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May 9, 2022, Via email to pubcom@finra.org

Re: FINRA Regulatory Notice 22-08 (Complex Products)

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street
Washington, DC 20006-1500

Dear Ms. Mitchell:

The Alternative & Direct Investment Securities Association (“ADISA”)¹ appreciates the opportunity to provide comments on the Financial Institution Regulatory Authority’s (“FINRA”), Regulatory Notice 22-08, entitled “Complex Products and Options” (the “Notice” or “RN 22-08”). In RN 22-08, FINRA reminds its members of “Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements.” In the body of the Notice, FINRA reiterates and updates its view of “complex products” and reminds firms of the framework that they should utilize when making such products available – whether through a recommendation or otherwise – to their clients and customers. RN 22-08 contains a lengthy and detailed request for comment and/or suggestion, moreover, intended to generate feedback on the issues outlined by FINRA in the Notice, including possible areas for further rulemaking and/or development.

ADISA’s membership includes member firms as well as firms that create, manage and distribute investment products which fall within FINRA’s definition of complex product. We wish to address what we see as the potentially unwonted and certainly undesirable effects emanating from the approach that FINRA currently takes and is considering expanding. In ADISA’s view, advocating for more comprehensive training and oversight efforts within members firms that offer complex products may well lead to the creation of a two-tier system within members’ firms – one for complex products, and another for non-complex products. In addition, adding to the requirements already announced by FINRA will only further restrict or limit the offer and sale of

¹ ADISA (Alternative & Direct Investment Securities Association), is the nation’s largest trade association for the non-traded alternative investment space. Through its 4,500 financial industry members, ADISA reaches over 220,000 finance professionals, with sponsor members having raised in excess of \$200 billion in equity in serving more than 1 million investors. ADISA is a non-profit organization (501c6), registered to lobby, and also has a related 501c3 charitable non-profit (ADISA Foundation) assisting with scholarships and educational efforts.

these important and necessary products, products that address risks and seek to produce outcomes that are desired by investors.

At bottom, explicitly identifying products as “complex” and imposing new and additional requirements regarding their offer and sale suggests that such products operate outside of applicable disclosure parameters and documents, irrespective of their effectiveness. For these reasons, ADISA believes that FINRA should be extremely cautious about how it defines and enforces rules, guidelines and suggestions relating to investment products that go beyond simply exposure to publicly traded stocks and bonds.

ADISA recognizes that member firms engaged in the distribution and sale of investment products should ensure that all products are well-understood and well vetted, especially where the product is intended to help bring about a specific result or outcome. In ADISA’s view, the marketing, distribution and sale of “alternative” products, whether or not “complex” in nature, is and can continue to be appropriately handled by FINRA under its current rules and regulations. The Securities and Exchange Commission’s (“SEC”) Regulation Best Interest (“Reg BI”) provides an applicable and clear framework for the offer and sale of all investment products to member firm clients, without resort to special supervisory responsibilities that will effectively inhibit firms from making such products available to those investors who truly need them.

At the heart of RN 22-08 is the notion that FINRA has identified a product type that it calls “complex” and is both bringing additional products to the list as they gain use, visibility and even popularity in the marketplace as well as surfacing (if not suggesting) additional procedural guidelines applicable to their offer and sale. ADISA understands FINRA’s desire to focus member firms’ attention to products that contain or present elements that are not “plain vanilla,” but submits that the reach of FINRA’s “complex” product definition goes too far and sweeps too many products into this sphere. More important, in ADISA’s view the Notice goes too far in suggesting how the offer and sale of such products may be further regulated.

Importantly, the Notice recognizes that complex products – like a number of alternative investments – can add important dimensions to client portfolios: e.g., “[t]he availability of complex products and options can potentially expand the investment opportunities for retail investors and, if properly understood, offer favorable investment outcomes (e.g., enhancing returns, limiting losses or improving diversification).” The Notice then moves on, however, noting that “important regulatory concerns arise when investors trade complex products without understanding their unique characteristics and risks.”

In the Notice, FINRA reiterates the fact that it has construed the term “complex product” flexibly to avoid a static definition that may not address the evolution of financial products and technology. It refers back to Regulatory Notice 12-03, where it described characteristics that would render a product “complex” – i.e., “a product with features that may make it difficult for a retail investor to understand the essential characteristics of the product and its risks.” In FINRA’s view, “[a]ny product with multiple features that affect its investment returns differently under various scenarios is potentially complex. This is particularly true if it would be

unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return.”

Using this broad definition, RN 22-08 identifies additional products as being on the ever-growing list of “complex products.” These include (i) “defined outcome exchange-traded funds (ETFs)” which offer exposure to the performance of a market index or reference asset but with downside protection and an upside cap on potential gains over a specified period; (ii) mutual funds and ETFs that offer strategies employing cryptocurrency futures; and (iii) interval funds, or tender-offer funds that provide limited liquidity to investors. The focus on these product types is based on the potential for investor misunderstanding, and not the efficacy or cost-effectiveness of such product. This is consistent with FINRA’s approach to these product types going back to 2012 (and before), which is to focus principally on the features involved and their potential to confuse, mislead or disappoint investors and not on whether such products work or operate as described.²

This point (this distinction) is important, as we see this approach as directionally flawed. Identifying qualities that make products “complex” and the difficulties posed by such products is one thing; providing that the complexity of a product necessitates more scrutiny and supervision by a firm is quite another.³ ADISA understands and shares FINRA’s goals of trying to make sure that investment products work as described, and that these products do not cause disruption in the marketplace when they function differently than expected. We submit, however, that those two policy goals are very different and do not necessarily support the notion that firms must establish additional procedures, etc., in order to allow their representatives to recommend (or a platform to sell) these products.⁴

FINRA’s concerns, as expressed in RN 22-08, go primarily to: (i) the risk of confusion or failure to understand complex products on the part of retail investors; and (ii) the risk that said products will fail to perform as expected by their retail purchaser. These risks are said to increase the risk of “inappropriate” recommendations and sales by registered representatives. FINRA’s assertion that investors may fail to understand complex products and/or purchase such products on the basis of a reference asset that may not yield the expected return, is not supported by statistical evidence. Despite FINRA’s listing of settled actions involving said types of products, there is no proof that legally mandated prospectus disclosure, along with sales and training literature created for use with such products, do not fulfill their mandated purpose. Creating a firm based system,

² RN 22-08 does in at least one instance move beyond investor confusion and addresses the possibility that such products might have outsized impact on the securities markets generally. In a nod to remarks of SEC Chair Gensler, the Notice states that “complex products can potentially create system-wide risks by operating in unanticipated ways when markets experience volatility or stress conditions,” and further notes the Chair’s point that “[t]rading in complex products may also affect underlying assets.”

³ As stated in the Notice, “[t]he fundamental point for firms is that if a product has similar features of complexity, such as embedded derivative-like features or a structure that produces different performance expectations according to price movements of other financial products or indices, then firms should err on the side of applying their procedures for enhanced oversight to the product.”

⁴ “FINRA emphasized that the complexity of a product often necessitates more member firm scrutiny and supervision, and we advised members to apply heightened supervision for complex products. We recommended that a member periodically assess complex products that the member offers to determine that their performance remains consistent with the manner in which the member is selling them and provide comprehensive training for registered representatives that sell complex products.”

with its associated cost and time commitments, disregards the role of such materials and adds unnecessary costs and barriers.

FINRA's further belief, echoing the thoughts of Chair Gensler, that complex products can create system-wide risks again does not support the creation of elaborate training and supervision structures at member firms. If FINRA is concerned with the impact of these products on markets and member firms, it can engage with the SEC in appropriate rulemaking (or even work with Congress to address these market impact issues in appropriate legislation). It is difficult to see how directing firms to do more training and firm diligence will address what is a concern that pertains to the products themselves rather than one focused on how they are sold to or bought by investors.

In sum, ADISA is supportive of FINRA's efforts to ensure that all products, be they alternative or seemingly complex, are understood and appropriately recommended or sold by member firms. We believe, however, that creating a large and growing category known as "complex products" and suggesting or recommending additional training and even licensure steps to accompany firms' offer and sale of such products runs a substantial risk of lessening firms' appetite for offering such products to their customers. This reduction if not elimination of member firms' willingness to offer and sell such products is truly risky, as it threatens to deny to investors access to the types of products that FINRA, in its Notice, recognizes "offer favorable investment outcomes (e.g., enhancing returns, limiting losses or improving diversification)."⁵

In the absence of evidence showing that such products do not operate as intended or designed, it is ADISA's view that this approach brings with the possibility of disincentivizing the sale of products that already utilize lengthy and necessary disclosure about their features and risks, while simultaneously limiting their availability through an important channel. There is no objectively provable assertion in the Notice that such products do not work or operate as described. Subjecting them to onerous additional oversight and regulation runs counter to the disclosure-focused approach underlying the federal securities laws and to the SEC's intent behind adopting Reg BI. For these reasons, ADISA submits that FINRA should not increase the burden on members firm as suggested in RN 22-08 when offering such products over that which is required now, and to consider withdrawing the approach to such products outlined in the Notice and in prior notices on this issue.

ADISA appreciates very much the work of FINRA. Much progress has been made and we ask that you give our comments consideration. We stand ready to assist further in any way we can and to discuss our comments at your convenience.

Sincerely,



John H. Grady
Chair, ADISA Legislative and Regulatory Committee

⁵ E.g., The Stanger NAV REIT TR Index, an important alts measurement among ADISA's members outperformed the S&P500, 64% to 27% for the last 5 years.