Institute for Portfolio Alternatives

May 9, 2022

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
pubcom@finra.org

Re: Regulatory Notice 22-08 (the "Notice")

Dear Ms. Mitchell:

The Institute for Portfolio Alternatives appreciates the opportunity to comment on the Notice. The IPA represents the sponsors and distributors of alternative products, including non-listed REITs and business development companies, interval funds, and tender-offer funds.[1]

FINRA plays an important role in creating and enforcing standards applicable to the provision of investment advice. The Notice provides an important reminder of the sales practice and supervisory measures that broker-dealers should adopt concerning the purchase of so-called "complex products" by retail investors. This guidance to the industry illustrates a benefit of the self-regulatory model, to provide guidance to broker-dealers so that they can satisfy regulatory expectations. We welcome the opportunity to participate in the discussion of how to strengthen investor protection while maintaining consumer choice and continued access to investment advice and products. We applaud FINRA's commitment to the issuance of guidance on sales practice and other matters.

We respectfully offer four essential observations about the Notice:

- First, while the Notice might have been inspired by the trading of complex products in self-directed accounts, non-listed REITs and BDCs, interval funds, and tender-offer funds are not "traded" and they are rarely, if ever, purchased in those types of accounts. Rather, these investments are distributed through registered broker-dealers and investment advisers who have fiduciary duties and regulatory frameworks requiring them to act in their customers' best interest.

[1] The IPA's mission is to ensure that investors have access to alternative investments, with easy-to-understand information about the benefits and the risks, while being well-protected from inappropriate sales practices. Our members include the sponsors of diversifying investments, wire house broker-dealers, independent broker-dealers, regional broker-dealers, registered investment advisers, law firms, accounting firms, transfer agents, valuation firms, due diligence firms, and technology firms.

- Second, the Securities Exchange Commission and FINRA should address under existing law any problem related to the distribution of complex products through these financial professionals. No amendment to existing sales practices standards is necessary.

- Third, any rulemaking concerning complex products would necessitate a definition of "complex," which will be difficult, if not impossible.

- Fourth, however one might define the term "complex," the definition should not extend to interval funds and tender-offer funds, which are registered closed-end funds that provide shareholder repurchase programs regulated by the Commission.

1. Retail Investors Do Not Trade Our Members' Products in Self-Directed Accounts

We understand that the Notice arose, in part, from a concern that retail investors might inflict harm on themselves when they trade complex products in self-directed accounts. Sometimes this harm can have tragic consequences. In one well-publicized example, a 20-year-old college student mistakenly believed that he owed almost $750,000 from a complex options trading strategy and subsequently took his life.[2]

The Notice repeatedly refers to potential issues related to self-direct accounts. As the Notice states:

> Although complex products do not always translate into more investment risk, their complexity may confuse investors who may not adequately understand their features. These concerns may be heightened when a retail customer is accessing these products through a self-directed platform and without the assistance of a financial professional, who may be in a position to explain the key features and risks of the product to the retail investor.[3]

The products offered by our members are <u>not</u> "traded" and they rarely are, if ever, purchased in self-directed accounts. Non-listed REITs and BDCs, tender-offer funds, and interval funds are distributed through registered broker-dealers and investment advisers who must act in their customers' best interest. Therefore, the legitimate concerns about errant trading of complex products by retail investors in self-directed accounts, without the guidance of a regulated financial professional, do not apply to the distribution of our member's products.

[2] https://www.ft.com/content/45d0a047-360f-4abf-86ee-108f436015a1.

[3] Notice at 3.

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One also must distinguish our members' products from options. An option has a nonlinear payoff, meaning that the option holder can benefit from price movements of the underlying in one direction and avoid any harm in the other direction. Depending upon the option, it can provide exposure to either positive or negative price movements. Moreover, the size and speed of these option price movements depend upon various complex relationships including the option's Delta (its price sensitivity to price movements of the underlying), Gamma (the sensitivity of its Delta to price movements of the underlying), and Vega (its price sensitivity to a change in price volatility of the underlying). Because of these characteristics, options are traded in various strategies, such as bull spreads, bear spreads, butterfly spreads, collars, and straddles.

Non-listed REITs and BDCs, tender-offer funds and interval funds have none of these attributes. Their price movements have a linear payoff. They are sold and redeemed at the net asset value of the underlying assets and liabilities and do not represent a leveraged interest in that underlying portfolio. They are not used in complicated trading or hedging strategies. The products offered by our members neither possess the operational or economic complexity nor carry the attendant risks of options.

In short, the distribution of non-listed REITs and BDCs, tender-offer funds and interval funds present none of the concerns from the trading of options or other complex products in self-directed accounts. If the Commission or FINRA were to impose any new requirement or compliance expectation on self-directed accounts then it should refrain from imposing a similar measure on broker-dealers and investment advisers, at least without a careful consideration of the costs and benefits of doing so. For example, a requirement that a customer complete training or a learning course might be useful for a self-directed account, but would serve little purpose for a customer advised by a financial professional who must act in the customer's best interest. [4]

2. Existing Law Address Issues in Professionally Serviced Accounts

While the Notice emphasizes self-directed trading, it also refers to the recommendation of complex products by registered broker-dealers and investment advisers.[5] Existing law is more than adequate to address any problems in these accounts.

In June 2019, the SEC adopted Regulation Best Interest ("Reg. BI")[6] and a series of related regulations and interpretations regarding standards of conduct for broker-dealers and RIAs. Reg. BI establishes a comprehensive regime designed to enhance investor protection by requiring that broker-

[4] *See* Notice at 8.

[5] *See, e.g.,* Notice at 1.

[6] SEC Release No. 34 – 86031.

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dealers and representatives not place their financial or other interests above those of their clients. A series of related regulations require extensive disclosure about the services broker-dealers and RIAs provide, the capacity in which they are acting, fees and expenses, and conflicts of interest that may exist between the adviser and the client. They also require development and implementation of a comprehensive regime to identify, disclose, and manage conflicts of interest. While the SEC does not refer to Reg. BI as a fiduciary standard, it draws extensively on common law fiduciary principles and produces the same practical results for most investors. Importantly, Reg. BI provides a clear and straightforward compliance road map for broker-dealers and other financial professionals.

The principles of Reg BI and the fiduciary duty are broad enough to address these problems. In adopting Reg BI the Commission emphasized the importance of understanding the terms, features and risks of complex products in order to establish a reasonable basis to recommend these products to customers.[7] Reg BI and the fiduciary duty of an investment adviser suggest that firms must apply heightened scrutiny when assessing whether these recommendations are in a customer's best interest.[8]

The Commission implemented Reg BI in June 2020 and issued its release on the fiduciary duty of an investment adviser in July 2019. Perhaps more guidance will be necessary as the implementation of these standards continues to develop. This interpretive guidance can address any problems arising from the recommendation of complex products. It would be premature to address them by amending or fundamentally reinterpreting the sales practice standards.

3. New Rulemaking Will Necessitate a Definition of "Complex Product"

The Notice avoided a definition as scrupulously as FINRA's previous statements:

> 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.[9]

To date, FINRA has issued informal guidance to broker-dealers about the types of compliance and supervisory measures they should consider when recommending complex products. FINRA has not defined "complex product," and a definition may not be necessary when FINRA is only providing informal guidance.

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[7] Notice at 6.

[8] *Id.*

[9] Notice at 2.

If FINRA or the Commission were to engage in rulemaking about complex products, however, then it could ill-afford the luxury of no definition. If broker-dealers or investment advisers were required by law to adopt specific measures concerning the sale of "complex products," then under accepted notions of due process and the Administrative Procedure Act the Commission and FINRA would have to define what it means by "complex." The definition would need to be unambiguous so that broker-dealers could distinguish complex products from all others, yet flexible enough to address the evolution of financial products and technology.

One can surmise the difficulty of defining "complex product" by considering those products that have complicated features, but that FINRA does not consider to be "complex." An example might be exchange-traded funds. The size of the ETF market is about $10 trillion.[10] FINRA does not consider most ETFs to be complex products, but retail purchasers of ETFs probably fail to comprehend the structure and operation of these products.[11] Most retail investors are unfamiliar with creation units, redemption units, or authorized participants.

Indeed, *the Commission staff* was confounded when State Street first filed its ETF exemptive application. As former Chairman Breeden said, the staff could not figure out how the new product might fit into existing law:

> From one division's perspective they had a square peg trying to fit in a round a hole. From another division's perspective they had round peg trying to fit in a square hole, and the other division thought it was a triangle. It was a perfectly legitimate product, but each of the divisions had a this isn't the way we do business.[12]

If FINRA or the Commission choose to adopt a rule applicable only to complex products, then it would have to define the term in a way that is unambiguous yet flexible, consistent with notions of due process and the Administrative Procedure Act, and exclusive of products like ETFs.

We respectfully recommend that FINRA and the Commission address any sales practice problem by issuing guidance under existing law.

4. Interval Funds and Tender-Offer Funds Are Not "Complex"

[10] https://www.statista.com/statistics/224579/worldwide-etf-assets-under-management-since-1997.

[11] An exception is the leveraged and inverse ETF. *See* Notice at 2.

[12] https://www.sechistorical.org/collection/oral-histories/2019-11-20_Richard_Breeden_OH_2_T.pdf (sic).

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For the first time, FINRA in the Notice asserted that interval funds and tender-offer funds are "complex":

> Unlike traditional mutual funds, which in most situations allow investors to redeem 100 percent of their holdings in a specific fund at the next determined daily net asset value, [interval funds and tender-offer funds] present complexities in the redemption process and in the amount of holdings available for redemption during a given period . . . [I]nvestors may not be able to redeem all of their holdings during a repurchase window if the total amount of shares tendered by shareholders for repurchase exceeds the threshold set by the fund's board for that repurchase window. In addition, shareholders must comply with the repurchase request deadline several weeks prior in order to redeem shares in the given period. Further, at the time an investor must commit to the repurchase process for an upcoming window, the investor will not know the price at which shares will be redeemed.[13]

In their previous notices and releases, neither FINRA nor the Commission ever referred to these products as "complex," and for good reason.[14]

Interval funds and tender-offer funds are closed-end funds registered under the Investment Company Act of 1940. FINRA does not consider other registered closed-end funds to be "complex." FINRA apparently considers interval funds and tender-offer funds to be complex only because they provide a repurchase program that offers liquidity to their shareholders. A closed-end fund that trades at a discount and lacks a repurchase program is not "complex," but when it adopts a repurchase program that benefits its shareholders then it becomes complex.

Any rationale for this approach must account for the legal nature of those repurchase programs. The Commission strictly regulates their repurchase programs under specific provisions of federal law. Interval funds repurchase their shares under Investment Company Act Rule 23c-3. Tender-offer funds repurchase their shares under Section 23(c)(2) of the Investment Company Act and Rule 13e-4 of the Securities Exchange Act.

FINRA *itself* treats interval funds as mutual funds for purposes of the filing requirements and compensation limitations of its corporate financing rules. [15]

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[13] Notice at 2.

[14] *See, e.g.,* Commission Chair Gary Gensler, *Statement on Complex Exchange-Traded Products* (Oct. 4, 2021); SEC Investor Bulletin: Interval Funds (Sept. 25, 2020); FINRA Investor Alert, *Interval Funds – 6 Things to Know Before You Invest* (Jan. 23, 2018); FINRA Regulatory Notice 12-03 (Jan. 2012).

[15] *See* Rule 5110(h)(2)(B).

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Simply put, it makes no regulatory sense to deem interval funds and tender-offer funds as "complex" merely because they afford their shareholders with greater liquidity in repurchase programs that the Commission strictly regulates.

We respectfully request that FINRA reconsider this novel definition of "complex."

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The IPA appreciates the opportunity to comment on the Notice. Should the staff have any questions about our comments, please feel free to contact me or Anya Coverman, General Counsel, at (202) 548-7190.

Sincerely,

Anthony Chereso
President & CEO, Institute for Portfolio Alternatives

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