

# Legal Update

## Continuing Focus on Complex Products: FINRA Sweep Update on Supervision of Options Trading Accounts

Complex products continue to be a regulatory cause célèbre, drawing attention from the Securities and Exchange Commission (“SEC”) and the Financial Industry Regulatory Authority, Inc. (“FINRA”).

In October 2020, the SEC issued a joint statement by then Chairman Jay Clayton; Dalia Blass, Director, Division of Investment Management; William Hinman, Director, Division of Corporation Finance; and Brett Redfearn, Director, Division of Trading and Markets, that noted times of “market stress ... typically have a disproportionate impact on complex products, such as leveraged/inverse products ...” and observed that the “pricing and trading dynamics of these products during the spring market was not consistent with investor expectations” even though the relevant products had operated in accordance with their terms. The statement went on to note that the SEC would “consider requirements that include, among other things, additional obligations for broker-dealers and investment advisers relating to complex products, as well as point-of-sale disclosures or policies and procedures tailored to the risks of complex products.”<sup>1</sup> Roughly a year later, in a statement on complex exchange traded products in October 2021, Chair Gary Gensler reiterated that he “directed staff of the Securities Exchange Commission to study the potential risks of complex financial products...” and (specifically in reference to exchange traded products) noted these products “can pose risks even to sophisticated investors, and can potentially create system-wide risks by operating in unanticipated ways when markets experience volatility or stress conditions.” He concluded by stating that “potential rulemaking could strengthen the investor protections around these products.”<sup>2</sup> When addressing the International Swaps and Derivatives Association in May 2022, Chair Gary Gensler once again addressed complex products and reiterated the same themes stating that “The use of derivatives can present unique and potentially significant risks to investors across market sectors. These investment products, though, also can pose risks even to sophisticated investors, and can potentially create system-wide risks by operating in unanticipated ways when markets experience volatility or stress conditions.... I’ve asked our Division of Investment Management and Division of Examinations to take a renewed and focused look at the use of derivatives by registered investment companies so that they’re compliant with our rules.”<sup>3</sup> Chair Gensler also stressed that while complex products may be offered and traded in a manner consistent with federal securities laws, such products are not suitable for all investors. FINRA has also weighed in on complex products by releasing Regulatory Notice 22-08 (Complex Products and Options) in March 2022 (our Legal Update on Notice 22-08 is available [here](#)).

FINRA launched a targeted examination of practices relating to options account opening, ongoing options account supervision and customer communications in connection with options in August 2021.<sup>4</sup> Earlier this month, FINRA provided updated guidance in the form of questions for firms to consider as they review and evaluate their supervisory systems for options account activity of both self-directed and full-service brokerage account customers.<sup>5</sup> The questions focus on firms' processes for approving customers to trade options, including related information gathering, options trading disclosures and ongoing supervision of options accounts.

In the updated guidance, FINRA also reminds member firms of their existing obligations under FINRA Rules 2360 (Options), 2090 (Know Your Customer), 2210 (Communications with the Public), 2220 (Options Communications), 2260 (Disclosures), 2264 (Margin Disclosure Statement), 3110 (Supervision), 4210 (Margin Requirements) and 4512 (Customer Account Information), as well as, in the case of retail customers, Regulation Best Interest.

## Options Account Approval

Member firms are required, under existing rules, to implement procedures for conducting due diligence when approving customers for options trading accounts. In the updated guidance, FINRA acknowledged that firms take a variety of approaches, spanning from fully manual to fully automated, to reviewing customer account information and applications for options trading accounts. Suggested questions, in addition to several others, for firms to consider when evaluating their policies and procedures include the following:

- whether a firm permits an options account applicant to select a level (rather than defaulting to the highest level of approval) for which they may be eligible;
- whether a firm imposes enhanced requirements for complex options trading;
- whether applications are reviewed for potential red flags, including logical inconsistencies, in the information provided by customers in account applications;
- whether (and how) policies address situations where the customer resubmits a modified application; and
- whether a firm employs systems and controls to identify customers that were erroneously approved to trade options or are trading above their previously approved level.

## Options Disclosures

FINRA also provided a list of suggested questions for firms to consider in connection with member firms' ongoing disclosure obligations and responsibilities with respect to communication with customers regarding options. Among the suggestions were the following:

- whether a firm tailors communications to potential customers based on background, including limiting communications to customers meeting eligibility criteria;
- whether a firm provides supplementary disclosures to customers when approved for a higher level of trading or otherwise provides information specifically relating to complex options strategies;

- whether any representations made with respect to maximum loss are properly caveated (e.g., with respect to dividend risk); and
- whether additional educational opportunities (e.g., seminars, videos, articles, guides) are available and when this information is provided to customers.

## Options Trading Supervision

Finally, FINRA also reminded member firms that their procedures, processes, systems and controls for options trading should consider the firm’s overall risk profile in addition to considering the relevant FINRA Rules and other regulatory obligations. Among other questions, FINRA suggests that firms consider the following:

- whether ongoing reviews of trading activity are performed to confirm customers do not engage in trading beyond their approved level;
- whether ongoing evaluations of customer accounts and account activity are performed and customer account information is reviewed to determine whether certain accounts should be downgraded;
- whether accounts approved for complex options strategies are reviewed with more frequency; and
- whether account eligibility is revisited as market conditions change.

The updated FINRA guidance is not intended to create any additional requirements or provide new interpretations of existing requirements. It is merely offered by FINRA for consideration by member firms when developing new, or reviewing and modifying existing, practices in connection with their existing obligations to maintain a reasonably designed supervisory system and written procedures for options account approvals, options trading supervision, and customer communication and diligence related to options accounts and trading. Hyperlinks to additional resources on this topic are also provided by FINRA in the Appendix to the updated guidance.

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## Endnotes

- <sup>1</sup> See the SEC’s [Joint Statement Regarding Complex Financial Products and Retail Investors](#).
- <sup>2</sup> See SEC Chair Gensler’s [Statement on Complex Exchange Traded Products](#).
- <sup>3</sup> See SEC Chair Gensler’s [“A ‘New’ New Era”: Prepared Remarks before the International Swaps and Derivatives Association Annual Meeting](#).
- <sup>4</sup> See [FINRA Targeted Examination Letter on Option Account Opening, Supervision and Related Areas](#).
- <sup>5</sup> See FINRA’s [Update on Sweep: Option Account Opening, Supervision and Related Areas](#).