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May 9, 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:

Milliman Financial Risk Management LLC (“Milliman FRM”) appreciates the opportunity to comment on the categorization of and requirements around complex financial products. Milliman FRM is a Securities and Exchange Commission (SEC) registered investment adviser that provides financial risk management services to the global retirement savings industry. Milliman FRM provides investment advisory, hedging, and consulting services to institutional and registered fund clients. Milliman FRM’s approach relies on utilizing reliable and transparent strategies, which have been tested for more than 20 years and in multiple market crises (e.g., the 2000 “dot-com bubble” and the 2008 global financial crisis). The majority of Milliman FRM’s strategies offered to retail customers are focused on reducing risk. Milliman FRM understands FINRA’s concerns and shares its goals of ensuring retail investors are best positioned when making investment decisions. As FINRA contemplates product categorization, Milliman FRM strongly recommends that a distinction be made between riskiness and complexity.

Product disclosure

In Regulatory Notice 22-08 (the “Notice”) FINRA describes 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 (including the payout structure and how the product may perform in different market and economic conditions).¹

All product sponsors should strive to make clear the unique characteristics of their offerings. Sponsors should provide materials and tools to ensure brokerages and financial advisors can fully educate their retail investors.

¹ See <https://www.finra.org/rules-guidance/notices/22-08>.

As other commenters likely have noted, mutual funds and exchange-traded funds (ETFs) are subject to a rigorous disclosure regime by the SEC. Funds must disclose the investment strategy, its mechanics, the instruments utilized, and associated risks in a straightforward manner to the investor in the fund's prospectus. A fund's disclosure makes clear to the investor that while a product may have intricate construction, its overall risk remains low. Milliman FRM appreciates that even with clear disclosure, an investor may not become an expert in the details of how a portfolio operates. Milliman FRM also understands that while disclosure is valuable, oftentimes retail customers may not fully engage with the material available to them. As FINRA considers recommendations for best practices, working with its members to develop a method to ensure delivery of fund materials prior to investment would increase the likelihood an investor benefits from the pre-existing SEC disclosure requirements.

Complexity and risk

Milliman FRM is the investment advisor or sub-advisor to a range of "Defined Outcome" funds. A Defined Outcome fund typically offers features such as "exposure to the performance of a market index or reference asset but with downside protection and an upside cap on potential gains over a specified period (typically one year)."² The prospectus for this style of fund typically describes in detail how instruments such as options work together to create a cap, buffer, floor, or other parameter. On positive performance typically a cap, the maximum percentage return that can be achieved, is struck. Certain other features reduce the risk of the product. A buffer seeks to absorb a specified percentage of losses. A floor will protect against losses exceeding a pre-defined and disclosed percentage. While the interplay of options positions to create these product features may seem complex, it does not result in an investor taking greater *risk* (i.e., a higher probability of losses). In the Notice, FINRA is focused on complexity and ties it together with risk. As discussed above, complexity and risk do not always move together. In asking its members to consider product classifications, FINRA should allow for this distinction to shift how a product is treated.

The overall risk of a Defined Outcome strategy compared to a typical passive, equity index tracking fund, is arguably lower. The retail customers know in advance of their investment the maximum upside they can achieve and the downside protections the fund seeks to offer. These protections reduce the potential losses an investor will face. An investment in an index tracking fund is entirely contingent, and the retail customer has no view on its future performance.

1940 Act Rules

In addition to the long standing disclosure requirements, the SEC has recently introduced new rules under the Investment Company Act of 1940 in order to control certain risks. Primarily relevant is the new rule controlling the usage of derivatives, Rule 18f-4³. For funds that use derivatives this rule sets a risk based (value at risk, or VaR) cap. For Defined Outcome or managed volatility strategies, this rule effectively limits derivatives usage, but recognizes that derivatives may be risk reducing. This risk reduction would be reflected in

² *Id.*

³ See <https://www.sec.gov/investment/derivatives-use-registered-investment-business-development-companies>.

the results of the VaR calculation. For funds seeking to utilize derivatives for leverage, this rule effectively caps how much leverage can be used, as the fund’s VaR would hit the SEC determined limit.

Rule 18f-4 requires daily monitoring, periodic reporting both to the SEC and to the fund’s board of trustees, and the establishment of policies and procedures to govern the use of derivatives. Rule 18f-4 is but one example; there are many 1940 Act rules which control the risks of a publicly offered fund (e.g., the liquidity rule⁴). The regulatory framework the SEC has implemented is specifically designed to protect retail investors by controlling how a fund can operate. Restrictions or qualifications on access to registered funds are unwarranted.

Outcome Periods & Tools

Milliman FRM notes that Regulatory Notice 22-08 compares Defined Outcome funds to “geared ETPs [exchange-traded products]” because “defined outcome ETFs provide the specified outcome if an investor buys the ETF at the beginning of the period and holds it until the end. Otherwise, an investor’s returns could deviate significantly from the specified outcome.”⁵ Milliman FRM does not believe this comparison is well-suited. A geared exchange traded product has a single day reset period and utilizes leverage to increase exposure. These are not typical characteristics of a Defined Outcome fund. As Regulatory Notice 22-08 notes, Defined Outcome funds usually have outcome periods of one year. Defined Outcome funds typically do not utilize leverage and do not amplify possible downside risk.

Regarding FINRA’s concern regarding interim period investment or divestiture, Milliman FRM and other Defined Outcome fund sponsors have created easy to access and understand tools that detail the current value of the fund, detailed performance metrics, and how that corresponds to its parameters (e.g., cap, buffer, etc.)⁶:

Current Outcome Period Values (Current/Net) ⓘ ³		As of	05/05/2022
Fund NAV ⓘ			\$9.43
Fund Return ⓘ			-5.70%
Index Returns ⓘ			-2.64% / -2.95%
Outcome Period Days Remaining ⓘ			309
Fixed Income Contribution ⁴ ⓘ			-4.32%
Primary Index Strategy Zone ⓘ			Within Buffer
Secondary Index Strategy Zone ⓘ			Within Buffer
Remaining Buffer ⓘ			8.77% / 7.92%
Remaining Downside Before Buffer ⓘ			0.00% / -0.83%
Remaining Cap ⓘ			17.04% / 16.06%
Remaining Option Premium / Discount ⓘ			1.21% / 0.37%

⁴ See <https://www.sec.gov/rules/final/2018/jc-33142.pdf>.

⁵ See <https://www.finra.org/rules-guidance/notices/22-08>.

⁶ See <https://millimanfunds.com/>.

An interim period investor is able to easily determine the remaining buffer or upside prior to depositing funds. An existing investor can easily determine the value of their holdings if they were to exit early. The style of charts these tools utilize are also present in most Defined Outcome funds offering documents. These tools have now been in use for years by product sponsors, and have been a key way other regulators may have gained comfort with the unique aspects of Defined Outcome funds. Financial advisors have been making use of these tools to educate their customers. Certain sponsor tools allow for a demonstration of market scenarios and how a Defined Outcome fund's parameters (e.g., cap and buffer) will react. There has been widespread voluntary adoption of these tools by product sponsors. It would be beneficial if FINRA worked with its member to ensure that retail investors have easy access to such tools. Milliman FRM believes fulsome education and preservation of choice, rather than restrictions, are essential.

Investor access

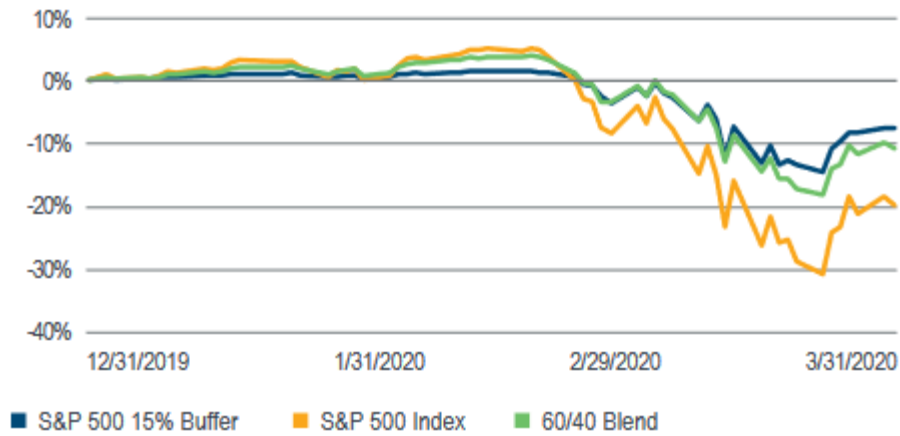
Milliman FRM and its parent company, Milliman, Inc., have long been key partners to the retirement savings industry. Core to Milliman's mission is to help protect the financial well-being of people everywhere. The aforementioned experience of Milliman FRM, executing risk management strategies through crises and over decades, led to the design and release of products that, given the ambiguity of the current definition, may be deemed "complex". Milliman FRM notes that its strategies are not only present in exchange traded products, but across a range of registered fund products and institutional accounts. Milliman FRM feels strongly that its well-tested strategies should not be restricted; instead more education should be encouraged. Specialized risk management should not be walled off only to institutions or those with the time to navigate complex account procedures. These are important products for all investors, particularly those seeking to limit the risk they take as they near, or during, retirement.

For those in retirement and taking regular withdrawals from their portfolios, sustained market declines can quickly lead to a rapidly declining account, jeopardizing the retiree's financial plan; sequence risk is possibly the greatest risk to retirees⁷ The investment strategies Milliman FRM helps offer, such as Defined Outcome funds, seek to absorb downside losses during such sustained market declines, thereby ensuring that a retiree will be able to rely on their portfolio for their needs without entering a situation of rapid account depletion. As an example, consider the performance of a buffered strategy during the early phase of the pandemic in 2020⁸:

⁷ See Milliman FRM's "The Sequence-of-returns effect" at <https://frm.milliman.com/-/media/milliman/pdfs/2021-articles/8-20-21-the-sequence-of-returns-effect.ashx>.

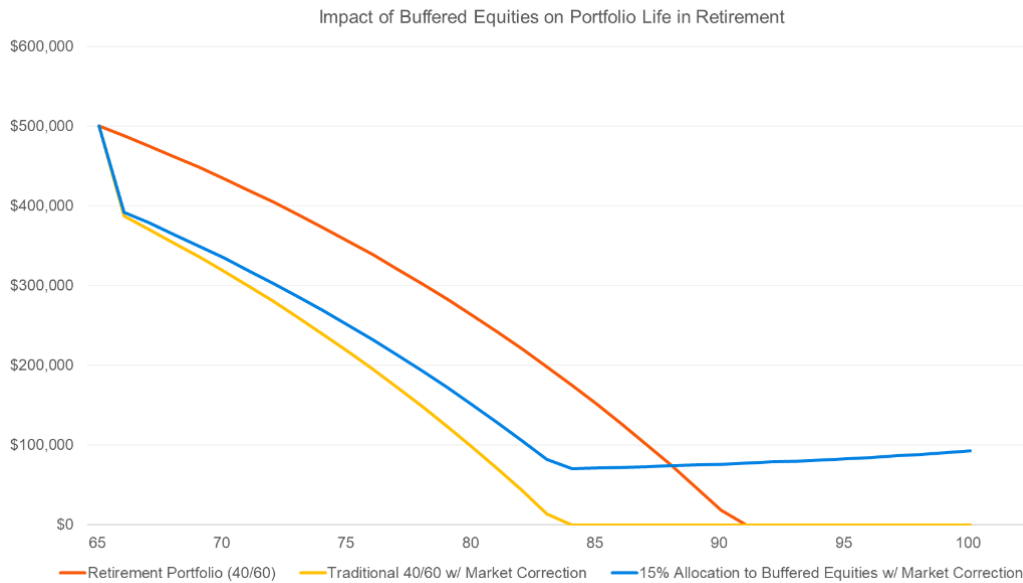
⁸ See Milliman FRM's "Investment Risk Reduction Q1 2020" at https://frm.milliman.com/-/media/milliman/pdfs/2020-articles/articles/10-15-20-millimanfrm_white-paper_investment-risk-reduction-v1.ashx.

Cumulative Returns



Source: Bloomberg and calculations by Milliman FRM

For a retail customer at or in retirement and taking withdrawals from their accounts, access to a buffered product may significantly reduce depletion of their portfolio. For these retail customers, additional gating, restrictions, or the introduction of additional requirements for their advisors, may all lead to depriving them of tools Milliman FRM believes can enable a successful financial plan. Taking a broader view of retirement success, the following analysis illustrates the impact an allocation to Defined Outcome strategies may have during retirement⁹:



⁹ See Milliman FRM's "Sequencing Risk" at <https://frm.milliman.com/-/media/milliman/pdfs/2021-articles/12-20-21-insight-sequence-of-returns.ashx>. This document contains a detailed breakdown of the portfolios and of the assumptions made in the analysis represented.

Milliman FRM firmly believes that investors should be able to choose the products that best align with their risk tolerance. A broad category of “complex” products that require testing or special account privileges to access may stigmatize products that are essential tools, resulting in fewer investors achieving financial well-being. Milliman FRM appreciates this opportunity to comment. If you have any questions or require further information, please contact Adam Schenck at 312-499-5759 or Ehsan Sheikh at 312-577-2915.

Sincerely,

Adam Schenck
Principal and Managing Director

Ehsan Sheikh
Senior Counsel