

MEMO# 34082

March 21, 2022

FINRA Solicits Comments on Sales Practices for Complex Products; Member Call Scheduled for April 4 at 2 pm (Eastern)

[34082]

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TO: ICI Members SUBJECTS: Advertising

Alternative Investments

Closed-End Funds

Compliance

Disclosure

Distribution

Exchange-Traded Funds (ETFs) RE: FINRA Solicits Comments on Sales Practices for Complex Products; Member Call Scheduled for April 4 at 2 pm (Eastern)

FINRA recently issued a regulatory notice expressing concerns associated with the sale of complex products and options to retail investors, and soliciting comment on related practices and rule enhancements.[\[1\]](#) The notice describes what FINRA views to be complex products, which could include certain regulated funds (e.g., leveraged and inverse funds ("geared funds"), defined outcome exchange-traded funds, interval and tender offer funds, and "alternative funds"), and highlights regulatory concerns that arise when investors trade complex products and options without fully understanding their characteristics and risks. It then describes actions that regulators have taken to strengthen investor protections around the sale of these products and the increased trading volumes in them.

FINRA asks several questions about the sale of complex products and related regulations, including whether it should require enhanced policies and procedures that could restrict the ability of self-directed investors to make unsolicited investments in complex products, and requests feedback by May 8. ICI will have a member call to discuss the notice and potential comments on Monday, April 4 at 2:00 pm (Eastern Time). If you would like to participate in the call, please contact Nadia Ishmael at nadia.ishmael@ici.org to receive dial-in information. In the meantime, if you have any questions or comments about the notice, please contact Ken Fang at kenneth.fang@ici.org.

We briefly summarize the notice below.

I. Complex Products and Related Concerns

FINRA notes that there is no standard definition of a "complex product" but describes one broadly 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).

It provides several examples of complex products, including several types of registered funds. These would include geared funds, defined outcome exchange-traded funds that offer exposure to certain assets (e.g., a market index) with downside protection on potential losses and an upside cap on potential gains over a period, funds that offer strategies employing cryptocurrency futures, interval and tender offer funds, and alternative funds.[\[2\]](#) FINRA notes that these examples are not exhaustive.

FINRA states that complex products may have features or payout structures that would be confusing to retail investors or may perform unexpectedly in various market or economic conditions, even if they do not create more investment risk. It indicates that these concerns may be heightened when a retail investor accesses these investments through a self-directed platform without the assistance of a financial professional. In addition, it states that the products potentially could create system-wide risks by performing unanticipatedly when markets experience volatility or stress. It therefore concludes that well-conceived protections in the sale and trading of complex products benefits market integrity in underlying markets.[\[3\]](#)

II. Regulatory Actions and Increased Trading Volume Related to Complex Products

The notice summarizes the efforts of FINRA, the Securities and Exchange Commission,[\[4\]](#) and foreign regulators[\[5\]](#) to address the risks of complex products.[\[6\]](#) It highlights several actions FINRA has taken to issue guidance,[\[7\]](#) adopt product-specific rules,[\[8\]](#) and implement a risk-based examination program.[\[9\]](#)

The notice then describes the increased trading in complex products and options. It cites that the US structured retail products market is continuing to show record volumes of products launched. It states that defined outcome ETFs have grown to nearly 150 ETFs with almost \$10 billion in market value. It notes that, while the number of geared ETPs and the market value they represent have remained fairly stable, some geared ETPs often are among the most actively traded ETPs and retail investors continue to purchase them.[\[10\]](#)

III. Request for Comment

Given the continued concerns and increased activity regarding complex products and options, FINRA is soliciting comments in a number of related areas. FINRA focuses particularly on those accessible to self-directed retail investors, and whether the current regulatory framework is appropriate to address the concerns that complex products and options raise.

It provides an extensive list of questions that FINRA may use for future rulemaking that might affect the sale of complex products and options. These include questions about: how complex products are categorized; whether any product-specific requirements FINRA has issued should apply more generally to complex products; and should different or additional requirements be applied to complex products, even for self-directed transactions (e.g.,

whether FINRA members should implement an account approval process before a retail customer account can transact in a complex product; whether retail customers should demonstrate their understanding of complex products by completing a knowledge check; and whether it should require retail customers to review disclosures and attest that they have read and understood them before permitting them to transact in a complex product). We attach the full list of the questions related to complex products as Appendix A.

Kenneth Fang
Associate General Counsel

endnotes

[1] See FINRA Regulatory Notice 22-08, Complex Products and Options (Mar. 8, 2022), available at www.finra.org/rules-guidance/notices/22-08?msclid=1684061ba6c711ecb4227fd878791a8c.

[2] FINRA indicates that complex products could include "alternative funds," which it previously described as registered funds that seek to accomplish their objectives through non-traditional investments and trading strategies. These funds might invest in assets such as global real estate, commodities, leveraged loans, start-up companies, and unlisted securities that offer exposure beyond traditional stocks, bonds, and cash. See notice at n. 40 (citing to FINRA Investor Alert: Alternative Funds Are Not Your Typical Mutual Funds (June 11, 2013), available at www.finra.org/investors/alerts/alternative-funds-are-not-your-typical-mutual-funds?msclid=28a986efa6d411ec98c0b90df2f96d0b).

[3] The notice provides similar background for options, which could raise concerns when investors transact in them without understanding their vocabulary, strategies, and risks.

[4] The notice highlights several SEC actions intended to address the risks of complex products, including:

- SEC Chair Gensler's 2021 direction to SEC staff to study the risks of complex exchange-traded products ("ETPs") and to present recommendations for potential SEC rulemaking to address those risks.
- The SEC's 2019 adoption of Regulation BI emphasizing the importance of understanding the features and risks of complex products to establish a reasonable basis to recommend them to retail customers, and the SEC's 2019 interpretation regarding investment adviser standards of conduct suggesting that firms apply heightened scrutiny when assessing whether recommendations of potentially high-risk products are in a retail customer's best interest.
- The SEC's 2019 proposed sales practices rules that would have required broker-dealers and SEC-registered investment advisers to exercise due diligence in approving a retail customer or client's account to transact in certain geared investment vehicles before accepting or placing orders to engage in those transactions.
- The statement from Former SEC Chair Clayton and SEC staff noting concerns that retail investors are independently selecting complex products for which they may not appreciate the unique characteristics and risks and stating that the SEC staff would review the effectiveness of existing regulatory requirements in protecting

investors—particularly those for self-directed accounts—who invest in complex products.

- Statements from the SEC's Division of Examinations about focusing on complex products and enforcement actions from the SEC's Division of Enforcement with respect to the sale of complex ETPs.

[5] The notice highlights several examples of foreign regulator actions related to the sale of complex products, including:

- Europe: Regulations and guidelines under the EU's Markets in Financial Instruments Directive ("MIFID II") providing that firms should adopt robust and objective procedures, methodologies, and tools to appropriately consider the different characteristics and risk factors of each investment product they recommend and match that with investor information. In addition, for non-advised accounts trading complex products, MIFID II requires firms to assess the appropriateness of the investment and issue warnings if the investor does not have the knowledge or experience to understand a product's risks.
- Canada: Enhanced suitability obligations and product due diligence and guidance through which firms can determine that a particular security is appropriate for retail investors because it has complex or unique features that make it difficult to understand.
- Hong Kong: Definitions of what complex products are and providing minimum information and warning statements that must be provided to investors.
- In addition, the notice cites to international regulations that impose product governance obligations to ensure that product development is client focused and distribution is consistent with an identified target market for the product.

[6] The notice also briefly describes FINRA's actions to address the risks of options, including issuing guidance reminding FINRA members of the steps that they must take to approve investors to trade options. See FINRA Regulatory Notice 21-15, FINRA Reminds Members About Options Account Approval, Supervision and Margin Requirements (Apr. 9, 2021), available at <https://www.finra.org/rules-guidance/notices/21-15>.

[7] The FINRA-issued guidance includes Regulatory Notice 12-03, which broadly discusses complex products and provides guidance regarding related compliance procedures. See FINRA Regulatory Notice 12-03, Heightened Supervision of Complex Products (2003), available at www.finra.org/rules-guidance/notices/12-03. FINRA also has published regulatory notices focusing on the particular risks of specific products, such as structured products, geared ETPs, principal protected notes, commodity futures-linked ETPs, reverse convertibles, volatility-linked ETPs, and oil-linked ETPs.

[8] FINRA has adopted rules to address risks from specific types of products (e.g., options, security futures, direct participation programs, deferred variable annuities, index, currency index, and currency warrants) and reminds its members to review their obligations under those rules as well as under Regulation BI.

[9] FINRA's examination program, among other things, reviews relevant communications and disclosures made to customers, analyzes related customer account activity, and evaluates supervisory systems and controls to mitigate risk.

[10] The notice also cites to the large growth in the trading volume for listed options, growing to over 38.6 million contracts a day in 2021, more than 30 percent higher than the

29.6 million contracts per day in 2020, and almost 100 percent higher than the 19.8 million contracts per day in 2019.

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