INVESTMENT COMPANY INSTITUTE®

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May 5, 2022

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 22-08: Complex Products and Options

Dear Ms. Mitchell:

The Investment Company Institute[1] strongly opposes imposing any additional requirements on the purchase or sale of any publicly offered funds[2] because FINRA may deem a fund to be a "complex" product.[3] Although we support FINRA's overarching goal of protecting investors and ensuring that investments are appropriate for them, the contemplated requirements are unnecessary for funds. Funds already are subject to substantive regulations aimed at protecting retail investors that when coupled with the existing suitability obligations and best interest conduct standard for broker dealers provide a robust regulatory framework.

This letter describes the robust requirements applicable to funds and relevant requirements applicable to broker-dealers and sets forth our concerns with FINRA imposing any new requirements on fund purchases or sales simply because a fund is deemed a complex product. We explain below how FINRA doing so:

- would undermine the current disclosure-based securities law framework (Section I);
- is unnecessary (Section II); and

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[1] The Investment Company Institute ("ICI") is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $31.3 trillion in the United States, serving more than 100 million investors, and an additional $10.0 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

[2] Unless otherwise specified, we use the term "fund" to refer to investment companies registered under the Investment Company Act of 1940 and business development companies ("BDCs") that elect to be regulated under that Act whose securities offerings are registered under the Securities Act of 1933.

[3] *See* Complex Products and Options, FINRA Regulatory Notice 22-08 (March 8, 2022) (the "Regulatory Notice"), *available at* https://www.finra.org/rules-guidance/notices/22-08. FINRA describes a complex product 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* Regulatory Notice at 3.

- would be arbitrary, given the overly broad scope of the term "complex product" (Section III).

For more than 80 years, funds have provided investors a professionally managed investment vehicle with a strong governance framework, subject to comprehensive regulation. Consistent with the historic approach under the federal securities laws, funds must adhere to strict disclosure requirements to provide investors and prospective investors with a prospectus containing key information about the fund's essential characteristics (*e.g.*, its investment objective and strategy) and principal risks, in plain English, in a standardized order and format.[4] The Investment Company Act adds an additional layer of safeguards designed to, among other things, minimize conflicts of interest, protect fund assets, reduce risks, and ensure compliance with the federal securities laws. The combination of these requirements provides investors with thorough information and additional substantive protections to ensure that fund management does not abuse its position of trust. 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. We agree.

Broker-dealers rightly make suitability and best interest decisions, which depend heavily on understanding the facts and circumstances of each investor. To layer particular 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.[5] 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.[6] Heading in this direction could be the beginning of a slippery slope where the government substitutes its judgment for those of investors.

Further, 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. In the past, FINRA has characterized a number of products as being complex or difficult to understand, including those that we estimate encompass approximately 5,600 current funds that currently have more than $7.6 trillion of

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[4] *See* Section 5(b)(2) of the Securities Act. *See also* Forms N-1A and N-2. Registration statements for open-end funds (Form N-1A) and closed-end funds (Form N-2), which include the prospectus, must be filed on the SEC's EDGAR Filing System and are publicly available.

[5] 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. We strongly disagree with any wealth- and knowledge-based requirements and believe 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. *See infra* Section I.

[6] FINRA traditionally has not imposed restrictions on self-directed transactions, and we question whether FINRA has the authority to do so absent a broker-dealer recommendation. *See infra* Section I.

assets.[7] With approximately $34 trillion of registered fund assets in the United States,[8] this means that approximately 2 out of every 5 funds might be deemed complex and subject to these enhanced requirements.

Any additional requirements have every potential to reduce investor choice and stymie product innovation. Imposing unnecessary roadblocks for investors to invest in SEC-reviewed, registered offerings may discourage them from using potentially beneficial investment tools. Issuers, too, may be discouraged from developing innovative new products that could help investors better accomplish their long-term investment goals, including funds that may have "complex" investment strategies but carry relatively low risk, in favor of more "plain vanilla" products that are not deemed complex.

I. Additional Requirements Would Undermine the Disclosure-Based Securities Law Framework

The securities laws historically have distinguished between two types of offerings—public and private. Private offerings typically have reduced protections[9] and transparency,[10] and therefore are subject to enhanced standards that require investors to meet some wealth- or knowledge-based test.[11] Public offerings typically have enhanced protections and transparency, and are available for all investors, including retail investors. Once an issuer has registered a securities offering under the Securities Act, the SEC has relied on disclosure to inform investors of the nature of the offering.[12] For example, the SEC's official investor website, Investor.gov, notes that the Securities Act has two basic objectives:

- to require that investors receive financial and other significant information concerning securities being offered for public sale; and

- to prohibit deceit, misrepresentations, and other fraud in the sale of securities.

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[7] For these purposes, the term "fund" refers to investment companies registered under the Investment Company Act and BDCs that elect to be regulated under that Act.

[8] *See* Investment Company Institute, *2021 Investment Company Fact Book*, ch. 2, *available at* https://www.icifactbook.org/21_fb_ch2.html.

[9] Investors in unregistered offerings are subject to risks not associated with registered offerings because some securities law liability provisions do not apply to private offerings.

[10] Exempt issuers generally are not required to provide information comparable to that included in a registration statement, and the Commission staff does not review information that may be provided to investors. As a result, any information that an exempt issuer provides may not provide risks in a balanced and understandable manner.

[11] *See*, *e.g.*, Section 501(b) of Regulation D (defining "accredited investor"); Rule 144A under the Securities Act (defining "qualified institutional buyer"); Section 2(a)(51) of the Investment Company Act (defining "qualified purchaser"); Rule 3c-5 under the Investment Company Act (defining "knowledgeable employee").

[12] The purpose of registering securities offerings is to provide investors with full and fair disclosure of material information about public issuers *so that investors can make their own informed investment decisions*. *See*, *e.g.*, SEC, Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 10649 (June 18, 2019), at note 2 (citing SEC Commissioner Francis M. Wheat, Disclosure to Investors—A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts (Mar. 1969)) (emphasis added), *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf.

It adds that, "[a] primary means of accomplishing these goals is the disclosure of important financial information through the registration of securities. This information enables *investors, not the government*, to make informed judgments about whether to purchase a company's securities."[13]

When broker-dealers recommend that an investor buy or sell a security, the suitability rule (FINRA Rule 2111) and best interest standard (Regulation Best Interest) provide additional protections. FINRA's suitability rule requires that a firm or associated person have a reasonable basis to believe that the recommended transaction or investment strategy involving a security or securities is suitable for the customer. Suitability is based on the information obtained through reasonable diligence of the firm or associated person to ascertain the customer's investment profile.[14] More recently, the SEC has established a "best interest" standard of conduct for broker-dealers and associated persons when they make recommendations involving any securities transaction or investment strategy involving securities.[15] Together, these regulations require broker-dealers to ensure that any recommendations are suitable for and are in the best interest of their customers.

FINRA's Regulatory Notice asks whether it should impose additional requirements on investments that it deems to be complex products.[16] FINRA is concerned that retail investors may trade complex products without understanding their unique characteristics and risks.[17] The Regulatory Notice notes that FINRA already has imposed additional product-specific conditions on certain types of investments, including, in some cases, account opening requirements and specific suitability requirements (*e.g.*, a reasonable belief that a customer has the knowledge and experience to evaluate the risks involved and the financial ability to bear these risks).[18] It asks whether it should apply those requirements or others to all complex products, such as requiring retail customers to demonstrate their understanding of complex products, providing additional required disclosure when opening an account, or requiring broker-dealers to periodically reassess retail customer accounts to ensure that initial account approvals are appropriate. Any requirements that FINRA settles on would set additional minimum thresholds or hurdles (*e.g.*, disclosure) for investors to meet before they could even

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[13] *See* Investor.gov, The Laws that Govern the Securities Industry (describing the "Securities Act of 1933") (emphasis added), *available at* www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry.

[14] *See* FINRA Website, Topics – Suitability (describing the FINRA suitability rule), *available at* www.finra.org/rules-guidance/key-topics/suitability?msclkid=292687b3bda011ec98b224ee287d61e9.

[15] *See* FINRA Website, Topics – SEC Regulation Best Interest (Reg BI) (describing broker-dealer responsibilities under the SEC's Regulation Best Interest), *available at* www.finra.org/rules-guidance/key-topics/regulation-best-interest?msclkid=61e3b111bda111ec88e48ea8e1a5bfce.

[16] *See* Regulatory Notice at Request for Comment No. 6 (asking whether certain product-specific requirements should apply more generally to complex products) and No. 7 (asking whether additional requirements should apply with respect to complex products (*e.g.*, imposing obligations before a retail customer's account may be approved to transact in complex products or requiring continuous or periodic assessments after it is approved)).

[17] *See* Regulatory Notice at 1.

[18] The products it has applied these requirements to include options, security futures, direct participation programs, deferred variable annuities, and index, currency index, and currency warrants.

access an investment. These conditions could apply not only to broker-dealer recommendations but also to self-directed transactions.[19]

We strongly oppose any additional requirements, as they are inconsistent with the historic approach of the securities laws and unnecessary. Despite the Commission's posture of letting "investors, not the government" decide what investments to make, FINRA's potential actions would produce the exact opposite effect, impeding sales of products that in FINRA's judgment require heightened protections. By imposing additional hurdles on investments in publicly offered securities, FINRA could blur the line between public and private offerings, upending the traditional positions for retail investors by imposing wealth- or knowledge-based thresholds traditionally reserved for investments in private offerings to retail products. Even adding new disclosure-based requirements risks infringing on the SEC's traditional jurisdiction on determining what disclosure is appropriate for a retail offering.[20] Imposing these conditions on the sale of retail products based on the characteristics and risks of a product also establishes a dangerous precedent of forcing government bodies to engage in merit-based regulation. It would require them to assess whether a product's characteristics and risks are difficult for a retail investor to understand, rather than simply facilitating easy-to-understand and appropriate disclosure through the SEC disclosure requirements coupled with a robust review process.

We also are concerned that FINRA may impose additional requirements on investors engaging in self-directed transactions that do not involve a broker-dealer recommendation. FINRA historically has not restricted self-directed transactions, except in extremely rare instances involving specified products that are not typical equity or fixed-income securities (options, security futures, and warrants). Expanding the scope of the restrictions to potentially encompass traditional equity and fixed-income securities would encroach greatly on a retail

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[19] *See*, *e.g.*, Regulatory Notice at Request for Comment No. 6 (asking whether account opening requirements should apply irrespective of whether a recommendation has been made), No. 7 (asking whether additional requirements should apply, regardless of whether a recommendation has been made), and No. 12 (asking whether additional guardrails are needed for self-directed platforms, including in cases where communications through the platform do not rise to the level of a recommendation under Regulation Best Interest). FINRA typically does not impose restrictions on self-directed transactions but notes that its rules governing options, security futures, and warrants apply restrictions irrespective of whether a broker-dealer has made a recommendation. *See* Regulatory Notice at 8.

[20] The SEC has established disclosure-based requirements for certain types of specialized products and continues to evaluate ways to improve upon such disclosure. *See*, *e.g.*, SEC, Special Purpose Acquisition Companies, Shell Companies, and Projections, Securities Exchange Act Release No. 94546 (Mar. 30, 2022) (proposing enhanced disclosure requirements for special purpose acquisition companies), *available at* www.sec.gov/rules/proposed/2022/33-11048.pdf. We believe that this system works and ensures that retail investors have the information they need to make an informed investment decision about those products. Notwithstanding those requirements, we agree with and, in fact, encourage FINRA and broker-dealers to continue to provide educational materials about products voluntarily.

investor's ability to freely choose what publicly offered security to invest in,[21] and we question whether FINRA even has the regulatory authority to impose such restrictions.[22]

For transactions resulting from broker-dealer recommendations, any new requirements also would provide little value, as existing regulations already seek to ensure that investors are making appropriate investments. If FINRA believes that a particular recommended investment is unsuitable or not in the best interest of an investor, then it can and should bring cases under the suitability rule or Regulation Best Interest.[23]

II. Additional Requirements are Unnecessary for Funds

The Regulatory Notice provides a non-exhaustive list of products that it believes are complex, including several types of funds (*e.g.*, leveraged or inverse funds, defined outcome ETFs,[24] mutual funds and ETFs that invest in cryptocurrency futures, and interval funds and tender offer funds[25]). It asks whether product-specific or additional conditions should be placed on transactions in those funds or other products that it deems to be complex.

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[21] In addition, there likely will be operational issues for broker-dealers, as they will need to move up their due diligence evaluations to apply at the account opening, rather than at the time of a recommendation.

[22] Section 15A(b)(6) of the Securities Exchange Act of 1934 grants self-regulatory organizations of broker-dealers, such as FINRA, with limited authority to craft rules that are designed to:

(i) prevent fraudulent and manipulative acts and practices,

(ii) promote just and equitable principles of trade,

(iii) foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities,

(iv) remove impediments to and perfect the mechanism of a free and open market and a national market system, and

(v) in general, protect investors and the public interest.

Self-regulatory organizations may not design rules to permit unfair discrimination between customers, issuers, brokers, or dealers or to regulate matters not related to the purposes set forth above.

Perhaps FINRA would impose additional restrictions on self-directed transactions to protect investors and the public interest, but FINRA has not provided any evidence that self-directed investors do not understand the harm of complex products. Perhaps FINRA would impose requirements to prevent fraudulent and manipulative acts and practices, but FINRA does not allege that any of its member has engaged improperly by simply offering the products to self-directed investors. We do not believe the other limited rationales for self-regulatory organization rulemaking apply to limitations on self-directed transactions. Rather, we are concerned that such rules have every potential to discriminate between sophisticated and unsophisticated customers (*e.g.*, through minimum required wealth- or knowledge-based standards) and are not in the public interest.

[23] FINRA also could provide investor education and guidance about certain specified products. Providing additional information to allow investors and their agents to better make investment decisions is a key tenet of the federal securities laws.

[24] Defined outcome ETFs 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. *See* Regulatory Notice at 3.

[25] Interval funds are continuously offered closed-end funds that redeem shares by making periodic repurchase offers at NAV. *See* Rule 23c-3 under the Investment Company Act. Tender offer funds are continuously offered closed-

continued

As with other publicly offered securities, we strongly object to FINRA imposing any additional requirements on transactions in funds.[26] Although FINRA has imposed additional conditions on specific products, none of those products are a good analog for funds.[27] Compared to those products, funds are subject to a different and enhanced securities law regime that makes additional restrictions unnecessary.

Like other publicly offered securities, funds must disclose their key characteristics and risks in a set order and format, which must be provided to all investors, prior to or at the time of investment. In addition, the Investment Company Act, among other things, provides additional and important safeguards requiring funds to: confine their use of leverage;[28] restrict their transactions with affiliates;[29] custody their assets with qualified custodians;[30] diversify their holdings;[31] retain fidelity bonds for their officers and employees to protect against larceny and embezzlement;[32] obtain annual audits of their financial statements from independent accountants registered with the Public Company Accounting Oversight Board;[33] and maintain certain books and records.[34] The Investment Company Act also requires funds to value their

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end funds that periodically repurchase shares at the discretion of the fund's board. *See* Rule 13e-4 under the Securities Exchange Act.

[26] *See supra* Section I.

[27] We note that FINRA has imposed additional requirements on transactions in deferred variable annuities, which are funds registered under the Investment Company Act. The requirements, however, were imposed to address the truly unique insurance features of those products (*e.g.*, long surrender periods and different payout structures) that are unlike those seen with any other type of fund.

[28] The Investment Company Act and related SEC and staff guidance strictly limit funds' ability to use leverage. Generally speaking, open-end funds can borrow from a bank, provided there is at least 300 percent asset coverage. Closed-end funds may issue one class of debt, provided there is at least 300 percent asset coverage. They also may issue one class of preferred stock, provided there is at least 200 percent asset coverage. BDCs may issue debt, provided they have at least 150 percent asset coverage. *See* Sections 18 and 61 of the Investment Company Act.

[29] The Investment Company Act generally prohibits transactions between funds and their affiliates, such as fund managers, a corporate parent of fund managers, or an entity under common control with fund managers. Among other things, the Act prohibits transactions between funds and affiliates buying for their own account. It also prohibits joint transactions between funds and their affiliates. *See* Sections 17(a), 17(d), and 57 of the Investment Company Act.

[30] The Investment Company Act requires funds to keep their assets separate from the assets of fund managers to protect against theft or misappropriation. *See* Section 17(f) of the Investment Company Act.

[31] Funds select whether to adhere to the diversification requirements of the Investment Company Act. If they do (and most do), with respect to 75 percent of their portfolio, no more than 5 percent may be invested in any one issuer. *See* Section 5(b) of the Investment Company Act. In addition, Subchapter M of the Internal Revenue Code provides funds with an exemption from full corporate taxation only if they are diversified. Generally speaking, to be diversified under Subchapter M, a fund may not invest more than 25 percent of its assets in the securities of any issuer. So, under Subchapter M, a fund with no cash position must be invested in the securities of at least 12 issuers. The typical fund invests in many more issuers—as of December 2020, the median number of stocks held by US equity mutual funds was 78. *See* ICI, *2021 Investment Company Fact Book*, Appendix A, *available at* https://www.icifactbook.org.

[32] *See* Section 17(g) of the Investment Company Act and Rule 17g-1 thereunder.

[33] *See* Section 30(g) of the Investment Company Act.

[34] *See* Section 31 of the Investment Company Act.

assets pursuant to board-approved valuation procedures[35] and disclose these values, along with their holdings, periodically.[36]

In complying with these provisions, each fund must follow formalized practices pursuant to written policies and procedures reasonably designed to prevent federal securities law violations.[37] Further, funds are required to have a board of directors, which generally have at least a majority of members who are independent of a fund's manager.[38] The board oversees the management, operations and investment performance of the fund and is subject to state law duties of care and loyalty and has specified responsibilities under the Investment Company Act.

We appreciate that FINRA seeks to ensure that investors understand the characteristics and risks of complex products before investing in them. Any additional restrictions, however, would be unprecedented in the context of funds subject to the robust regulatory regime of the Investment Company Act. FINRA must consider the strong protections of the Investment Company Act and how any additional requirements may affect funds and their investors, not only in this context, but as precedent it could set for the regulation of other funds and products.[39]

III. Additional Requirements Would be Applied Arbitrarily, Given the Broad Description of "Complex Product"

To avoid a static definition that does not cover future products and technologies, FINRA does not define what a complex product is. Instead, it describes one as:

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[35] Funds generally use market values to price portfolio securities for which market quotations are readily available. When market quotations are not readily available, such as for certain exempt offerings, funds must price portfolio securities and all other assets using "fair value" as determined in good faith by the fund's board of directors. *See* Section 2(a)(41) of the Investment Company Act..

[36] To meet periodic disclosure requirements, funds must compute and provide their net asset value ("NAV") at least quarterly. More than 95 percent of closed-end funds calculate the value of their portfolios every business day, while others calculate their portfolio values weekly or on some other basis. *See* ICI, A Guide to Closed-End Funds (May 2021), *available at* https://www.ici.org/cef/background/bro_g2_ce. Open-end funds must compute and disclose NAVs daily. *See* Rule 22c-1 under the Investment Company Act. Open-end and closed-end funds also provide their holdings quarterly on Form N-PORT or N-CSR filings. BDCs provide their holdings on Form 10-Q or 10-K filings.

[37] Rule 38a-1 under the Investment Company Act requires funds to adopt policies and procedures to prevent violations of the federal securities laws. *See also* SEC, Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003), *available at* www.sec.gov/rules/final/2016/33-10233.pdf.

[38] On most fund boards, independent directors make up at least 75 percent of its members. *See* ICI/IDC, *Overview of Fund Governance Practices, 1994-2020*, *available at* www.ici.org/system/files/2021-10/21_pub_fund_governance.pdf.

[39] For example, we note that funds that use derivatives now are implementing Rule 18f-4 under the Investment Company Act. That rule is a comprehensive regulation intended to limit a fund's ability to use derivatives in a manner that addresses investor protection concerns. *See* SEC Adopts Modernized Regulatory Framework for Derivatives Use by Registered Funds and Business Development Companies (Oct. 28, 2020), *available at* https://www.sec.gov/news/press-release/2020-269. Imposing additional investor protection restrictions through FINRA because a fund may use derivatives therefore seems superfluous. *See infra* note 44 and surrounding text (noting that FINRA has indicated that funds using derivatives for hedging or leverage may be deemed complex).

> . . . 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).

FINRA states that its description could encompass products that do not necessarily result in greater risk.[40] FINRA asks what types of products should be viewed as complex, whether its description appropriately covers necessary products, and whether it should apply additional conditions on transactions in these complex products.[41]

The scope of the "complex products" description is too broad and will lead to arbitrary results. FINRA has at one point or another deemed several types of investments to be complex products, "complex," or difficult for investors to understand, including: closed-end funds,[42] global real estate funds,[43] multi-strategy funds,[44] funds using derivatives for hedging or leverage,[45] funds investing in start-up companies/initial public offerings,[46] target-date funds,[47] exchange-traded notes,[48] principal protected notes,[49] structured notes,[50] and asset-backed securities.[51] With these statements, approximately 5,600 funds would be impacted with over $7.6 trillion of assets. This means that approximately 2 out of every 5 funds and 22 percent of total US fund assets would be deemed complex products, potentially subject to enhanced investor qualification or other requirements.[52]

Regardless of whether FINRA intended to impact so many funds and products, to ensure clarity, FINRA or other governmental bodies will need to make affirmative determinations as

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[40] *See* Regulatory Notice at 4 ("Although complex products do not always translate into more investment risk, their complexity may confuse investors who may not adequately understand their features.").

[41] *See* Regulatory Notice at Request for Comment No. 1, No. 6, and No. 7.

[42] *See* FINRA Investor Alert: Closed-End Fund Distributions: Where is the Money Coming From? (Oct. 28, 2013), *available at* www.finra.org/investors/alerts/closed-end-fund-distributions-where-money-coming.

[43] *See* 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.

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *See* FINRA, Save the Date: Target Date Funds Explained ("Target-Date Fund Notice"), *available at* https://www.finra.org/investors/insights/save-date-target-date-funds-explained.

[48] *See* FINRA Investor Alert: Exchange-Traded Notes – Avoid Unpleasant Surprises (July 10, 2012), *available at* www.finra.org/investors/alerts/exchange-traded-notes-avoid-unpleasant-surprises.

[49] *See* FINRA Structured Notes with Principal Protection (June 2, 2011), *available at* www.finra.org/investors/alerts/structured-notes-principal-protection-note-terms-your-investment.

[50] *See* FINRA Regulatory Notice 12-03: Heightened Supervision of Complex Products, *available at* www.finra.org/rules-guidance/notices/12-03.

[51] *Id.*

[52] *See supra* notes 7-8.

to which of the multitudes of products in the marketplace are complex.[53] Whatever the outcome, if the determinations truly are based on a retail investor's understanding of how an investment would perform in different markets and economic conditions, the results will be subjective. Consider a global operating company that has a significant presence in Ukraine. Would a retail investor know that the company's stock price might take a larger than expected hit with the recent Russian invasion of Ukraine? Here one could presume that the answer might be in the principal risk disclosure that the operating company provides, which assuming it is drafted appropriately, should be sufficient for a retail investor to understand. But similar principal risk disclosure also could appear for a defined outcome ETF that caps potential gains when the reference asset it tracks overperforms. Is the operating company's stock a complex product because a retail investor may not understand how it may perform in different market environments? If not, what is the difference between its risks potentially to a number of global market events and the defined outcome ETF's risks (which FINRA seemingly has deemed a complex product)?

FINRA states that its focus is whether a retail investor understands how well a product will react in different market and economic conditions and not on whether a product creates more investment risk. This may lead to odd results under which FINRA deems relatively low risk products as being complex. For example, FINRA has deemed alternative funds (funds it describes as using investment strategies that differ from the buy-and-hold strategy typical in the mutual fund industry) as complex products, including funds that use derivatives for hedging and leverage. In many instances, however, a fund that uses derivatives to hedge may have a much lower relative risk level than an operating company's stock (as determined by a standard Value-at-Risk test).[54] Under this standard, even target-date funds, which many investors rely on to meet their long-term investment goals, might be deemed to be complex products due to their investment glide paths that could take an investor to or through an announced target date or because "investment risk exists throughout the lifespan of the fund and is difficult to foresee."[55] Irrespective of the set of products FINRA hopes to capture, the "know it when I see

[53] On the other hand, broker-dealers have lived with suitability requirements for quite some time and developed appropriate processes to determine how to apply them to new products on a product-by-product basis.

[54] A value-at-risk ("VaR") test estimates potential losses on an instrument or portfolio, expressed as a percentage of the value of the instrument or portfolio's assets (or net assets when computing a fund's VaR), over a specified time horizon and at a given confidence level. *See*, *e.g.*, Rule 18f-4(a) under the Investment Company Act. We note that a retail investor may even find the payout structure and performance of a fund that uses derivatives to hedge the currency risks of its foreign investments easier to understand than a fund that does not. The payout structure of the non-currency-hedged fund might require investors to have a view on both the underlying international market and the relevant currencies versus the US dollar, whereas the currency-hedged fund mitigates the currency risk for investors through the embedded currency hedges.

[55] *See* Target-Date Fund Notice, *supra* note 47. At the very least, we strongly urge FINRA to clarify that it would not deem target-date funds to be complex products.

it" test described would be applied arbitrarily, would cause confusion as to whether a product is complex and how any new requirements are applied,[56] and simply would not work.[57]

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ICI and its members appreciate the opportunity to comment on the Regulatory Notice. If you have any questions or require any further information, please contact Dorothy Donohue at 202-218-3563 or Kenneth Fang at 202-371-5430.

Sincerely,

/s/ Dorothy Donohue

Dorothy Donohue
Deputy General Counsel

/s/ Kenneth Fang

Kenneth Fang
Associate General Counsel

[56] In addition to potential confusion with classifying investments as complex, there may be operational challenges with identifying complex products on platforms, particularly for self-directed investors. For example, many self-directed platforms currently do not have a way to classify whether an investment has exposure to cryptocurrencies or derivatives or, if it does, how much exposure to either it has. Investors, however, would have access to documents (*e.g.*, prospectuses and shareholder reports) that disclose this information.

[57] FINRA has provided investor-focused educational pieces on products that it deems complex. In addition, it has issued regulatory notices reminding its members about their sales practices and supervisory obligations with respect to such products. When it determines that its members have eschewed these obligations, it has brought enforcement actions against them. Although the Regulatory Notice indicates that there has been an increase in the trading of complex products, the notice does not indicate that there has been a corresponding increase in the frequency of investor suitability or best interest cases. Thus, it is not entirely clear what problem FINRA is trying to address. If FINRA has concerns about retail investors investing in specific products, we encourage it to continue with its effective approach of providing education and member guidance about those products. Imposing additional qualification or other restrictions broadly would be arbitrary and improper.