May 9, 2022

Submitted By Email

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

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

Dear Ms. Mitchell:

Innovator Capital Management, LLC ("*Innovator*") appreciates the opportunity to respond to the request by FINRA for comments on Notice 22-08.

As a threshold matter, we strongly agree with many of the comments[1] submitted that oppose any FINRA-administered regulatory regime that installs a number of barrier-creating measures designed to inhibit investors from accessing investment companies that are subjectively labeled "complex" and, without distinction, "risky" for investors.

To the extent, however, that FINRA nevertheless moves forward with any such regime, Innovator believes it should reflect two critical elements:

1. A registered investment company that utilizes derivative instruments and complies with Rule 18f-4 under the Investment Company Act of 1940 (the "1940 Act"), including compliance with either the Rule's relative VaR test or absolute VaR test, should not be deemed a "complex product," especially as within this proposed FINRA regime there is no distinction between "complex" and "risky" as was otherwise framed by the U.S. Securities and Exchange Commission ("*SEC*") in Rule 18f-4 and its adopting release.[2]

[1] Innovator is aware that the Investment Company Institute (ICI), among other organizations and interested parties, has submitted a letter on behalf of the industry and its members, which Innovator also supports and endorses.

[2] Since the initial launch of this 1940 Act fund category by Innovator in August 2018, Notice 22-08 rightly identifies by name the increased acceptance of this investment solution by Innovator. See also slide 6 of the recent 2022 global survey from fund custodian Brown Brothers Harriman for data on global investor demand for protective investment solutions made available by Innovator Defined Outcome ETFs: https://www.bbh.com/content/dam/bbh/external/www/investor-services/insights/2022-global-etf-survey/20220183-IS-ETF%20Survey%20Report.access.pdf

2. Any broker-dealer that offers and sells a complex product, including proprietary products or products such broker-dealer has been incentivized to offer, to its customers should not be permitted to exclude from its platform a comparable, competitive product by virtue of the fact that the comparable, competitive product is deemed complex.

Background

Innovator is the sponsor of the first and largest suite of exchange-traded funds registered under the 1940 Act ("ETFs") that utilize an option strategy to produce predetermined investment outcomes which seek to protect potential downside losses over a fixed time period (an *"Outcome Period"*) based upon the performance of a benchmark (the "*Innovator Defined Outcome ETFs*" or "*Innovator ETFs*").[3] Until the launch of the Innovator ETFs and other like-structured ETFs offered later by other ETF issuers, outcome-based strategies had only been available to large institutional investors or high-net-worth individuals through professionally managed accounts, structured notes and insurance products. Delivering defined outcome strategies in the ETF wrapper is an efficient solution that offers a number of advantages over these products including, most importantly: lower costs for investors; purchase and sale flexibility; liquidity; daily portfolio transparency; lack of credit risk; and tax efficiency.

To date, these Innovator Defined Outcome ETFs have each successfully reset at the end of their respective outcome periods, with more than one hundred such fund resets. Thus, the provision of the Innovator Defined Outcome ETFs as investor solutions are noted as attractive risk-reducing solutions for investors via the use of exchange-traded derivative instruments, rather than using derivatives as risky day trades or for seeking returns that actually increase investor risk.

The Innovator ETFs comply with all aspects of the federal securities laws, including those imposed by the 1940 Act. In this regard, the Innovator ETFs make available to investors daily information about the current Outcome Period and the Protection and Caps of the Innovator ETFs. We believe investors easily understand the potential benefits and risks of the Innovator ETFs including during intra-Outcome Period purchases and sales at market prices. Toward that

[3] The Innovator Defined-Outcome ETFs' investment strategy provides shareholders with participation in any gains experienced by a benchmark over the course of the Outcome Period, subject to a cap on upside returns (a *"Cap"*), and a predetermined downside protection through a buffer against benchmark losses (a *"Buffer"*) or a maximum of benchmark losses (a "*Floor*," and together with the Buffer, the "*Protection*") for the Outcome Period. In seeking to achieve these defined outcomes, the adviser purchases and sells call and put FLexible EXchange Options (*"FLEX Options"*). Each FLEX Option has the same reference asset (*e.g.,* S&P 500) and expiration date (*e.g.,* April 30, 2022). However, each FLEX Option has a specifically selected strike price. Due to the customizable nature of FLEX Options that allows for specific strike prices to be selected for the same reference asset and expiration date, when each of the FLEX Options expires on the last day of the Outcome Period, the Innovator ETFs are expected to achieve an investment return that works within the applicable investment parameters that produce a Cap and applicable Protection.

end, Innovator has worked extensively with the SEC staff to develop detailed registration statement and website disclosures regarding the Innovator ETFs.[4]

The Impact of FINRA's Current Position on Complex Products

Due to the lack of an objective regulatory definition of "complex product," most large broker-dealer platforms have determined that the Innovator Defined Outcome ETFs are "complex products" under the current guidance articulated in FINRA Regulatory Notice 12-03: Heightened Supervision of Complex Products ("*Notice 12-03*"). Accordingly, in order to offer the Innovator ETFs on their platform, broker-dealers must undertake a number of tasks and conduct a rigorous review of both the Innovator ETFs and also their own customers, as outlined in Notice 12-03.[5] As a practical matter, most broker-dealers have elected not to undertake these steps, which results in the Innovator ETFs (as well as similar defined outcome ETFs offered by other ETF issuers) being kept off of most broker-dealer platforms. Because broker-dealers have determined that the extra effort involved, and regulatory risk undertaken, to offer these products does not outweigh the remuneration that they might otherwise receive for placing the Innovator ETFs on their platform, they have elected to exclude these ETFs. Whether or not intended by FINRA, the designation of Innovator ETFs as complex products functions as a strict barrier to investor access.

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[4] See e.g., an Innovator Defined Outcome ETF prospectus (available at: https://www.innovatoretfs.com/pdf/bjul_prospectus.pdf); and the website disclosure, pricing tool and timing tools for Innovator's Defined Outcome ETFs (available at: https://www.innovatoretfs.com/caps/# and https://www.innovatoretfs.com/define/#pricing and https://www.innovatoretfs.com/define/timingtool/).

[5] For example, Notice 12-03, in addition to requiring broker-dealers to engage in post-approval review, a special training of registered representatives, consideration of a customer's financial sophistication, discussions with the customer, consideration of whether less complex or costly products could achieve the same objectives for the customer, Notice 12-03 also requires broker-dealers to ask the following questions:

- For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled?
- Conversely, to whom should this product not be offered?
- What is the product's investment objective and is that investment objective reasonable in relation to the product's characteristics? How does the product add to or improve the firm's current offerings? Can less complex products achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? How is the product expected to perform in a wide variety of market or economic scenarios? What market or performance factors determine the investor's return? Under what scenarios would principal protection, enhanced yield, or other presumed benefits not occur?
- What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
- Does the product present any novel legal, tax, market, investment or credit risks?
- Does the product's complexity impair understanding and transparency of the product?
- How does this complexity affect suitability considerations, or the training requirements associated with the product?
- How liquid is the product? Is there an active secondary market for the product?

Innovator's Defined Outcome ETFs are thus practically barred from being offered to potential investors, notwithstanding that the Innovator ETFs: i) operate pursuant to SEC and national securities exchange listing rules; ii) operate with registration statement disclosure and published website disclosure discussed and vetted with SEC staff in the Division of Investment Management and the Division of Trading and Markets; iii) are themselves managed, not by individual investors, but by Innovator, an investment adviser registered under the Investment Advisers Act of 1940 that is approved annually by the board of trustees of the Innovator ETFs; iv) are primarily risk mitigating investments (that is to say, they provide investors the ability to participate in market upside (to a cap) while limiting downside risk); and v) can be bought and sold by investors in a number of other ways, and without any restriction, such as through self-directed brokerage accounts.[6]

At the same time, structured notes with substantially similar strategies and that are issued by large financial institutions which are affiliated with the broker-dealer, are made available on these same platforms. Such broker-dealers have no difficulty with placing a proprietary structured note that they have deemed complex on their platform but deny their customers access to a substantially similar investment in ETF form (also deemed complex) that is less expensive, more transparent, more liquid, and highly regulated, on their platform.

FINRA's Potential Future Position on Complex Products

In Notice 22-08, FINRA reiterates the views it expressed in Notice 22-08 with respect to sales practice obligations regarding complex products and, though it doesn't propose any specific practice or rule, FINRA asks for comments on effective practices and enhancements that it may undertake in the future. Unlike in Notice 12-03, however, Notice 22-08 FINRA specifically calls out defined outcome exchange-traded funds as complex products. In doing so, FINRA compares defined outcome ETFs unfavorably to structured notes by stating that such notes offer similar exposures but without an underlying portfolio of listed options. FINRA also seems concerned about the growth of defined outcome ETFs, noting that they have grown to number nearly 150 and have gathered $10 billion in assets. Last, it cites an unfavorable piece in ETF.com that analyzes an Allianz-sponsored defined outcome ETF and concludes that an individual investor should instead invest in and directly manage an S&P 500 ETF along with a simultaneous locked-in investment in a one-year certificate of deposit.

In making these observations, FINRA misses the mark. It seems to ignore the attributes of a defined outcome ETF and also to misunderstand the relative differences between a structured note and a defined outcome ETF. By observing that the principal difference worth noting between a structured note and a defined outcome ETF is the latter's use of derivative instruments, FINRA truly leaves out the most of the story. The Innovator Defined Outcome ETFs – the product of extensive and thoughtful SEC staff review prior to launch – symbolize 1940-Act protections, transparency, liquidity, and low fees, all while delivering targeted downside loss protections for investors. In stark contrast, structured products that promise

[6] Indeed, Innovator had previously raised this as a potential concern in connection with the adoption of Rule 18f-4, as the SEC noted in its adopting release of Rule 18f-4 (c.f., http://www.sec.gov/rules/final/2020/ic-34084.pdf (footnote 591, page 182)). While noting this concern raised by Innovator, the SEC expressly chose not to adopt related sales-practices for 40 Act funds utilizing derivatives which otherwise comply with the VaR test.

defined outcomes are complex, opaque, illiquid, difficult to trade or exit, expensive, and subject to significant credit and counterparty risk, all without 1940 Act protections. FINRA surprisingly suggests that a fund that holds offsetting exchange-traded options with a demonstrated value-at-risk that is both well below the 200% limit under Rule 18f-4 and certainly less than that of most broad-based indexes is somehow riskier (or more complex) than an investment that holds nothing, but simply represents the promise of a bank or insurance company. Further, FINRA's concern that defined outcome ETFs have gathered $10 billion in assets seems equally misplaced given that structured products represent a huge market with approximately $7 trillion invested globally (which is actually slightly more than the global ETF market). And last, it shocks us that FINRA would cite to an article that stands for the proposition that an investor should go out on his or her own and try to recreate a defined outcome using a certificate of deposit (which cannot be liquidated within one year without penalty). We don't think the goal of any FINRA regulatory review of complexity or risk should advocate, directly or indirectly, that an investor go out on his or her own to see if he or she could recreate what FINRA already believes is a complex return profile. By citing this comparison, FINRA also seems to diminish and devalue the individual actions and decisions of both the adviser and the investor.

Accordingly, we think that any effort to promulgate a rule that would continue to so impact the Innovator Defined Outcome ETFs directly, and by name, could benefit from a deeper effort to understand all aspects of these investment vehicles. In that regard, we would be please to meet with FINRA staff in-person or by teleconference.

In the meantime, to the extent FINRA moves forward with regard to a formal rule that would regulate complex products, we believe it should consider the following modifications.

A registered investment company that utilizes derivative instruments and complies with Rule 18f-4 under the Investment Company Act of 1940 (the "1940 Act"), including compliance with either the Rule's relative VaR test or absolute VaR test, should not be deemed a "complex product," especially as within this proposed regime there is no distinction between "complex" and "risky" as was otherwise framed by the SEC in Rule 18f-4 and its adopting release.

Notice 22-08 generally equates 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: "FINRA 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" 49 times.

What Notice 22-08 does not offer, however, is any objective way to measure risk or any meaningful ways to mitigate it. On the other hand, for certain products – namely, registered

investment companies that utilize derivatives, such as the Innovator ETFs – the SEC already has developed a method to measure risk. And there are a panoply of rules under the 1940 Act that seek to manage and regulate for investment risk – from disclosure rules and practices, to prohibitions on affiliated transactions, to requirements that funds develop detailed compliance policies and procedures.

More specifically, Rule 18f-4 was promulgated as a solution to the risk that a fund may undertake while using derivatives. In the nearly 400 page adopting release to Rule 18f-4,[7] the SEC details how a fund is required to comply with either of two value-at-risk tests, relative VaR or absolute VaR. VaR is an estimate of an instrument's or portfolio's potential losses over a given time horizon and at a specified confidence level. In adopting the VaR tests, the Commission got to the heart of what an investor should be concerned about…not complexity and not leverage, but the value at risk. As noted above, because all of the Innovator Defined Outcome ETFs mitigate and limit risk through the use of Protection, they satisfy the relative VaR test, and in doing so, are well below the 200% limit under Rule 18f-4 and certainly less than the VaR of most broad-based indexes.

Accordingly, the Innovator ETFs should not be included in any definition of "complex product" in any FINRA-promulgated rule or position that, in effect, seeks to regulate on the basis of mitigating excessive risk.

To the extent that FINRA believes that the Innovator ETFs are complex, not necessarily because of their level of risk (which we have demonstrated is below that of plain vanilla ETFs), but because FINRA believes that they are difficult for an investor to understand, FINRA would be supplanting its view for that of the SEC and the regime that Congress has adopted in the federal securities laws. Specifically, the SEC has viewed and commented on the prospectus, statement of additional information and website disclosure that the Innovator ETFs have adopted. We believe that these disclosures and web tools are more than sufficient to ensure that investors have the information they need to make an informed and educated decision on whether and how to invest in the Innovator ETFs.

But to the extent that FINRA believes that the SEC (as a body) supports the effort outlined in Notice 22-08, we believe that FINRA has neglected to consider a broader context. In that regard, we note FINRA's citation to a joint Commissioner Statement on Complex Exchange-traded Products from Commissioners Lee and Crenshaw (the "Joint Statement").[8] In the Joint Statement, Commissioners Lee and Crenshaw were speaking about exchange-traded products that are not registered as investment companies. They state that the "Commission should endeavor to adopt a consistent approach to exchange-traded products with similar features [as registered investment companies]. Some exchange-traded products are registered investment companies and are therefore [already] subject to the requirements of the Investment Company

[7] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-34084 (November 2, 2020); available at: https://www.sec.gov/rules/final/2020/ic-34084.pdf

[8] See 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*, at footnote 54; available at: https://www.finra.org/rules-guidance/notices/22-08.

Act designed to protect investors, such as limitations on a fund's ability to incur leverage, requirements for boards of directors and chief compliance officers, and prohibitions on affiliated transactions." They went on to say, "[h]owever, products that are registered exclusively under the Securities Act of 1933 are not subject to the same requirements that apply to products that are registered under the Investment Company Act…."

In other words, the Commissioners believed that most concerns over 1940 Act-fund complexity had already been solved by the 1940 Act, the rules thereunder and SEC staff interpretations thereof. We take the point that one concern that the Commissioners voiced that was not addressed by the 1940 Act directly was the desire for a sales practice regime for complex products. In that regard, however, it is critical to note that:

1. Proposed sales practice rules (Rule 15l-2 and 211(h)-1) for leveraged/inverse investment vehicles were abandoned. Although Commissioners Lee and Crenshaw were "deeply disappointed" by the SEC's failure to find the votes to pass the proposed sales practice rules, the SEC on the whole rejected this approach insofar as it applied to leveraged/inverse vehicles, and we imagine broadening it to a non-defined category of "complex" investment vehicles would not have fared better. It would be entirely inappropriate for FINRA to now end run that Commission action by doing indirectly what the SEC was not able to accomplish directly.[9]

2. In the Joint Statement, Commissioners Lee and Crenshaw advocated that "the Commission should adopt and implement a tailored sales practice framework." They did not advocate for a FINRA-administered regime.

3. Any effort to regulate so-called complex products should take into account all types of like investment products and all types of sales channels so that the federal securities regulators can act to create level regulatory playing fields. FINRA can reach an important, but limited, set of products and sales channels. FINRA's treatment of complex products today can reach ETFs bought and sold on broker-dealer platforms. It cannot reach the exact same product sold in mutual fund form or bought through an investment adviser. Accordingly, any effort to regulate all products evenly, could only be accomplished by an initiative begun by the SEC. In this regard, we note that neither Rule 6c-11 (which was promulgated to codify all ETF exemptive applications and unify the conditions applicable to ETFs) and Rule 18f-4 (which was promulgated, as discussed above, to regulate the use of derivatives by funds) addresses fund or ETF "complexity," despite years of development and consideration by the Commission and its staff, and despite numerous opportunities to do so.

Any broker-dealer that offers and sells a complex product, including proprietary products or products such broker-dealer has been incentivized to offer, to its customers should not be

[9] *See generally*, SEC Decision on Leveraged ETFs Sparks Concern for Retail Investors, Financial Times (October 29, 2000); available at: https://www.ft.com/content/f607fc5d-8b10-4c09-9274-d040e617caa6

permitted to exclude from its platform a comparable, competitive product by virtue of the fact that the comparable, competitive product is deemed complex.

The Innovator ETFs, despite their obvious advantages over structured products, have not been allowed to compete with structured products that are issued and offered by bank and insurance company affiliates of broker-dealers. Using the label of "complex product" as a way to keep Innovator ETFs off of broker-dealer platforms, and yet allows them to continue to offer their customers affiliated structured products that are demonstrably more complex, more costly, opaque, difficult to trade and exit, riskier (from a credit and counterparty perspective), and much less liquid, is a practice that should be prohibited. In other words, allowing broker-dealers to themselves decide what is and is not a "complex product" has had the opposite intended effect. It has kept less complex and less costly investments from investors.

Notice 12-03 demands that "Registered representatives should consider whether less complex or costly products could achieve the same objectives for their customers. For example, registered representatives should compare a structured product with embedded options to the same strategy through multiple financial instruments on the open market, even with any possible advantages of purchasing a single product." And Regulation BI broadly requires a broker-dealer, when making any securities transaction to a retail customer, shall act in the best interest of the retail customer without placing the financial or other interest of the broker-dealer ahead of the interest of the retail customer.

However, neither Notice 12-03 nor Regulation BI have led to any reforms in the practices outlined above. We think any effort by FINRA to regulate complex products should seek to require that any broker-dealer that offers and sells a complex product, including proprietary products or products such broker-dealer has been incentivized to offer, to its customers should not be permitted to exclude from its platform a comparable, competitive product by virtue of the fact that the comparable, competitive product is deemed complex.

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If you have any questions or comments in connection with the foregoing, please contact the undersigned at 800-208-5212 or our counsel at Chapman and Cutler, Morrison Warren at (312) 845-3483 or Barry Pershkow at (202) 478-6492.

Sincerely,

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