

MEMO# 34122

April 25, 2022

Draft ICI Comment Letter on FINRA's Request for Comment on Sales Practices for Complex Products; Comments Requested by May 2

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TO: Closed-End Investment Company Committee
ETF (Exchange-Traded Funds) Committee
Investment Adviser and Broker-Dealer Standards of Conduct Working Group
Registered Fund CPO Advisory Committee
SEC Rules Committee
Variable Insurance Products Advisory Committee RE: Draft ICI Comment Letter on FINRA's Request for Comment on Sales Practices for Complex Products; Comments Requested by May 2

In March, FINRA 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 potential 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, 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.^[2] FINRA asks several questions about the sale of complex products and related regulations, including whether it should apply enhanced requirements that could restrict the ability of investors, including self-directed investors, to make investments in them.

ICI's draft comment letter in response to the notice is attached for your review. Please provide any written comments to Ken Fang at kenneth.fang@ici.org by close of business on Monday, May 2, 2022. Comments on the notice are due to FINRA by May 9, 2022.

Summary of Draft Letter

The draft letter strongly opposes imposing any additional requirements on the purchase or sale of any publicly offered funds because FINRA may deem a fund to be a "complex" product.^[3] It notes that funds already are subject to substantive regulations aimed at

protecting retail investors, and that the Securities and Exchange Commission has long recognized that this panoply of requirements is sufficient to enable funds to publicly offer their shares freely to retail investors, subject to the existing suitability and best interest determinations that apply to all broker-dealer recommendations.

The draft letter states that carrying over in full fixed wealth, knowledge, or other requirements to entire classes of securities, particularly those that are subject to regulation under the Investment Company Act, would be a monumental and draconian shift in regulatory policy that could blur the historic dividing line between public and private offerings.^[4] It would mark a change from the existing disclosure-based, product-agnostic regulatory regime to one that evaluates the merits of each product. This would be especially true if FINRA, as it is considering, were to impose enhanced requirements on self-directed transactions—those that investors themselves choose to engage in and do not involve a broker-dealer recommendation.^[5] Heading in this direction could be the beginning of a slippery slope where the government substitutes its judgment for those of investors, and the draft letter strongly disagrees with these contemplated approaches.

Further, the draft letter states that applying any additional requirements to instruments that FINRA deems "complex" without clearly defining or describing such term raises concerns about the arbitrary scope and breadth of any potential requirements.

The draft letter sets forth concerns with imposing any additional requirements on the purchase or sale of publicly offered funds in four sections, explaining how any new requirements:

- would undermine the current disclosure-based securities law framework (Section I);
- are unnecessary for publicly offered funds (Section II);
- would be applied arbitrarily, given the overly broad scope of what a complex product might be (Section III); and
- would reduce investor choice and inhibit innovation (Section IV).

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?msclkid=1684061ba6c711ecb4227fd878791a8c. For a summary of the Regulatory Notice, please see ICI Memorandum No. 34082, available at www.ici.org/memo34082.

^[2] FINRA does not define "complex product" but describes one generally 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).

See notice at 3.

[3] For purposes of the draft letter, the term "fund" refers to investment companies registered under the Investment Company Act of 1940 and business development companies that elect to be regulated under that Act.

[4] Although FINRA does not specify what form any additional restrictions would take, it suggests that restrictions could range from wealth- and knowledge-based requirements traditionally imposed on private offerings to additional required disclosure. The draft letter disagrees with any wealth- and knowledge-based requirements and states that the SEC, not FINRA, should impose any additional disclosure requirements related to any specific types of complex products that it deems necessary through its regulatory authority over registered offerings.

[5] FINRA traditionally has not imposed restrictions on self-directed transactions, and the draft letter questions whether FINRA has the authority to do so absent a broker-dealer recommendation.