to provide data in addition to what we have summarized here and insight that speaks to the effectiveness of such disclosures for mitigating the unanticipated risks of day trading.

I. The Definition of The Promotion of Day Trading is Outdated and Should Account for Digital Nudges, Which May Induce People to Trade Excessively.

As FINRA conducts its retrospective review of its requirements governing day trading, Morningstar asks FINRA to reconsider the current definition of the promotion of day trading as we believe this definition is outdated. This definition is important to consider for answering question 1 from the notice, "Have the original purposes of and need for the day-trading requirements (including the day-trading account approval and risk disclosure requirements, and the pattern day trading requirements) been affected by changes to technology?"

FINRA rule 2130 defines the promotion of day trading as follows:

"A member shall be deemed to be "promoting a day-trading strategy" if it affirmatively endorses a "day-trading strategy," as defined in paragraph (e) of this Rule, through advertising, its website, trading seminars, or direct outreach programs. For example, a member generally shall be deemed to be "promoting a day-trading strategy" if its retail communications address the benefits of day trading, rapid-fire trading, or momentum trading, or encourage persons to trade or profit like a professional trader. A member also shall be deemed to be "promoting a day-trading strategy" if it promotes its day-trading services through a third party. Moreover, the fact that many of a member's customers are engaging in a day-trading strategy will be relevant in determining whether a member has promoted itself in this way."[2]

Under this current definition, only explicit advertisements of day trading are promotion, whereas softer promotional materials such as digital "nudges" in the form of push notifications are not. The SEC has previously relied on the definition of nudge in the book *Nudge: Improving Decisions About Health, Wealth, and Happiness* by Thaler & Sunstein 2009: "any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives."[3] Under this definition, push notifications are a digital nudge because they do not forbid any action nor do they alter incentives; instead, they

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[2] FINRA. 2013. "2130. Approval Procedures for Day-Trading Accounts." https://www.FINRA.org/rules-guidance/rulebooks/FINRA-rules/2130.

[3] Thaler, R.H., & Sunstein, C.R. 2009. "Nudge: Improving Decisions About Health, Wealth, and Happiness." P. 6. https://www.researchgate.net/file.PostFileLoader.html?id=53abe564cf57d7df1e8b45f4&assetKey=AS%3A273548994646025%401442230571326. The SEC uses this definition of "nudge" in its Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices.

provide suggestions and reminders in order to influence behavior. In the case of trading apps, a digital nudge could be used to induce increased trading activity.

Digital nudges that induce people to trade excessively should be viewed by FINRA as promoting day trading. Push notifications may influence casual traders to trade more than they otherwise would have simply by reminding them of the market and how it is performing.

Push notifications can and do induce people to trade more often. For example, the financial app Betterment pushed notifications during periods of market volatility as a warning to users. After assessing the impact of these warnings, Betterment found that "despite their good intentions, they were incentivizing people to trade more when they sent out these notifications, because the preponderance of their clients had never worried in the first place."[4] Moreover, Morningstar's study found that investors—experienced or not—by and large dislike the promotion of day trading through push notifications, with the exception of active day traders.[5]

Reminding customers of the prices of stocks through push notifications can be enough to increase trading. The definition of promoting day trading should be expanded to include any digital practices that encourage people to trade more. These digital nudges currently fall under the radar.

The existing climate for day-trading promotion is such that day-trading promotion does not occur nearly as much as it used to, but that is not necessarily true. Promotion does not occur in the same ways it used to, but promotion still occurs, especially by way of these digital nudges and other engagement practices.

II. Setting Margin Accounts as The Default for Day Trading Promotes Risky Trading Activities.

FINRA Rule 4210 "Margin Requirements" defines "day trading" as "the purchasing and selling or the selling and purchasing of the same security on the same day in a margin account."[6] This rule falls under FINRA's proposed retrospective rule review, making margin accounts and how people interact with them a primary concern. FINRA states that day-trading activities do not necessarily solely occur in margin accounts and can occur in cash accounts as well. Morningstar agrees with this belief and would be supportive of limiting day trading in both cash and margin accounts. Nonetheless, at a minimum, we recommend that FINRA start by addressing how some trading apps default user accounts to margin accounts.

Expanding the definition of the promotion of day trading to include trading apps defaulting to margin accounts could help introduce new requirements to margin accounts. Margin trading is risky for unsophisticated investors, and trading apps should not throw new traders and users into margin trading with little understanding or experience. Yet when trading apps default the account settings to margin accounts, they do just that.

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[4] Benz, C. 2021. "Daniel Crosby: 'If You're Excited About It, It's Probably a Bad Idea.'" Morningstar. https://www.morningstar.com/portfolios/daniel-crosby-if-youre-excited-about-it-its-probably-bad-idea.
[5] Comment Letter on Digital Engagement Practices. P. 22.
[6] FINRA. 2024. "4210. Margin Requirements (f)(8)(B)(i)". https://www.FINRA.org/rules-guidance/rulebooks/FINRA-rules/4210.

Morningstar considers trading apps defaulting to margin accounts to be an endorsement of margin accounts. By presenting margin accounts to unsophisticated investors, trading apps are promoting margin trading, and therefore the definition of promoting day trading should expand to include such practices. Promoting margin accounts is promoting day trading as Rule 4210 defines it. By enabling thousands or even millions of investors to engage in trading through margin accounts, these firms are creating a situation in which investors are more likely to trade during periods of market volatility.

At the minimum, if a financial firm or trading app defaults investors into margin accounts, then they should come with effective disclosures on the risks of margin trading while informing the investor how and if they can change their account type, encouraging safer financial activities.

III. Risk Disclosures Are Most Effective When They Are Presented "Just In Time."

Question 4 of the regulatory notice asks, "How effective are the risk disclosure requirements in communicating the potential risks of day trading to prospective customers?" FINRA Rule 2270 requires that trading platforms provide risk disclosures whenever they are deemed to promote day trading. However, more useful risk disclosures would be effective when provided to investors not just at promotion but imminently before trade execution. We intend to address this question specifically by focusing on "just-in-time" disclosures.

Risk disclosures are an effective tool for protecting investors from risky trading practices they are not prepared for, but when and how they are presented to the investor matters. Easy-to-understand, simple disclosures will help inform unsophisticated investors, such as those defaulted into margin accounts, of the risks associated with trading activities. In order for just-in-time disclosures to be most effective and not burdensome they should be particularly pertinent to the transaction at hand. Clear disclosures may involve basic numerical examples of risks that give investors a tangible understanding of how the risks could affect them.

Not only is it important for financial firms to make risk disclosures clear and concise, but when firms present the disclosures to investors matters. When financial firms present just-in-time disclosures, they are providing the disclosure when an investor is making an important financial decision. To use margin trading as an example, presenting a risk disclosure on the risks of margin trading before execution of the trade—when the investor is actively making a decision—would remind the investor of the risks when they need to consider them the most. For example, Betterment successfully discouraged overtrading with a just-in-time disclosure that popped up before the execution of a trade reminding people of the tax consequences of such trades. That disclosure provided investors with the information they needed exactly when they needed it most. The disclosure slowed the process of the trade, allowing more time for investors to consider their actions.

Relevant to consideration of just-in-time disclosures is an experiment conducted by the Financial Conduct Authority of the UK. This experiment examined investor behavior when purchasing a fund in response to "warnings." One treatment group had to click through a disclosure on the "review screen" of a trade in the form of a just-in-time disclosure. Other groups received warnings and charts providing information on the fund in comparison to other funds before the investor initiated the trade. The control group received nothing.[7] The researchers found that a just-in-time disclosure on the review screen resulted in a 10.5% increase in the number of people canceling the purchase, revisiting the landing page, and selecting a different, cheaper fund than those who did not receive a review screen. While all groups receiving disclosures experienced a change in decision-making toward cheaper funds, just-in-time disclosures through review screens had the most impact on behavior.

Conclusion

In summary, we support FINRA's retrospective rule review on the efficacy and efficiency of day trading and encourage FINRA to broaden the definition of promotion of day trading. First, Morningstar suggests expanding the definition to include digital nudges by financial firms and trading apps, particularly broker-dealers in the form of push notifications. FINRA should, however, take care in that expansion not to stifle push notifications completely, as financial firms can use them to promote saving and other financially healthy practices.

Second, Morningstar suggests FINRA expand the definition of promotion of day trading to include defaulting trading accounts to margin accounts, as doing so promotes day trading.

Third, Morningstar emphasizes the importance of clear, brief, and direct disclosures provided just in time to give investors critical information exactly when they most need it in an easy-to-understand manner.

We thank FINRA for the opportunity to comment on the Request for Information. Should you wish to discuss any of the comments in this letter, please do not hesitate to contact any of us as indicated below:

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[7] Hayes, L., Lee, W., & Thakrar, A. 2018. "Now You See It: Drawing Attention to Charges in the Asset Management Industry." Financial Conduct Authority, Occasional Paper 32, P. 1-32. https://www.fca.org.uk/publication/occasional-papers/occasional-paper-32.pdf.