Reconsidering the "Complex Product" Designation

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On March 8, 2022, the Financial Industry Regulatory Authority, Inc. (*"FINRA"*) issued Regulatory Notice 22-08 (Complex Products and Options) (*"Notice 22-08"*) discussing the current state of regulation regarding the sale of "complex products" by FINRA members. Notice 22-08 requested comment on whether FINRA's current framework – which already imposes significant obligations on broker-dealers selling so-called complex products – is appropriately tailored to address the risks associated with complex products or whether it should impose additional regulation.[1] Notice 22-08 is FINRA's most significant statement on sales of complex products since it issued Regulatory Notice 12-03 (Heightened Supervision of Complex Products) (*"Notice 12-03"*) in January of 2012.

Later, in April 2023, the Securities and Exchange Commission (*"SEC"*) staff (the *"Staff"*) released a Staff Bulletin (the *"Bulletin"*) that discussed the standards of conduct for broker-dealers (*"BDs"*) and duty of care for investment advisers ("*IAs*") when providing buy/sell recommendations and investment advice to retail investors regarding complex or risky investment products.[2] In the Bulletin, the Staff stated that BDs and IAs are permitted to recommend, or provide advice about, such products only when a reasonable basis exists that such recommendation is in the best interests of the investor.

Despite these recent regulatory efforts, industry participants continue to have no clear understanding of what qualifies a product as either "complex" or "risky." Nor do these pronouncements offer any guidance as to when an investment product might cease to be complex or risky. In that regard we note that the history of investment products is replete with examples of products that were, at inception and during early adoption, considered complex or risky. However, over time, those characterizations no longer applied. For example, all exchange-traded funds (*"ETFs"*) were, at one time, deemed complex because investors bought them at market price rather than at net asset value. Investments in certain asset classes such as commodities or foreign securities were, at earlier times, considered risky; they now form the basis of what many would consider a well-balanced and diversified portfolio of investments.[3] And so when the investing public may no longer consider a given investment or asset class to be either complex or risky, it is unclear when, or even whether, regulators similarly recognize the dissipation of these labels.

In light of the innovation occurring within the investment products arena, it is time not only for more definitive guidance regarding complex products to be issued, but also for a more rational regulatory scheme that considers a wide variety of factors, including, for example, that products a regulator might deem complex may be, in fact, less costly, more liquid, more transparent, better performing, and overall in the best interests of a client than comparable investment products. This is particularly the case for those products that provide a ring-fenced exposure to an asset class without undue risk. For example, ETFs are now offered that provide investment exposure to an underlying reference asset with downside protection that allows the ETFs to have values-at-risk lower than the S&P 500 (*"Defined Outcome ETFs"*).

This article proposes an objective framework for BDs and IAs to consider Defined Outcome ETFs, regardless of whether they are deemed complex under the current regulatory environment, by utilizing a well-established measure of risk to assess whether an investment in those vehicles is in a client's best interest.

Key Takeaways

- *"Complex product" regulation is ambiguous, overly broad, and often lags behind investor experience.*
- *These products may be excluded from platforms regardless of benefits.*
- *Certain complex products do not present undue risk.*
- *A more objective regulatory standard that emphasizes level of risk is required.*

Current State of "Complex Product" Regulation

Whether an investment product sold by FINRA members is "complex" is currently governed by Notice 12-03, which states that a product is complex if it has 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).[4] In Notice 12-03, FINRA laid out various examples of products it deemed to be "complex," which included products that have an embedded derivative component that may be difficult to understand. In Notice 22-08, FINRA expanded on its previous examples, identifying additional products that may be deemed "complex," including Defined Outcome ETFs.

FINRA noted in Notice 22-08 that, although it currently does not have any rules or regulations specifically addressing complex products, it has product-specific rules (such as Rule 2360 (Options) and Rule 2220 (Options Communications)) that address many complex products, and has issued prior guidance in Notice 12-03, which advises member firms to apply heightened supervision for complex products. Regulatory Notice 21-15 (Options Account Approval, Supervision and Margin), for example, outlines the steps a member firm must undertake in connection with approving an investor to trade options.[5] In Notice 22-08, FINRA also reminded member firms to review their obligations under FINRA Rules and *Reg BI*, and to determine whether their policies and procedures continue to reflect the investor protection goals that these rules seek to achieve.

The SEC also has considered complex products. SEC Chair Gary Gensler directed the Staff over three years ago to study the risks of complex exchange-traded products (*"ETPs"*) and to present recommendations for potential rulemaking to address those risks.[6] Prior to this directive, upon adoption of Reg BI, the SEC emphasized the importance of understanding the terms, features and risks of complex products, such as inverse and leveraged ETPs, in order to establish a reasonable basis to recommend these products to retail customers.[7] In addition, in an October 2020 joint statement, then-SEC Chair Jay Clayton and the Staff had noted their concern that retail investors are independently selecting complex products for which they may not fully appreciate the unique characteristics and risks.[8]

More recently, in the Bulletin, the Staff noted that firms should generally apply "heightened scrutiny" when a risky or complex product is being recommended. In the Bulletin, the Staff also suggested that firms which recommend or provide advice regarding complex products implement procedures specifically designed to address recommendations or advice about complex or risky[9] products and provide training and appropriate supervision to help ensure financial professionals understand the features and risks of complex financial products. Like the FINRA notices, the Bulletin also includes a non-exhaustive list of products for which heightened scrutiny should be applied: "inverse or leveraged exchange-traded products, investments traded on margin, derivatives, crypto asset securities, penny stocks, private placements, asset-backed securities, volatility-linked exchange-traded products, and reverse-convertible notes."[10]

Impact of Complex Products Designations on Defined Outcome ETFs

The "heighted supervision" or "heighted scrutiny" that are applied to complex products under the BD and IA Care Obligations involves significant due diligence on the part of a firm. It must develop an understanding of the terms, features and risks of a product being offered and the customer to which it is offered. A firm also must provide training to registered representatives, so they understand the risks and benefits associated with a complex product and the likely performance of such product over a wide range of normal and extreme market scenarios. A firm is required to

provide written procedures to ensure registered representatives do not recommend a product before it has been thoroughly vetted by the firm. Firms have also been tasked with developing a system of internal controls to periodically review the product and procedures associated with a recommendation to purchase. Firms also must assess each client's experience and risk tolerance whenever recommending a complex product and whether such client has the knowledge and experience needed to evaluate the risks of the complex product and would need to discuss such features with the client before making the recommendation to purchase.

Although Defined Outcome ETFs may be beneficial to their clients, certain BDs have not engaged in this due diligence and monitoring, perhaps because Defined Outcome ETFs may compete with their own structured products. Such BDs may recommend a structured note offered by an affiliate of the BD and deny their customers access on their platform to a substantially similar investment in ETF-form that is less expensive, more transparent, more liquid, and highly regulated. At the same time, these same BDs have relatively quickly undertaken the required due diligence and review for not only the affiliated structured note, but also other complex products, such as ETFs which hold crypto asset securities. This suggests that the exclusion of Defined Outcome ETFs by BDs from their platforms is not necessarily due to risk or the burden of completing the required due diligence. Rather, these BDs may be using the status of Defined Outcome ETFs as complex products to exclude them for their own reasons versus those of their client. Excluding an entire line of beneficial products from investors in favor of proprietary products that are more expensive, less transparent, less liquid and less regulated, would seem to violate at least the spirit of Reg BI by not allowing investors access to products that may be in their best interests. All to say, although likely unintended by FINRA, the designation of Defined Outcome ETFs as complex products essentially functions as a strict barrier to investor access and incongruously leaves investors with products that are not in their best interest.

Treating Defined Outcome ETFs Differently

We think regulation based on an "eye of the beholder" perspective misses the mark. What a particular regulator, or person(s) within that regulator, views as complex can lead to needless restrictions and unintended consequences (as noted above). For example, FINRA continues to label funds that use derivatives or seek leveraged/inverse exposure as complex. In many respects, this reflects archaic views as such techniques have been in use for several decades and are well known and fairly well understood. More importantly, however, they are used by professionals. Unlike the direct use of options by retail investors, for example, registered investment companies are managed by registered investment advisers, and such funds have robust disclosure, both detailed and in plain English.

Nevertheless, to the extent that FINRA and the SEC continue to label certain products as complex, we think there is a strong case for treating Defined Outcome ETFs as outside of that designation.

Defined Outcome ETFs are risk mitigating investments. They provide investors the ability to participate in equity market upside (to a cap) while limiting downside risk. **Importantly, Defined Outcome ETFs expose investors to *less risk* than many broad equity market indexes such as the S&P 500.**

It seems clear that one of FINRA's primary focuses for designating an investment as a "complex product" is the risk that such a product can pose to an investor and how an investor may not understand these risks. Notice 22-08 generally joins complexity with risk. For example, Notice 22-08 states in the very first paragraph: "[i]mportant regulatory concerns arise when investors trade complex products without understanding their unique characteristics and risks. Therefore, we have taken steps to address complex products and options over the years, including…issuing investor-focused alerts to highlight the risks of these products …." (emphasis added). In addition, under the section of Notice 22-08 entitled "Background & Discussion," FINRA states that it has "described 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…." (emphasis added). Under the section of Notice 22-08 entitled "Concerns Raised by Complex Products and Options," FINRA states: "[i]f a product has features or payout structures that would be confusing to retail investors, or if it performs in unexpected ways in various market or economic conditions, investors may not fully understand the attendant risks." (emphasis added) In fact, Notice 22-08 goes on to use the word "risk" forty-nine times.

Despite FINRA's focus on the risks associated with complex products, it does not currently exclude lower risk products from the designation. As a result of this unnecessarily broad definition of complex products, investors may not be provided access to such lower risk products that very well may be appropriate for them. As noted above, many Defined Outcome ETFs have relatively low levels of risk. This is evidenced by the lower value-at-risk (*"VAR"*) values that Defined Outcome ETFs have versus traditional equity index tracking funds. As a result of the adoption of Rule 18f-4 under the Investment Company Act of 1940 (the "*Investment Company Act*"), the SEC uses VAR as a method to objectively measure risk for investment companies that utilize derivatives in their portfolios. VAR is an estimate of an instrument's or portfolio's potential losses over a given time horizon and at a specified confidence level. Many Defined Outcome ETFs have VARs that are materially lower (and therefore less risky) than the S&P 500. The VARs of Defined Outcome ETFs are lower because they are designed to mitigate and limit risk through the use of protection from losses.

As stated above, it appears that FINRA's main concern regarding complex products is the risk that they pose to investors. However, many Defined Outcome ETFs have substantially less risk than other products considered to be "complex products" by FINRA and even have less risk than more "vanilla" investment products that track broad-based indexes. The below table illustrates this point by providing the VAR's of several Defined Outcome ETFs vs. the S&P 500 as of September 30, 2023. It is interesting to note how the VARs of the Buffer ETFs (a type of Defined Outcome ETF) are significantly less than ETFs that are not generally considered "complex."

Current 3-Year 99% VAR at 20-Day Horizon vs. S&P 500

Category	Ticker	Exposure	VAR
Buffer ETFs	BJUL	9% Buffer	68%
	PJUL	15% Buffer	49%
	UJUL	30% Buffer (-5% to -35%)	49%
Thematic ETFs	ARKK	Innovation	281%
	MTUM	Momentum	134%
	TQQQ	3x QQQ	370%
	UPRO	3x S&P 500	288%
	JEPI	Premium Income	80%
	VTV	U.S. Value	82%
Risk Managed ETFs	SPLV	Low-Vol	88%
	USMV	Low-Vol	89%
	NOBL	S&P 500 Dividend	93%
5 Largest ETFs	SPY	S&P 500 ETF	103%
	VOO	S&P 500 ETF	103%
	IVV	S&P 500 ETF	104%
	VTI	Total Market	108%
	QQQ	Nasdaq 100	137%
Single Stock	TSLA	Tesla	352%
	NVDA	Nvidia	289%
Bonds	AGG	Core Bonds	40%
	HYG	High Yield	56%
	LQD	Corporates	62%
	TLT	20+ YR U.S. Treasuries	97%

Source: Bloomberg L.P. as of September 30, 2023

Accordingly, Defined Outcome ETFs should either be treated differently than other complex products, or FINRA and the SEC should expressly exclude Defined Outcome ETFs from the “complex product” or “risky” designations. Defined Outcome ETFs should not be lumped in with other products that use derivatives to magnify risks. Defined Outcome ETFs are less “complex” than many other ETFs currently offered by BDs and IAs as they are not built on complicated and unreliable historical correlations, switching strategies, quantitative factors, technical triggers or hypothetical back-tests to deliver risk mitigation. BDs and IAs can subject their clients to greater risk when recommending ETFs that use complex trading strategies rather than Defined Outcome ETFs with known outcomes. It would be in line with the spirit of the BD and IA Care Obligations to offer the best possible product to their clients rather than something with similar investment objectives but greater attendant risk.

Additionally, absent a clear guidance from FINRA or the SEC, BDs and IAs should consider using VAR as an objective measure of risk in determining if a product is a “complex product.” As stated previously, Defined Outcome ETFs are not similar to other “complex products” as they have substantially less risk than other products considered to be “complex.” Using VAR as a risk measure would provide an objective means to assist BDs and IAs in determining whether a product is a “complex product” and should be subject to the requirements imposed on complex products. Defined Outcome ETFs essentially offer a way for investors to invest in broad market indices with guardrails.

Additional FINRA-Imposed Requirements Are Unnecessary for Defined Outcome ETFs

As noted above, in Notice 22-08 FINRA is seeking to go beyond the current regulatory framework regarding complex products and asks what additional regulation is required. In any effort to improve or clarify the complex product regulations, we think it is important for FINRA and the SEC to speak, if not with one voice, then at least more cohesively. FINRA also should take note that adding additional layers of regulation of sales practices ostensibly negates or opposes the existing scheme of federal securities laws currently in place.

Consistent with the historic approach under the federal securities laws, Defined Outcome ETFs must adhere to strict disclosure requirements to provide investors and prospective investors with a prospectus containing key information about the Defined Outcome ETF’s essential characteristics and principal risks in a standardized format.[11] In contrast to traditional structured products, an additional layer of safeguards exist for Defined Outcome ETFs registered under the Investment Company Act which are 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 SEC has long recognized that these requirements are 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 BD recommendations. These disclosures are sufficient to ensure that investors have the information they need to make an informed and educated decision on whether and how to invest in a Defined Outcome ETFs. There has been no evidence provided to suggest that Defined Outcome ETFs require additional disclosures or sales practice requirements than those needed for those equity funds that are not deemed to be complex products. BDs rightly make suitability and best interest decisions, which depend heavily on understanding the facts and circumstances of each investor. To layer the additional requirements required for complex products on Defined Outcome ETFs would ultimately just limit access to products that have the potential to help investors.

In addition, the Investment Company Act, among other things, provides additional and important safeguards requiring Defined Outcome ETFs to:

- confine their use of leverage;
- restrict their transactions with affiliates;
- custody their assets with qualified custodians;
- diversify their holdings;
- retain fidelity bonds for their officers and employees to protect against larceny and embezzlement;

- obtain annual audits of their financial statements from independent accountants registered with the Public Company Accounting Oversight Board; and
- maintain certain books and records.

The Investment Company Act also requires Defined Outcome ETFs to value their assets pursuant to board-approved valuation procedures and disclose these values, along with their holdings, periodically.

In complying with these provisions, each Defined Outcome ETF must follow formalized practices pursuant to written policies and procedures reasonably designed to prevent federal securities law violations. Further, Defined Outcome ETFs are each required to have a board of directors, which generally have at least a majority of members who are independent of a Defined Outcome ETF's manager. The board oversees the management, operations and investment performance of a Defined Outcome ETF and is subject to state law duties of care and loyalty and has specified responsibilities under the Investment Company Act. BDs and FINRA should consider the strong protections of the Investment Company Act before imposing additional requirements on Defined Outcome ETFs.

Additionally, Defined Outcome ETFs must comply with the SEC's Rule 6c-11, which requires them to disclose their portfolio holdings on a daily basis on their website along with additional historical information on premiums and discounts and bid-ask spread information. This provides investors and prospective investors with additional information which may be used to understand and assess their investments.

Conclusion

For the reasons stated above, Defined Outcome ETFs should be treated differently from other complex products or excluded from the definition of complex product in any SEC or FINRA-promulgated rule or position. Defined Outcome ETFs should not be subject to the heightened scrutiny typically required of complex products. FINRA's principal focus for complex products is that they may involve more risk than traditional investment products. This is not the case for Defined Outcome ETFs that have less risk than the S&P 500. Additionally, Defined Outcome ETFs are already subject to the general disclosure requirements of the securities law regime and the enhanced requirements of the Investment Company Act. In addition, the SEC and FINRA should adopt a more objective test for what is a complex product using VaR – a test already developed by the SEC and that measures the risk to a fund that uses derivatives. The implementation of that test would exclude any registered investment company with a VAR less than the VAR of a broad-based market index such as the S&P 500. The current guidance precludes many investors from investing in products that may be beneficial. In addition, BDs could utilize the same approach to determine whether to make Defined Outcome ETFs available to their clients.

For More Information

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1 *See* FINRA Regulatory Notice 22-08 (Complex Products and Options) (March 2022).

2 Both Regulation Best Interest ("*Reg BI*") for broker-dealers (see Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 FR 33318, 33320-21 (June 5, 2019)) and the investment advisory fiduciary standard for investment advisers (see Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 FR 33669, 33669 n.7, 33672 (June 5, 2019)) are drawn from key fiduciary principles that include an obligation to act in the retail investor's best interest and not to place their own interests ahead of the investor's interest. Although the specific application of Reg BI and the IA fiduciary standard may differ in some respects and be triggered at different times, in the Staff's view, they generally yield substantially similar results in terms of the ultimate responsibilities owed to retail investors. In this article, the Reg BI obligations and investment adviser fiduciary standards are referred to as the "BD and IA Care Obligations."

3 See, *e.g.,* Fiona Boal and Jim Wiederhold, Traditional Uses of Commodities in a Diversified Portfolio (June 11, 2021); available at: https://caia.org/blog/2021/06/11/traditional-uses-of-commodities-in-a-diversified-portfolio; and Ari Levine, Yao Hua Ooi and Matthew Richardson, Commodities for the Long Run (Working Paper 22793, November 2016); available at: https://www.nber.org/system/files/working_papers/w22793/w22793.pdf

4 *See* FINRA Regulatory Notice 12-03 (Heightened Supervision of Complex Products) (January 2012).

5 *See* FINRA Regulatory Notice 21-15 (Options Account Approval, Supervision and Margin) (April 2021).

6 ETPs are defined to include: ETFs operating as registered investment companies; non-1940 Act pooled investment vehicles; and exchange-traded notes. *See generally* Gensler Statement on Complex ETPs, Statement on Complex Exchange-Traded Products at note 1 (Oct. 4, 2021). *See also*, SEC Asset Management Advisory Committee, Preliminary Recommendations of ETP Panel Regarding COVID-19 Volatility: Exchange-Traded Products (Sept. 16, 2020).

7 *See* Regulation Best Interest, Securities Exchange Act Release No. 86031 (Jun. 5, 2019), 84 FR 33318 (Jul. 12, 2019).

8 *See* SEC, Joint Statement Regarding Complex Financial Products and Retail Investors (Oct. 28, 2020).

9 The appearance of the phrase “or risky” as a regulatory concept in the context of complex product designation and regulation first appears in the Bulletin. We think a formulation of “and risky” would lead to a more objective standard of regulation as discussed later in this article.

10 Notably, this list does not include Defined Outcome Funds, which were included in Notice 22-08 - a possible signal from the SEC that it does not deem such products to be of the same complexity or risk as FINRA does.

11 *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.

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