May 9, 2022

Via E-mail: pubcom@finra.org

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

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

Dear Ms. Mitchell:

This will serve as comments of Cetera Financial Group, Inc. ("Cetera") with respect to FINRA Regulatory Notice 22-08 (the "Notice"). The Notice seeks the views of FINRA member firms and other interested parties regarding complex investment products and options.

Cetera is the corporate parent of five FINRA member firms which collectively serve more than one million customers. Our client base is primarily composed of individuals and small businesses saving and investing for education, retirement, and legacy purposes. We offer a broad range of investment products to our customers, tailored to their individual circumstances and objectives.

The Notice discusses sales practice and supervision issues faced by FINRA member firms with respect to "complex" investment products and options. Transactions in options and other derivative instruments represent a very small part of our business, but Cetera does offer a number of investment products that FINRA has characterized as complex at one time or another. As a preliminary matter, we would note that the list of investments that FINRA has previously characterized as being complex is long and widely varied. We would also note that most of them are offered by the large majority of FINRA members and are squarely in the mainstream of investment products in the United States.

We recognize that some investments involve higher levels of risk and complexity and that many of them are not appropriate for certain categories of investors. We support the longstanding requirements that FINRA member firms maintain and enforce supervisory systems and risk management practices to protect the interests of investors by making sure that both representatives and customers understand the risks and other relevant attributes of investments and strategies that are recommended to customers. However, a cornerstone of the FINRA sales practice supervision regime is flexibility for member firms in designing and implementing supervisory processes that reflect their client base, the investment products that they offer, and their supervisory infrastructure. The Notice poses a number of questions about practices that member firms might consider in connection with sales and supervisory oversight of investments that are deemed to be complex. As we will discuss in more detail below, any such practices that would be effective are likely to be unique as applied to different investment products. They would thus tend to be highly prescriptive and inconsistent with

the principles-based nature of the current FINRA supervisory framework. Perhaps more importantly, embarking on an exercise which would likely define large numbers of investment products as complex and requiring special processes to vet or supervise is likely to dilute the impact of any heightened supervisory process. The philosopher Aristotle stated that "A friend to all is a friend to none." If everything is complex or worthy of special supervision, the term loses its meaning. We do not believe that the interests of FINRA, its members, or the investing public would be served by this approach.

Summary

As FINRA considers complex products, options, and sales practice and supervisory processes applicable to them, it should be guided by three basic principles:

- FINRA members and other financial advisers are already subject to a comprehensive regulatory regime covering investment recommendations to customers. Adding an additional layer of regulatory requirements applicable to specific investment products is not necessary or helpful.

- FINRA should refrain from defining any category of investment products as "complex" or deemed worthy of special supervisory processes. Creating a workable definition would be exceedingly difficult and likely to create more confusion than clarity.

- There are substantive differences between self-directed platforms in which investors make their own investment decisions and those where financial professionals recommend investments and strategies. Regulation of sales practices and supervision applicable to self-directed platforms should be considered separately from those involving financial professionals who make investment recommendations to customers.

Comments on the Notice

1. **FINRA members and other financial advisers are subject to a comprehensive regulatory regime relating to investment recommendations to customers. Creating special requirements for certain categories of investment products would add significant and unwarranted burdens without a commensurate increase to investor protection.**

SEC Regulation Best Interest ("Reg. BI") became effective in 2020.[1] It incorporated fiduciary principles and adopted much of the existing FINRA framework relating to investment recommendations to customers. Reg. BI either created, expanded, or clarified specific obligations running from broker-dealers to customers. These obligations include duties of care, disclosure, and conflict management, and require FINRA member firms to maintain effective compliance practices to ensure that the obligations are met. FINRA Rule 2111 already contained many similar obligations, and has worked effectively for decades.

[1] Securities Exchange Act Release 34-86031. (The "Adopting Release.)

Reg. BI is specifically intended to be "product-neutral" and apply in a very similar way to all investment recommendations made to customers. Adding an additional layer of requirements applicable to specific investment products is unnecessary and creates a likelihood of conflict with the existing framework. It also adds cost and compliance burdens to FINRA members. These costs are likely to be passed on to customers without commensurate benefits.

Although Reg. BI is designed to be product-neutral, FINRA has previously adopted rules applicable to sales and supervision of specific investment products. For example, FINRA Rule 2330 applies to the offer and sale of deferred variable annuity contracts. (We note that variable annuity contracts have been characterized as complex and worthy of increased supervisory scrutiny by FINRA more than once, which was no doubt a significant factor in the adoption of Rule 2330.) Whether or not Rule 2330 has produced the desired effects in an effective way is a matter of debate. It has been in effect for more than ten years, and we are not aware of any studies or research which definitively establishes that Rule 2330 has enhanced investor protection or led to better investment outcomes. We can, however, state with certainty that the adoption of Rule 2330 involved the expenditure of a tremendous amount of time and energy by FINRA, and has vastly increased the amount of time, effort, and expense incurred by member firms in connection with it.

Variable annuity contracts consist of several different investment elements. They usually include insurance features such as death benefits, multiple investment options, guaranteed income or other provisions referred to as "riders", and tax deferral on investment gains within the annuity contract. However, while there are several different elements, we submit that none of them in and of themselves is particularly complicated. Despite that, it took more than five years for FINRA to adopt and implement Rule 2330.

Variable annuities represent a single type of investment product amongst the hundreds offered by FINRA members. If FINRA chooses to adopt new or heightened requirements applicable to any list of investments that meet an imprecise definition of "complex", it will have to go through a similar exercise with respect to each of them. FINRA is a large and sophisticated organization, but its' resources are finite. Creating a new set of requirements for a long list of investment products that would not add materially to the protections already in Reg. BI and existing FINRA rules would be an ineffective use of those resources.

Reg. BI has been in effect for less than two years. Broker-dealers have made significant investments in upgrading their product review and approval, sales practices, and supervisory oversight processes. A reasonable way to approach this issue would be to wait for some period of time to see how firms adapt to the new obligations created by Reg. BI. If there are problems with respect to specific investment products or investment advice in general, FINRA can take up those questions at that time. Proceeding now would not be advisable.

2. **FINRA should refrain from creating or defining any category of "complex" investment products.**

The text of the Notice begins with the following quote:

> "***There is currently no standard definition of a "complex product." Because new products and strategies are constantly introduced, FINRA has construed the term "complex product" flexibly to avoid a static definition that may not address the evolution of financial products and technology."*** [2] (Emphasis added.)

This simple statement is surely a major reason why neither the SEC nor FINRA has previously adopted a single definition of complex products. As the Notice points out, many different types of investments have been deemed by FINRA to be complex, usually for one of two reasons: Either their structure is inherently unusual or complicated or they consist of multiple underlying investment elements. Investment products that include features such as embedded derivatives, "best of", "worst of", or instruments that include "reset" features such as leveraged and inverse ETFs are examples of complex structures that may be difficult for financial professionals or investors to understand. However, as noted in our comments regarding variable annuity contracts, the fact that an investment product has multiple elements does not necessarily make it harder for financial professionals or investors to comprehend. Categorizing any investment product as complex simply because it has multiple elements is not an effective approach.

The universe of investment products changes constantly, based on the global economy, capital markets, investor demographics and preferences, and many other factors. Creating a definition of complex products that would be precise enough to be useful but flexible enough to adapt to changing conditions would be exceedingly difficult. Rulemaking that would result in the creation of an artificial and amorphous definition of complex investment products is not destined to be a productive exercise for FINRA or its membership.

3. **FINRA should recognize and clearly distinguish between the obligations of members utilizing investor-directed platforms and those that give advice and make recommendations to customers.**

Cetera's business is founded on providing advice and recommendations to customers to help them meet their investment goals. Some of our customers initiate investment purchases or strategies on their own, but we do not offer a self-directed platform on which customers execute transactions without the involvement of financial professionals. Despite that, we believe it is important to note that there are substantive differences between self-directed investment platforms and those in which financial professionals offer investment recommendations to clients. These differences should be taken into account when formulating rules or guidance.

One of the foundational elements of Reg. BI is the existence of a "recommendation" from the financial professional to a retail customer relating to an investment or investment strategy. Absent a recommendation, the care, disclosure, and conflict obligations do not apply. Many

[2] Notice, at 3.

investors prefer to make their own investment decisions without the involvement of a financial professional. Many prefer not to incur the additional cost, but some investors do not trade frequently or simply prefer to make and execute on their own decisions. Firms that offer purely self-directed platforms comprise the minority of FINRA members, but they represent a significant number of firms and serve a large number of investors. As FINRA considers the need for special practices, it should explicitly recognize that self-directed investment platforms involve a different set of supervisory and oversight considerations than those in which representatives make investment recommendations. There are categories of FINRA rules that should apply to all customer accounts and activities. Customer identification, anti-money laundering, financial capacity, and other similar requirements are essential to the safety and security of the securities industry and the economy more generally. However, the investor protection obligations in Reg. BI and corresponding FINRA rules should not apply to customers or transactions in which there is no investment recommendation by the firm or a representative.

The SEC recently sought public comment regarding "Digital Engagement Practices" employed by broker-dealers and other investment professionals.[3] One of the questions posed was under what circumstances the actions of a broker-dealer should be deemed to be recommendations and therefore subject to the provisions of Reg. BI. It is beyond the scope of this submission to discuss the broader question of what types of conduct could or should be deemed recommendations to customers, but we note that the SEC received a large number of comments on the issue without a real consensus. We also note that both Reg. BI and FINRA Rule 2111 rely primarily on the existence of a "call to action" from the firm to the customer. This framework has functioned well for both broker-dealers and customers, and we see no reason for substantive changes. The more important point is that self-directed platforms on which investors make their own investment decisions provide meaningful benefits to investors, but they are constructed on an economic and supervisory model that cannot function effectively if all transactions become subject to the provisions of Reg. BI or similar FINRA rules.

4. **Wholesale changes to FINRA rules applicable to investments in options and similar derivative instruments are likely not necessary, but a review may be in order.**

Investing in options creates unique risks for investors, primarily due to their inherent leverage and limited duration. The regulatory framework for options was developed some forty years ago, and the investment landscape and breadth of investment offerings available to the public has changed dramatically in that time. Wholesale changes to the regulatory regime applicable to options and other derivative instruments are probably not necessary, but a review of the existing framework may be in order. If that is to be done, it should be undertaken on its' own, separate from consideration of sales practices or supervision of other investment types.

****

[3] Release Nos. 34 – 92766 and IA – 5833. (August 2021.)

In addition to our comments above, we offer the following with respect to several specific questions posed in the Notice.

- **Question No. 2 – Sales and supervision practices that member firms have developed or implemented with respect to complex products.**

Cetera and many other FINRA members have developed numerous practices for supervision and oversight of certain investment products, although not necessarily because they are complex. For example, may firms employ a process requiring advance approval of purchases of securities that are illiquid or for which no established trading market exists. The criteria for review of transactions generally includes consideration of the investor's age, total and liquid net worth, investment time horizon, and holdings of other illiquid investments. Many firms have established limits on customer purchases of illiquid investments, both by individual issue and in the aggregate. These practices vary by firm, but they illustrate two important points: First, FINRA member firms have taken the requirements of Reg. BI seriously and created processes designed to protect investors. Second, the current principles-based FINRA regime which allows member firms flexibility to design and implement supervisory processes that best reflect its customers, product offerings, and supervisory infrastructure is alive and well. Substantive changes of the type discussed in this question are neither necessary nor appropriate.

- **Question No. 7 – Different or additional requirements for complex products.**

As noted in our comments above, we do not believe it is feasible to develop or implement a workable definition of complex investment products, and requiring firms to reach such a determination or adopt special practices is not warranted. Firms already have specific obligations to customers, and grafting additional requirements on them will not materially enhance investor protection. FINRA members should not be subject to any requirement to assess whether or not a product is complex or meets any other arbitrary definition prior to recommending it to a customer. The same should apply to the concept of requiring any heightened assessment of a customer's circumstances, including their financial situation, investment experience, and either general or investment-specific level of sophistication. FINRA should not impose any special approval requirements, by principals or others in connection with transactions in any investment product. We have noted that both Reg. BI and the current FINRA regime are generally "product-neutral" and impose the same obligations on broker-dealers when recommending any investment or investment strategy to customers. Firms have and should continue to have flexibility in designing supervisory processes that work best for them and their customers.

- **Questions No. 7 d. (i) and (ii). Obligations to monitor customer circumstances or investment recommendations after a transaction.**

FINRA should not consider creating any obligation to monitor either the financial status of a customer or an individual recommendation to buy, sell, or exchange any investment product absent a specific agreement between the firm and the customer. When it implemented Reg. BI, the SEC explicitly recognized that there are important and substantive differences between

transaction-based brokerage and fee-based investment advisory relationships. Coincident with the adoption of Reg. BI, the SEC's Division of Investment Management published guidance that clarified the circumstances under which advice provided by financial professionals would be deemed to be subject to the provisions of the Investment Advisers Act of 1940.[4] This is a significant issue, because if a broker-dealer or representative is deemed to be acting as an investment adviser, they would be subject to a number of obligations that do not apply to broker-dealers. The guidance stated that one of the primary factors indicating the existence of an advisory relationship is ongoing monitoring of the customer's accounts or individual investments. In issuing this guidance and in the Adopting Release, the SEC specifically stated that recommendations to customers in brokerage relationships must be in the best interest of the customer ***at the time of the recommendation***, but absent a specific undertaking by the firm, no such obligation to perform ongoing monitoring should exist.

A requirement for broker-dealers to perform ongoing monitoring of prior investment recommendations for any reason puts them at risk of being deemed to be acting as investment advisers. That is clearly inconsistent with both the letter and spirit of Reg. BI.

- **Question No. 7 - Restriction of access to investment products**.

Adoption of requirements of the types suggested in Question No. 7 would clearly restrict investor access to any investment product that meets an arbitrary definition of "complex". Given the burdens it would create for broker-dealers and lack of additional investor protection, such requirements should be avoided.

- **Question No. 7 - Standards applicable to other financial intermediaries**.

This question notes the existence of regulatory regimes governing the conduct of other types of financial intermediaries such as investment advisers and insurance agents. Each type of financial intermediary is subject to its own regulatory scheme because the products and services offered by each are different, as are the political subdivisions that establish and manage them. As a general matter, inconsistencies between regulations applicable to different people or organizations performing the same activities should be avoided. The existence of different regulatory regimes creates both the possibility of and incentives for regulatory arbitrage, in which industry participants seek to operate under rules that subject them to what they view as the least intrusive form of regulation. One such situation currently exists with respect to fixed-indexed and equity-indexed annuity contracts. These instruments are very similar to deferred variable annuities, but are defined in federal law as non-securities and may be recommended and sold by individuals who are not subject to the provisions of Reg. BI. This has led to instances in which two very similar investments are subject to a potentially undesirable form of regulatory arbitrage.

In general, we support the idea of harmonizing regulation applicable to different people or organizations performing similar activities. However, the regulatory regimes applicable to broker-dealers, investment advisers, and insurance professionals are different in countless ways,

[4] Release No. IA-5248, effective July 12, 2019.

and each type of business is regulated by a different group of governmental authorities. Coordination among them would likely be a benefit to all, but FINRA and other regulatory agencies should avoid the temptation to simply take requirements from other regimes and layer them onto their current frameworks. Such an approach runs the risk of creating the proverbial camel which began as a horse but was designed by a committee. The current FINRA regime is well-suited to the business activities in which broker-dealers engage and should be left as it is.

- **Question No . 8 – Targeted communications.**

As noted above, the threshold question for determining the applicability of the obligations in Reg. BI and FINRA Rule 2111 is and should be the existence of a recommendation to a retail customer. Whether or not any communication is deemed a recommendation depends on the surrounding facts and circumstances. As we noted above with respect to the SEC's recent request for comments on Digital Engagement Practices, the "call to action" criteria is well-known and clearly understood by both broker-dealers and customers. FINRA should not change that framework.

- **Question No. 10 - Additional supervisory obligations**

Our comments above discuss the many reasons why adoption of a definition of complex products or special standards relating to them are not appropriate. FINRA should not adopt any of the requirements or approaches mentioned in this question.

- **Question No. 12. - Transactions on self-directed platforms**

We have noted the underlying substantive differences between self-directed platforms and arrangements in which financial professionals make investment recommendations to customers. We reiterate that the threshold for applying obligations such as those in Reg. BI and FINRA Rule 2111 is and should continue to be the existence of a recommendation from the broker-dealer to the customer.

- **Options**

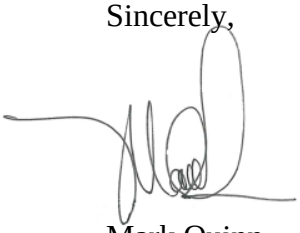
The Notice poses a number of questions relating specifically to transactions in options, many of which are very similar to those posed in relation to complex products more broadly. Recommendations to buy or sell options or to engage in investment strategies that utilize them are already subject to a specific set of regulations not applicable to other securities. This has been the case for many years and in general represents sound policy. The volume of trading in options and investment strategies that utilize them have multiplied over the past 30 years. Options and similar derivative instruments pose unique risks to customers, and that may militate in favor of a review of FINRA rules applicable to options trading. If FINRA decides to undertake to such a review, it should be focused on and dedicated to the unique investment characteristics of options and derivative instruments and include a comprehensive look at sales practices, risks, supervisory oversight, and deficiencies that have been identified in the current regime. It should include a review of both FINRA and the SEC's experience in examinations of broker-dealers, the costs and burdens that might be imposed on FINRA members and other financial intermediaries in

connection with a new regime, and the extent to which it might restrict or limit access to these products by investors. In all events, it should be conducted as a stand-alone endeavor and not as part of a broader review of other investment or supervisory practices relative to other investment products.

****

We appreciate this opportunity to provide our comments on the important issues addressed in the Notice. As always, we look forward to engaging with FINRA on this and other matters of significance to the securities industry. If we may supplement our comments or offer any further information, please let me know.

Sincerely,



Mark Quinn
Director of Regulatory Affairs
Cetera Financial Group