

Regulatory Notice

22-11

Alternative Mutual Funds

FINRA Reminds Firms of Their Sales Practice Obligations for Alternative Mutual Funds

Summary

Recently, FINRA took enforcement action against several firms for failing to establish or maintain a reasonably designed supervisory system for recommendations of alternative mutual funds, also sometimes referred to as “alt funds” or “liquid alts” (“Alt Funds”). FINRA is continuing to note such deficiencies in its examinations and communications reviews of such products.

This *Notice* reminds member firms of their sales practice and supervisory obligations for such funds, and, to that end:

- ▶ describes frequent findings in recent examinations and enforcement matters;
- ▶ shares effective practices FINRA observed at member firms; and
- ▶ notes considerations member firms may wish to take into account to improve their supervisory and compliance programs.

Questions or comments concerning this *Notice* may be directed to:

- ▶ [Joseph P. Savage](#), Vice President and Counsel, Office of General Counsel, at (240) 386-4534; or
- ▶ [Elena Schlickemaier](#), Senior Principal Analyst, Member Supervision, at (202) 728-6920.

Background

Alt Funds are open-end registered investment companies that seek to achieve their objectives through investments in non-traditional investments or asset classes. Industry participants, including member firms, have marketed or recommended Alt Funds to retail customers as products with sophisticated, actively managed hedge fund-like strategies that will perform well in a variety of market environments.

While these funds may be appropriate for some investors, FINRA has consistently emphasized the importance of member firms’ sales practice obligations for these and other products, especially when such products may carry additional risks for customers.

April 19, 2022

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Advertising
- ▶ Business Senior Management
- ▶ Compliance
- ▶ Legal
- ▶ Risk Management

Key Topics

- ▶ Complex Products
- ▶ Due Diligence
- ▶ Mutual Funds
- ▶ Suitability
- ▶ Supervision
- ▶ Training

Referenced Rules & Notices

- ▶ FINRA Rule 2111
- ▶ FINRA Rule 2210
- ▶ FINRA Rule 3110
- ▶ Notice to Members 03-71
- ▶ Notice to Members 05-26
- ▶ Regulation Best Interest
- ▶ Regulatory Notice 12-03
- ▶ Regulatory Notice 21-07
- ▶ Regulatory Notice 22-08

For example, FINRA has addressed member firms' supervisory and compliance obligations for Alt Funds by:

- ▶ providing guidance in *Regulatory Notices*, such as *Regulatory Notice 22-08* (FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements); *Regulatory Notice 12-03* (Heightened Supervision of Complex Products); *Notice to Members 05-26* (NASD Recommends Best Practices for Reviewing New Products); and *Notice to Members 03-71* (NASD Reminds Members of Obligations When Selling Non-Conventional Investments);
- ▶ noting these issues in *Regulatory and Examination Priorities Letters*, including addressing Alt Funds specifically in the 2015 letter, and complex products and product due diligence more generally in the following years' letters and reports; and
- ▶ issuing Investor Alerts noted in the Appendix—which some firms use to train their staff—to describe the complexity, limited performance histories and additional risks of such funds compared to traditional mutual funds.

In addition to meeting their obligations pursuant to FINRA Rule 3110 (Supervision), member firms that recommend Alt Funds should be aware of other relevant obligations that could apply to this business, including but not limited to Regulation Best Interest (Reg BI), FINRA Rule 2111 (Suitability) and FINRA Rule 2210 (Communications with the Public).

This *Notice*—including the “Questions for Consideration” below—does not create new legal or regulatory requirements or new interpretations of existing requirements. Member firms may consider the information in this *Notice* in developing new, or modifying existing, practices that are reasonably designed to achieve compliance with relevant regulatory obligations based on the member firm's size and business model.

Examination Findings and Enforcement Matters

FINRA regularly reviews member firms' supervisory systems as part of our examinations, including firms' obligations relating to specific products such as Alt Funds. In recent exams and communications reviews, we noted the following findings:

- ▶ **Inadequate Written Supervisory Procedures (WSPs)**—Firms did not address Alt Funds in their WSPs or maintained WSPs that mentioned Alt Funds, but did not include detailed sales practice and review procedures to address Alt Funds (and, as a result, did not conduct heightened investigation into the funds—including reviewing the unique risks and features of the funds—before approving the fund for sale to customers).

- ▶ **Inadequate Alt Funds Oversight**—Firms did not implement effective oversight of registered representatives' recommendations of Alt Funds. For example, firms failed to limit recommendations of Alt Funds to customers with an appropriate risk tolerance, tailor their trading surveillance and systems to address the unique risks and characteristics of Alt Funds and identify Alt Funds transactions for additional reviews.
- ▶ **Insufficient Review of Communications with the Public**—Firms did not review whether retail communications they used to market Alt Funds provided a sound basis for evaluating the facts with respect to these products, such as:
 - ▶ promoting Alt Funds based on their use of complex strategies—for example, involving short selling, derivatives, options trading or leverage—but failing to explain clearly how the strategies worked and the risks associated with such strategies, including greater share price volatility and heightened risk of loss of principal;
 - ▶ comparing Alt Funds favorably to traditional funds, but failing to balance the comparisons by disclosing the greater risks, costs and complexities of the Alt Funds; and
 - ▶ touting the historical performance of affiliated hedge funds with identical strategies interchangeably with the performance of the Alt Funds' strategies without disclosing the fact that some of the historical performance pre-dated the creation of the Alt Funds, and differences between Alt funds and hedge funds.

In recent enforcement actions¹, FINRA found that firms did not:

- ▶ conduct reasonable diligence and sold Alt Funds without a sufficient understanding of their risks and features;
- ▶ maintain a reasonably designed supervisory system to review representatives' recommendations of Alt Funds;
- ▶ provide reasonable guidance or training to representatives regarding the risks and features of Alt Funds; and
- ▶ maintain WSPs advising firm principals how to supervise recommendations of Alt Funds.

Effective Practices

FINRA found that some member firms implemented the following effective practices that helped them address the unique risks and characteristics of Alt Funds.

- ▶ **Reasonable Diligence for New Alt Funds**—Firms confirmed that their alternative investments policies and procedures required review and approval of any new Alt Funds (by, if applicable, their new product committees and alternative investment review committees).

- ▶ **Reasonable Diligence Documentation**—Firms maintained documentation of their reasonable diligence for Alt Funds, which included review of the funds’ strategies, communications with the fund companies, industry analyses and metrics.
- ▶ **Sales Restrictions**—Firms limited sales of Alt Funds to customers with accounts that were approved to trade options or restricted recommendations of Alt Funds that used strategies based on derivatives, options writing or the use of leverage.
- ▶ **Enhanced Oversight**—Firms implemented new surveillance systems or confirmed that their existing systems identified whether new products, such as Alt Funds, would be considered “complex” or “alternative” and applied a heightened level of review to transactions in those funds.
- ▶ **Enhanced Surveillance**—Firms modified their trading surveillance and review systems to trigger exceptions at lower concentration levels (depending on risk tolerance, investment objective and other factors) for complex or alternative funds, including Alt Funds, and required enhanced principal review for those transactions.
- ▶ **Ongoing Evaluation**—Firms regularly reviewed and evaluated all approved funds, including Alt Funds, to determine whether any funds’ characteristics changed in ways that would meet the firms’ criteria to be considered complex or alternative products (such as, but not limited to, increased portfolio investments in options, derivatives or short sales, and a more volatile performance history).
- ▶ **Training and Education**—Firms notified appropriate staff regarding regulatory guidance and investor alerts addressing Alt Funds and included training on Alt Funds in their annual compliance meetings.
- ▶ **Communications Pre-Use Filing and Review**—Firms voluntarily filed with FINRA, prior to use, proposed retail communications concerning new Alt Funds and incorporated any feedback FINRA provided prior to using the communications.

Questions for Consideration

The following questions may help firms evaluate whether their supervisory system, including WSPs, is reasonably designed to address the unique characteristics and risks of Alt Funds. The questions—which note both regulatory requirements and effective practices FINRA has observed member firms implement—focus on five main categories of activity: (1) how firms identify and address Alt Funds in their new products process; (2) how firms develop and implement WSPs for Alt Funds; (3) the scope of firms’ review and restrictions for transactions in Alt Funds; (4) the content of firms’ communications with customers regarding Alt Funds; and (5) how firms train and educate their associated persons about Alt Funds.

Firms should not infer any new obligations from the questions for consideration and may wish to evaluate the questions presented below in the context of a risk-based approach based on their business model.

New Products Reasonable Diligence Process

- ▶ Does your firm require a heightened level of diligence and supervisory review for Alt Funds prior to bringing them onto your firm's platform? If so, what is the scope of that review and does it address the unique characteristics and risks of Alt Funds?
- ▶ Does your firm's new product process, including the process your firm uses for Alt Funds, address the types of considerations, effective practices and questions noted in *Notice to Members 05-26* (NASD Recommends Best Practices for Reviewing New Products)?
- ▶ Does your firm have reasonably designed WSPs to determine which new funds should be deemed Alt Funds, and require review and approval of any new Alt Funds (by, if applicable, new product review or alternative investment due diligence review staff or committee(s))?

Supervisory System

- ▶ Does your firm's supervisory system address alternative investments or complex products, including Alt Funds? If so, how does your firm determine whether new Alt Funds meet your firm's definition of "alternative investments" or complex products?
- ▶ Does your firm's supervisory system address the types of questions noted in *Regulatory Notice 12-03* (Heightened Supervision of Complex Products) that should be considered before registered representatives recommend complex products, including Alt Funds, to retail customers, such as:
 - ▶ whether Alt Funds your firm recommends are intended for limited or general retail distribution and how your firm limits such distribution, if warranted;
 - ▶ how your firm addresses additional risks relating to Alt Funds for customers and whether the complexity of Alt Funds may impair customers' understanding and transparency of such products;
 - ▶ how Alt Funds add to or improve your firm's current offerings (including whether less complex products could achieve Alt Funds' objectives); and
 - ▶ how your firm and associated persons are compensated for offering Alt Funds?

- ▶ Does your firm regularly review and evaluate all approved funds to determine whether:
 - ▶ any funds have changed characteristics in such a way that they meet the firm's criteria to be considered alternative or complex;
 - ▶ such products may be performing differently than anticipated or risks relating to such products have changed, particularly in response to evolving market conditions; and
 - ▶ their performance and risk profile remain consistent with the manner in which the firm is selling them?
- ▶ Does your firm limit which associated persons are authorized to recommend alternative investments or complex products to retail customers and evaluate whether any other associated persons are making such recommendations?

Trading

- ▶ Do your firm's trading surveillance and review systems include Alt Funds and address the unique risks and characteristics of Alt Funds?
- ▶ How does your firm set exception levels for Alt Funds in your trading surveillance and review systems?

Communications with the Public

- ▶ Do your firm's written communications about Alt Funds accurately and fairly describe the features and characteristics of each Alt Fund and confirm that description is consistent with the representations in the fund's prospectus? For example, if discussing an Alt Fund's objectives, does your firm confirm that such statements are consistent with the objectives noted in the fund's prospectus and clearly indicate there is no assurance that the fund's objectives will be met?
- ▶ Do your firm's written communications with customers about Alt Funds balance the benefits and risks of these products? If so, do these communications refer to individual Alt Funds based on their specific strategies instead of bundling them under one umbrella category, such as "alternative mutual funds"?
- ▶ Does your firm manage the distribution of written communications to target only customers that have a risk profile that is consistent with the unique risks and characteristics of Alt Funds, such as customers who have a moderate or aggressive risk tolerance?

Training and Education

- ▶ Does your firm educate your associated persons about the unique characteristics and risks of Alt Funds, including how such funds will respond to various market conditions or the strategy the funds' advisers use in various market scenarios?
- ▶ Does your firm share the regulatory guidance issued on Alt Funds, including this or similar *Regulatory Notices*, with its registered representatives, staff and managers either through formal training or written alerts?
- ▶ Does your firm evaluate registered representatives' knowledge or require certain training prior to permitting them to recommend products such as Alt Funds?

Conclusion

As noted throughout this *Notice*, member firms must establish and maintain a reasonably designed supervisory system and associated WSPs to comply with sales practice obligations for all products the firm offers, and especially where products may carry additional risks for customers. The information presented in this *Notice* is intended to remind member firms of their obligations and provide them with ideas and questions that they can use to enhance their supervisory programs. Additional helpful resources can be found in the Appendix.

Endnotes

1. See [FINRA Letter of Acceptance, Waiver and Consent No. 2019061764801](#) (Mar. 18, 2021); [FINRA Letter of Acceptance, Waiver and Consent No. 2018056443801](#) (Mar. 29, 2021); [FINRA Letter of Acceptance, Waiver and Consent No. 2019061765001](#) (Mar. 29, 2021); [FINRA Letter of Acceptance, Waiver and Consent No. 2019061651201](#) (Dec. 29, 2021); and [FINRA Letter of Acceptance, Waiver and Consent No. 2019061764701](#) (Mar. 18, 2022).

Appendix – Additional Resources

Regulatory Guidance

- ▶ *Regulatory Notice [22-08](#)* (FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements)
- ▶ *Regulatory Notice [21-07](#)* (FINRA Provides Guidance on Common Sales Charge Discounts and Waivers for Investment Company Products)
- ▶ *Regulatory Notice [12-03](#)* (Heightened Supervision of Complex Products)
- ▶ *Notice to Members [05-26](#)* (NASD Recommends Best Practices for Reviewing New Products)
- ▶ *Notice to Members [03-71](#)* (NASD Reminds Members of Obligations When Selling Non-Conventional Investments)

Reports and Other Publications

- ▶ [Product Suitability](#) section of the [2017](#) Report on Examination Findings
- ▶ [2015](#) FINRA Regulatory and Examination Priorities Letter

Other Resources

- ▶ U.S. Securities and Exchange Commission, [Investor Alert: Alternative Mutual Funds](#) (Feb. 3, 2017)
- ▶ [FINRA Investor Alert: Alternative Funds Are Not Your Typical Mutual Funds](#) (June 2013)
- ▶ [Mutual Funds Topic Page](#)