

MEMO# 34128

May 5, 2022

ICI Files Comment Letter on FINRA's Request for Comment on Sales Practices for Complex Products

[34128]

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TO: ICI Members SUBJECTS: Advertising

Alternative Investments

Closed-End Funds

Compliance

Derivatives

Disclosure

Distribution

Exchange-Traded Funds (ETFs) RE: ICI Files Comment Letter on FINRA's Request for Comment on Sales Practices for Complex Products

Earlier today, ICI filed the attached comment letter in response to a FINRA 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] FINRA's 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"). It 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.

Summary of Comment Letter

ICI's comment 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 letter states that layering wealth, knowledge, or other requirements on the purchase or sale of publicly offered securities, including funds, 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.

Further, the 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.

It adds that additional requirements could reduce investor choice and stymie product innovation by, among other things, discouraging issuers from developing new products (e.g., funds that have complex investment strategies but carry relatively low risk) in favor of "plain vanilla" products that are not deemed complex.

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

- would undermine the current disclosure-based securities law framework (Section I);
- are unnecessary for funds, because of the robust regulatory framework they already are subject to (Section II); and
- would be applied arbitrarily, given the overly broad scope of what a complex product might be (Section III).

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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] 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 whose securities offerings are registered under the Securities Act of 1933.

[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 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 letter questions whether FINRA has the authority to do so absent a broker-dealer recommendation.

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