AMERICANS for TAX REFORM

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May 6, 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:

Americans for Tax Reform ("ATR") appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") regulatory notice on *Complex Products and Options* ("Notice").

ATR is a 501(c)(4) nonprofit, taxpayer advocacy organization that opposes all tax increases and supports limited government regulation.

The Securities Exchange Act of 1934 requires that the SEC review rules issued by FINRA to ensure that "the action will promote efficiency, competition, and capital formation." As drafted, the Notice's proposal to define "complex products" fails to promote the primary mission of the SEC and oversteps FINRA's statutory authority. Provisions of the Notice also risk eliminating trillions of dollars of affordable and accessible investment options for retail investors.

The Notice offers a paternalistic framework for the future regulation of publicly traded securities. While ATR acknowledges that FINRA is "dedicated to protecting investors," subsequent regulations that stem from the Notice could threaten "vibrant capital markets" and eliminate retail investors' access to a wide variety of publicly traded securities. Many of the financial products that could fall under the subjective definition include target date funds, asset-backed securities, closed-end funds, geared funds, commodities funds, variable annuities, global real estate funds, and funds using cryptocurrency futures. Subsequent rules that are issued as a result of the Notice could increase the cost of offering "complex products" to a point where these investments may offer lower returns than before, or retail investors may lose access to these services altogether.

Future regulation of complex products and options as proposed in the Notice will undermine the innovation retail investors have experienced over the past several years. According to a report from the Investment Company Institute ("ICI"), the cost of investing has dramatically decreased over the past 25 years. Implementation of strict prerequisites—as proposed in the Notice—for investing in complex products (e.g., knowledge tests, account opening requirements, proof of high-net worth, and learning courses) risks ruining this cost-cutting trend and eliminating the opportunity for the development of new cost-effective investment products.

Firms may stop offering certain products because of the ambiguity and subjectivity of the definition of complex products, and the overall costs of compliance. ICI estimates that "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."

FINRA should continue to promote rules and regulations that follow the SEC's traditional principles-based disclosure regime. For more than 80 years, the federal government has prioritized a system in which issuers disclose investment information so that investors can make educated investment choices. Last month, SEC Chair Gary Gensler stated that "[t]he core bargain from the 1930s is that investors get to decide which risks to take, as long as public companies provide full and fair disclosure and are truthful in those disclosures." Conversely, the Notice suggests prohibiting investors from making their own decisions and instead placing decision-making power in the hands of bureaucrats.

In 2017, Professor James Angel of Georgetown University stated that the SEC, and by extension FINRA, should "resist the temptation to get into merit-based regulation and leave the investment decisions to properly informed investors." According to Professor Angel:

> *The SEC should focus more on how to improve the level of communication with investors. Unfortunately, the practice is to focus on repetitive and expensive "disclosure" that checks legal boxes but does little to communicate relevant information to investors.*

Many complex products would likely be inaccessible to retail investors if the new regulations are implemented. This would be detrimental to investors as these products provide important benefits. Sophisticated investors would still have access, but many retail investors could be barred.

FINRA should follow Professor Angel's advice and focus on ensuring that investors receive the information they need to make informed investment decisions. Arbitrarily delineating the level of risk between complex and simple products fails to inform investors and could raise the cost of offering certain products to a point where many could be removed from the market entirely. This limits options for investors and certainly is not in their best interests. By publishing the Notice, FINRA has made it clear that is intends to shift to merit-based regulation, instead of the traditional disclosure-based regime.

The Notice falsely assumes that complex products are more volatile than simple equity and fixed-income securities. The need to define certain financial products based on unsubstantiated allegations of risk and volatility raises concerns about the serious nature in which FINRA is considering the provisions outlined in the Notice.

Although adequate transparency is necessary to keep investors informed and ensure that broker-dealers have a "reasonable basis" for suggesting certain investment options, obtrusive regulatory requirements will increase costs for brokerage firms and ETF managers, thus reducing returns to investors. This would stymie the accessibility of a wave of new innovative investment products on trading platforms available to investors of all socioeconomic backgrounds. Currently, FINRA's suitability standards, Regulation Best Interest, the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act, the Investment Company Act of 1940, and related regulations provide strong principles-based disclosure requirements that effectively safeguard investors' interests while ensuring that the market for complex investment products continues to thrive, enhance liquidity, and offer investors a multiplicity of options to earn higher yields.

Defining a complex product or option also exposes publicly traded securities to politicization. Since the SEC oversees FINRA, the current leadership at the SEC has influence over decisions made at the self-regulatory organization. Current leadership at the SEC could insist that ESG funds are not complex for the sake of expanding the investor base to promote certain climate-related investments (despite the fact that FINRA has previously labeled ESG index funds as "complex"). This benefits certain special interest groups and the Biden administration. At the same time, it prevents retail investors from accessing more affordable low-cost investment products that could offer higher returns than ESG funds. As administrations change, other types of products could be more or less favored, and fall in or out of FINRA's subjective and arbitrary definition of a complex product. It is essential that politics is removed as a potential impediment to what investments retail investors may willingly choose.

Under the Securities Exchange Act, the SEC has significant authority to dictate the rules adopted by FINRA. Section 19 of the Act explicitly states that "[n]o proposed rule change shall take effect unless approved by" the SEC or the strict approval guidelines laid out in the subsection. If a future rulemaking is proposed along the lines of the provisions incorporated into the Notice, the SEC will get the final say in whether the rule will be approved. The current environment at the SEC has not engendered confidence that retail investors will have opportunities to make their own decisions.

FINRA is pursuing potential regulations that closely align with the rhetoric displayed by the SEC. Both FINRA and the SEC appear to be concerned that unless an investor has a certain net worth or has received specific training, the investor cannot possibly make decisions on their own. However, Regulation Best Interest points out that net worth "may not necessarily correlate to a particular level of financial sophistication." FINRA should avoid deepening the divide between retail and sophisticated investors. Mandating different "approval requirements" or restricting access to only "high-net worth" investors will increase the pool of investors that lack access to capital markets.

FINRA has also violated its authority under Section 15A(b)(6) of the Securities Exchange Act. Under the statute, FINRA is required to (1) "to promote just and equitable principles of trade," (2) "perfect the mechanism of a free and open market," and (3) prohibit "unfair discrimination between customers, issuers, brokers, or dealers," among other requirements. The Notice asks questions that imply that future rules will require FINRA members to protect retail investors from themselves. Embedded in the list of questions about complex products, the Notice asks whether members should "implement an account approval process" or require retail investors to complete a "knowledge check" or "learning course" in order to prove they have the aptitude to invest in complex products. Tests and subjective qualification requirements can be unintentionally biased – resulting in unfair discrimination between customers in violation of FINRA's governing statute. Imposing these requirements on investors would deepen the divide between institutional and retail investors—allowing greater access to a wider variety of securities for the former but limiting choices for the latter.

Retail investors should be allowed to pursue riskier investments that offer higher returns. In the current economic environment, traditional stocks and bonds are offering unstable returns. If an investor wants to hedge and invest in a product that offers a higher yield, even if the risk is higher, they should be allowed to do so. Academics have pointed out how useful complex products can be

for "hedging purposes." All restrictions on these funds will do is "reduce the number of investors who can trade them, and thus reduce their liquidity."

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Ensuring that retail investors have access to innovative financial products that offer a multitude of options is the key to thriving capital markets. Unfortunately, the provisions of the Notice threaten to impose a new layer of regulation that will impede investors' access to complex products. Instead of imposing a paternalistic regulatory framework for retail investors, FINRA should stick to principles-based regulation that ensures clear lines of communication between fund managers and investors. Checking a box by requiring knowledge tests, prior account opening approval, and superfluous disclosures will surely increase the costs of these investment products or eliminate their availability to non-institutional investors. Wealthy investors will continue to thrive under the new regulatory regime while everyone else will be restricted.

Any future rules published by FINRA should carefully take into consideration the negative repercussions of restricting certain investment products to a select few. A thorough cost-benefit analysis would improve the rulemaking process and shed light on the reasons for pursuing this action. Currently, the Notice and potential changes to the market's regulatory structure have been drafted under questionable statutory grounds. If further justification for the proposed changes is not enumerated, future rules will likely fail to pass muster and be deemed arbitrary and capricious.

ATR appreciates the opportunity to comment on the Notice. If you have any questions or need any additional information, please contact Bryan Bashur at bbashur@atr.org.

Sincerely,

Americans for Tax Reform