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Via Electronic Submission: pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Re: FINRA Regulatory Notice 22-08

Dear Ms. Mitchell:

ProShare Advisors LLC and its affiliated entities ("ProShares")[1] appreciate the opportunity to submit comments to the Financial Industry Regulatory Authority ("FINRA") on Regulatory Notice 22-08[2] (the "Notice").

ProShares strongly opposes the unprecedented, harmful, and unnecessary restrictions on investor choice and access to public securities that would result from the measures described in the Notice. The restrictions on investors' right to buy public securities set forth therein are at odds with America's long-standing disclosure-based system, which gives investors the freedom to make their own investment decisions. As the Securities and Exchange Commission ("SEC") states on its own website, information provided by issuers of public securities "*enables investors, not the government, to make informed judgments about whether to purchase a company's securities.*"[3] The measures described in the Notice would upend these principles and turn FINRA into a merit regulator of investors and products.

Nothing in the federal securities laws gives FINRA authority to limit investors' own decisions about which securities to buy. FINRA simply does not have the authority to require investors to

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[1] This letter is submitted on behalf of ProShare Advisors LLC, ProFund Advisers LLC, each a registered investment adviser; ProFunds Distributor, Inc., a registered broker-dealer, and ProShares Capital Management LLC, a sponsor of certain commodity pools. ProShares has been at the forefront of the ETF revolution since 2006. ProShares now offers one of the largest lineups of exchange traded funds ("ETFs"), with nearly $70 billion in assets. The company is a leader in strategies such as dividend growth, bitcoin futures, and thematic and geared (leveraged and inverse) ETF investing. ProShares continues to innovate with products that provide strategic and tactical opportunities for investors to manage risk and enhance returns.

[2] Regulatory Notice 22-08: Complex Products and Options, FINRA (2022).

[3] The Laws That Govern the Securities Industry, U.S. Securities and Exchange Commission (*n.d.*).

pass tests or satisfy qualification requirements before they can invest, or to deny access or impose other substantive restrictions on investors' own decisions to buy public securities. The regulations contemplated by the Notice are a slippery slope that would allow FINRA to restrict access to any other public security in the future.

If adopted, these measures could deprive millions of investors of valuable products, many of which are used to diversify portfolios, hedge against market downturns, and help achieve long-term financial goals.[4] The investment knowledge tests to determine investor understanding and minimum net worth requirements put forth by FINRA would potentially lead to arbitrary, biased, and discriminatory treatment of investors, including investors from historically underserved communities. Additionally, brokerage firms may stop offering the many popular mutual funds, ETFs, and other products that FINRA designates as "complex" due to the vagueness, cost, and difficulty of implementing the measures described in the Notice. Further, issuers whose securities have been registered with the SEC but are nonetheless designated as "complex" by FINRA could be denied the full benefits of SEC registration – since issuers would, in effect, not be able to sell their shares to investors who do not meet the qualification standards set by FINRA. For these reasons, if adopted, the measures could limit innovation, deprive U.S. investors of valuable investment opportunities, inhibit capital formation, and harm financial markets. Despite considering such a radical and unprecedented scheme, the Notice does not actually attempt to quantify investor understanding of complex products – the purported basis for FINRA's potential regulations – or otherwise put forward any evidence that would justify these extreme measures.

This letter sets forth in more detail below ProShares' strong opposition to the potential restrictions on investor choice and access to public securities described in the Notice. While the Notice raises a number of potentially problematic issues, we focus primarily on FINRA's radical and unprecedented restrictions on individual self-directed investors' right to access public securities and markets. Our letter is organized as follows. In Part I, we provide a brief background on the Notice and the measures described therein. In Part II, we explain how these measures would upend the fundamental principles of the federal securities laws. In Part III, we show that these measures would exceed FINRA's limited statutory authority. In Part IV, we demonstrate that the measures would harm investors, are unnecessary, and would be unworkable. In Part V, we show that the SEC could not approve a FINRA rule proposal based on the measures described in the Notice. In Part VI, we demonstrate why the benefits of a FINRA rule proposal based on these measures could not outweigh its costs. Finally, in Part VII, we discuss the protections provided by Regulation Best Interest and that, as a result, the measures applicable to broker recommendations in the Notice would be unnecessary.

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[4] According to the Investment Company Institute, approximately 5,600 funds registered under the Investment Company Act of 1940 ("Investment Company Act") with over $7.6 trillion of assets would be impacted. This means that approximately 2 out of every 5 registered funds and 22 percent of total U.S. fund assets would be deemed complex products, potentially subject to enhanced investor qualification or other requirements. Comment of the Investment Company Institute, 2-3, Regulatory Notice 22-08 (2022) ("ICI Comment Letter"). The ICI fund numbers actually underestimate the potential impact of the measures FINRA is considering – since the ICI information does not include a number of securities and product types not registered under the Investment Company Act that FINRA has labeled as complex.

I. Background.

The Notice reminds FINRA members of FINRA's existing guidance with respect to recommendations of complex products and options and solicits comments on effective practices and potential rule changes related to options and complex products.

The Notice asks a series of questions and requests comment on whether FINRA should adopt new requirements that could prevent or deter investor access to securities that FINRA describes as "complex products." These potential regulations could apply to investors' own decisions about which securities to buy, as well as broker recommendations about such securities.

For example, the Notice asks whether self-directed investors should be pre-approved to buy complex products; whether investors should be required to pass "a knowledge check;" whether investors who fail the knowledge check should be required to complete "a learning course and additional assessment" before they can invest; whether investors would need to be re-certified to make additional investments in complex products; and whether access should be limited to "high-net worth or other categories of customers."

The implication of each of these questions is that investors who are not pre-approved, who fail the test, who don't take a required course, who are not re-certified, or who do not meet minimum wealth standards *will not be permitted to invest in publicly registered securities – including many popular mutual funds, ETFs, and other products – that FINRA has designated as "complex products."* This would be the case regardless of whether an investor makes their own investment decisions or is acting based on the recommendation of a broker.

The Notice puts forth a description (not a definition) of complex products and provides some examples of complex products. The Notice states there is "no standard definition" of a "complex product" and 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." As a result, brokers would need to make their own assessments of whether specific products fall under FINRA's description of "complex product" or one of the product types FINRA has historically identified as "complex."

FINRA has historically referred to dozens of product types as "complex" as shown in Exhibit A.

II. FINRA's scheme would upend the fundamental premises on which U.S. securities laws are based.

The federal securities laws are based on the twin concepts of issuer disclosure and investor choice. The current Chair of the SEC recently gave a speech in which he reaffirmed these fundamental premises, stating:

> "*The 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*."[5]

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[5] Chair Gary Gensler, Building Upon a Long Tradition, U.S. Securities and Exchange Commission (2022).

FINRA's measures would upend these fundamental premises and would replace the twin concepts of issuer disclosure and investor choice with a system of quasi-merit regulation, where investors are denied investment choice and access to public securities that are deemed "complex" according to a subjective standard that FINRA does not even attempt to define.

A. ***The fundamental premises of the federal securities laws are issuer disclosure and investor choice.***

The fundamental premises of the federal securities laws are issuer disclosure and investor choice. As President Franklin Delano Roosevelt explained in recommending the passage of the Securities Act of 1933 (the "Securities Act"):

> *"There is … an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.*
>
> *This proposal adds to the ancient rule of caveat emptor, the further doctrine, "Let the seller also beware."*[6]

In short, provided there is appropriate disclosure ("full publicity and information") investors get to decide which risks to take ("caveat emptor") and make their own investment decisions.[7]

Indeed, Congress specifically considered and rejected merit regulation – an approach in which regulators get to pick and choose the securities in which investors are allowed to invest – as the basis for the federal securities laws.[8] The restrictions on investor access to complex products set

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[6] 77 Cong. Rec. 937 (1933); *see also* SEC. v. Capital Gain Research Bureau, Inc., 375 U.S. 180, 186 (1963) (stating that the purpose common to the securities laws was to "substitute a philosophy of full disclosure for the philosophy of caveat emptor").

[7] *See, e.g.*, 77 Cong. Rec. H2919, S2983 (1933). Representative Sam Rayburn, then Chair of the House Interstate and Foreign Commerce Committee, expressed the same sentiment when recommending the approval of the Securities Act:

> "Let me repeat that what we seek to attain by this enactment is to make available to the prospective purchaser, if he is wise enough to use it, all the information that is pertinent that would put him on notice and on guard, and then let him beware." Senator Fletcher noted, "[t]he purpose of the bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation. That is the general purpose of the bill."

[8] *See, e.g.*, 77 Cong. Rec. H2950 (1933). Representative Reilly summarized the two paths Congress considered in his remarks during the House debates on the matter:

> "There are two theories … One is for the Federal Government to insist, as provided in this bill, that full information be given to the public regarding the soundness of the security offered for sale before the said securities are put on the market in interstate commerce.
>
> The other theory is, and it is a theory that has been advocated on the floor of this House today, that the Government of the United States should go further and withhold a permit to sell securities in interstate commerce that in the judgment of the Government should not be sold, thereby indirectly putting the approval of the National Government on the soundness of the securities that are permitted to be sold in interstate commerce."

forth in the Notice would resurrect this discarded approach by making FINRA the arbiter of who can invest and the securities in which they can invest.

Throughout its history, the SEC has repeatedly supported and emphasized these foundational principles and rejected the merits-based regulatory approach now put forth by FINRA. The SEC has long made clear its mission is administering the federal securities laws to support informed decision-making and choice by investors through disclosure, and not to engage in merit regulation. This principle has been affirmed again and again by the SEC and SEC Commissioners:

- *"Instead of utilizing a system of merit regulation based on state law models, the Securities Act of 1933 … was drafted as a 'Truth in Securities' Act emphasizing public disclosure of material information as the primary mechanism for federal regulation of the securities markets."* – Chair David S. Ruder, 1988[9]

- *"Ours is a disclosure-based system. And it is our job to promote clear, accurate and timely disclosures – proactively."* – Chair Harvey Pitt, 2002[10]

- *"The SEC is a disclosure-based agency, not a merit regulator."* – Commissioner Paul Atkins, 2003[11]

- *"Disclosure is indeed a key ingredient in the securities arena. It gives investors the information they need about their investments. It provides them with information about the operations, management and financial condition of the companies they invest in. And, it allows informed investors to participate in a free and fair market."* – Chair Mary Jo White, 2013[12]

- *"The SEC is, first and foremost, a* disclosure *agency. Our bedrock premise is that public companies should be required to disclose publicly and in a timely fashion the information a person would need in order to make a rational and informed investment decision. That is the foundation of our securities law regime and the core principle by which we administer those laws."* – Commissioner Daniel Gallagher, 2014[13]

These foundational principles were strongly re-affirmed by SEC Chair Gensler mere days ago when he stated that:

> *"Going back to the 1930s, we have a disclosure-based regime, not a merit-based one. The core bargain is that investors get to decide which risks to take, as long as*

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[9] Chair David S. Ruder, The Evolution of Disclosure Regulation by the Securities and Exchange Commission, U.S. Securities and Exchange Commission (1988).

[10] Chair Harvey L. Pitt, Testimony Concerning Financial Literacy, U.S. Securities and Exchange Commission (2002).

[11] Commissioner Paul S. Atkins, Recent Experience with Corporate Governance in the USA, U.S. Securities and Exchange Commission (2003).

[12] Chair Mary Jo White, The Importance of Independence, U.S. Securities and Exchange Commission (2013).

[13] Commissioner Daniel M. Gallagher, Remarks to the Forum for Corporate Directors, Orange County, California, U.S. Securities and Exchange Commission (2014).

> *public companies provide full and fair disclosure and are truthful in those disclosures."*[14]

FINRA itself has long acknowledged the fundamental premises of disclosure and investor choice and rejected merit regulation. As stated by FINRA's Chairman and CEO in 2012 when discussing complex products:

> *"[I]n the United States we do not engage in 'merit' regulation. Federal regulators do not deny retail investors the opportunity to invest in risky or complicated products. Instead, the federal securities laws require that issuers and intermediaries disclose the risks associated with securities products."*[15]

Thus, the fundamental premise of disclosure-based regulation, not merits-based regulation, has animated our federal securities laws since their inception, and this premise has been consistently reaffirmed by the SEC and FINRA.

B. ***FINRA's scheme constitutes merits-based regulation, upending the fundamental premises of the federal securities laws, disclosure and investor choice.***

FINRA's scheme ignores the foundational principles of disclosure and investor choice established by Congress and supported again and again by the SEC. The contemplated measures, if adopted, would turn the disclosure-based regime of the federal securities laws on its head. Rather than informing investors and empowering them to make decisions for themselves, FINRA contemplates creating a gauntlet of obstacles and roadblocks that interfere with investors' rights to make their own investment decisions. FINRA's contemplated measures could prevent or deter investors from investing in a wide range of public securities – all based on FINRA's subjective determinations of "complexity" and "understanding."

The measures FINRA is considering would institute a form of merits-based regulation grounded in amorphous and subjective concepts of "complexity" and "understanding" instead of the fundamental concepts of disclosure and investor choice. Rather than adhering to the core principles of the federal securities laws established by Congress, that have been affirmed again and again by the SEC, FINRA would chart a new course – one that could prevent or deter investor access to registered securities based only on a belief that individual investors ***might*** not understand them.

For example, FINRA is considering "[e]nhanced account approval processes before an account may trade in complex products," "[r]equirements that a customer complete training or a learning course before approval to trade in certain complex products," "[r]equired customer attestations regarding knowledge and experience," and – as if all that were not enough – an outright ban on access to complex products for investors who do not demonstrate "high-net worth."[16] This is the antithesis of the disclosure-based regime established by Congress and which the SEC and FINRA

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[14] Chair Gary Gensler, A Century with a Gold Standard, U.S. Securities and Exchange Commission (2022); s*ee also id.* (describing the Securities Act and the Securities Exchange Act of 1934: "A number of principles informed these statutes…. First, a basic faith that investors could make decisions if there was full, fair, and truthful disclosure").

[15] Chair and CEO Richard G. Ketchum, Remarks from the SIFMA Complex Products Forum, FINRA (2012).

[16] Notice, 13.

have long embraced.

The impact of the contemplated regulations comes into clearer focus when FINRA's pivotal role in the public markets is considered. Members of FINRA are the only financial institutions permitted to execute securities transactions on behalf of retail investors.[17] Self-directed investors have nowhere else to go to implement their personal investment choices and execute trades.

While the measures FINRA is considering purport to regulate only member behavior, in effect they would also regulate investors and issuers because of the central role FINRA and its members play in U.S. markets. *No longer would certain investors (those that fail to meet FINRA's standards) be able to make their own decisions to purchase public securities that have been designated as "complex" by FINRA. And no longer would a subset of registered securities (those designated as "complex") be freely available to all members of the public.* For these reasons, if adopted, the measures described in the Notice could fundamentally alter the concept of the self-directed investor and the character of U.S. public securities markets.

The increasing number of self-directed investors[18] who do not want to utilize brokers or other financial professionals for recommendations or advice, who cannot pay the higher fees for such additional services, or who do not want to undergo the potentially intrusive, biased, and burdensome qualification requirements set forth in the Notice, could be denied access to a broad range of public securities that the Notice itself concedes provide valuable benefits.[19] In effect, certain members of the public would only have access to those securities that FINRA or its members unilaterally decide are simple enough for the public to understand (*i.e.*, not complex).

Indeed, if the contemplated measures restricting investor choice and access are adopted, it is not clear these securities would be "public" at all, at least not in the sense intended by Congress when adopting the Securities Act.[20] Access to certain registered securities deemed "complex" by FINRA or its member firms would be available only to those investors determined to meet FINRA's qualification standards (*e.g.*, pre-approval, testing, net worth). Investors who fail to meet these inherently subjective or arbitrary standards could be denied access to certain publicly registered securities (*e.g.*, until they take required courses or pass more tests). In addition, issuers whose securities have been registered with the SEC for public distribution would be denied the full benefits of registration. In essence, FINRA is considering its own "accredited" investor standard for a subset of investors and a subset of publicly registered securities.

The result is that FINRA would become a merit regulator and gatekeeper of both individual investors and publicly registered securities – limiting self-directed investors' decisions and

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[17] Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Release No. 34-56145 (2007).

[18] Bernice Napach, The Challenge that Self-Directed Investors Pose to Advisors, Think Advisor (2021).

[19] For example, based on the ICI data cited herein, FINRA has labeled 40% of the registered funds currently offered in the U.S. as complex products. These investors could be shut out of some or all of these funds. ICI Comment Letter, 2-3.

[20] *Compare* Securities Act §§ 7 and 10, *with* Securities Act § 4(a)(2) (providing different statutory treatment of public and private offerings).

investment choices and directing and controlling access to trillions of dollars in public securities and markets.

Nothing in the federal securities law gives FINRA this authority.

C. ***The regulations contemplated by the Notice are a slippery slope that would allow FINRA to restrict access to any other public security in the future without limitation.***

If FINRA can determine that individual investors making their own investment decisions should be prevented or deterred from buying public securities because they "*may* not understand (emphasis added)" key features of certain securities, there is no stopping point to FINRA's power in this area. The logical extension of the authority seemingly claimed by FINRA in the Notice is that FINRA would be able to restrict investor access to *any* public security.

In this manner, the Notice posits a world in which FINRA and its member firms get to decide which risks individual investors making their own decisions can take, which investors can take them, and which products they can buy.

To show that this is not just rhetoric, it is worth considering some examples of "complexity" discussed in the Notice and the logical outgrowths of their application:

- If FINRA has the authority to limit access by self-directed investors to shares of a registered investment company that it deems complex by virtue of having an offshore subsidiary,[21] then nothing prevents FINRA from limiting access to the equity or debt securities of thousands of U.S. companies that also use offshore subsidiaries.

- If FINRA can establish barriers to self-directed investors purchasing shares of a registered investment company because the product has, for example, embedded leverage[22] then nothing prevents FINRA from limiting access to the equity securities of thousands of U.S. companies that have embedded leverage by virtue of their debt issuances or other practices.

- If FINRA can establish barriers to self-directed investors purchasing shares of a registered investment company because the product has, for example, exposure to cryptocurrency,[23] then nothing prevents FINRA from limiting access to the equity securities of any company that has a disfavored asset on its balance sheet.

- If FINRA may restrict self-directed investors' access to closed-end funds[24] – a product category that was expressly authorized by Congress[25] in the Investment Company Act of 1940 (the "Investment Company Act") – then nothing constrains its authority to restrict

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[21] Notice, 4.

[22] Notice, 3.

[23] Notice, 4.

[24] Notice, 4.

[25] *See* Investment Company Act § 23.

access to any publicly registered security.

- If FINRA can determine that a product is complex because it has "features that may make it difficult" for retail investors to understand "how the product may perform in different market and economic conditions,"[26] then nothing constrains FINRA's authority to label any publicly registered security as complex – since public securities often contain such features (*e.g.*, balance sheet intricacies, exposure to developing sectors and trends).

As shown above, based upon the scope of authority implied by the Notice, the breadth of securities that FINRA could effectively restrict or remove from the public sphere is essentially unlimited. It leaves open the all too real danger that FINRA could use this authority to restrict unfavored products or companies or advance other political or regulatory agendas.

Such power goes well beyond the authority given to self-regulatory organizations ("SROs") such as FINRA under the federal securities laws, as explained below.

III. FINRA does not have the authority to adopt measures restricting investor access or choice.

Nothing in the Securities Exchange Act of 1934 (the "Exchange Act") or other federal securities laws gives FINRA authority to adopt the measures restricting investor access and choice contemplated by the Notice. The Exchange Act gives FINRA authority to regulate its member broker-dealers. It does not give FINRA authority to regulate investors' own investment decisions or require investors to take exams. Nor does it give FINRA authority to regulate issuers of registered securities, issuers exempt from SEC registration, or registered investment companies. None of these powers are provided to FINRA by the Exchange Act or other federal securities laws. FINRA cannot grant these powers to itself.

A. ***FINRA's scheme exceeds its statutory authority.***

The measures restricting investor access and choice considered in the Notice would far exceed FINRA's statutorily limited regulatory authority. FINRA is a self-regulatory organization of broker-dealers. It is given authority to regulate its member broker-dealers by, and subject to, Section 15A of the Exchange Act. It is not given authority to regulate outside of this limited sphere, as discussed below.[27]

1. *FINRA's authority is specifically limited by the Exchange Act; the restrictions on investor access and choice in the Notice exceed this authority.*

FINRA's regulatory authority emanates from, and is limited by, Section 15A of the Exchange Act. As described in the legislative history for this section, Section 15A sets forth for FINRA "what the

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[26] Notice, 3.

[27] As noted by former SEC Commissioner Philip Loomis in connection with the amendments to the Exchange Act that codified the role of SROs, "the function of self-regulation should be limited to those areas as to which authority has been delegated to these organizations under the [Exchange Act]." Commissioner Philip Loomis, Jr., *The Securities Acts Amendments of 1975, Self-Regulation and the National Market System*, U.S. Securities and Exchange Commission (1975).

rules must be, and what they may not be, designed to accomplish."[28]

Accordingly, pursuant to Section 15A(b)(6), FINRA's rules must be designed to:

> prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade…to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. [29]

And conversely, under that same Section, FINRA's rules must not be designed:

> to permit unfair discrimination between customers, issuers, brokers, or dealers…or to regulate by virtue of any authority conferred by [the Exchange Act] matters not related to the purposes of [the Exchange Act] or the administration of the association.[30]

The measures considered by FINRA in the Notice that restrict the ability of self-directed investors to make their own investment decisions and invest in public securities do not satisfy, and in some cases contravene, the grant of authority described above. For example, the measures:

- *Are not designed to prevent fraudulent and manipulative acts and practices.* The measures contemplated in the Notice are intended to address a perceived lack of investor understanding. Nowhere does the Notice state that they are intended to prevent fraudulent or manipulative acts and practices or present any evidence of such practices in connection with self-directed transactions. If adopted, among other things, the measures under consideration would limit the freedom of investors with respect to self-directed transactions where there are no allegations of fraudulent or manipulative acts (such as improper conduct by member firms).

- *Are not designed to promote just and equitable principles of trade.* FINRA members are required to observe high standards of commercial conduct and just and equitable principles of trade. Measures that impose testing, qualification, or net worth requirements on individual investors are unrelated to any unjust or inequitable conduct by a broker-dealer and cannot be said to promote (or even have any reasonable relation to rules designed to promote) just and equitable principles of trade. To the contrary, requiring brokers to develop and administer tests of investor understanding (which are subject to potential bias), and to apply minimum net worth standards (which are arbitrary and say nothing about investor understanding), could potentially lead to arbitrary results and inequitable treatment of investors, particularly those from underserved communities, by FINRA

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[28] S. Rep. No. 93-865, at 24 (1974) ("Under the bill the scope of the rule-making authority and responsibility of exchanges and the NASD would be defined in terms of purposes and standards rather than subject matters. The purposes to be served by self-regulatory rules would be expressed affirmatively and negatively (what the rules must be, and what they may not be, designed to accomplish)").

[29] Exchange Act § 15A(b)(6).

[30] *Id.*

member firms.

- *Are not designed to remove impediments to and perfect the mechanism of a free and open market and a national market system.* The measures contemplated by the Notice are inconsistent with this requirement as they could prevent or restrict investor access to dozens of product types and thousands of individual funds (many of which are traded on U.S. national securities exchanges and are part of the national market system) representing over $7.6 trillion in assets and potentially impacting millions of individual investors. Rather than removing impediments to free and open markets, the measures would erect barriers to entry (both for investors and for products that might be denied the opportunity to be available on brokerage platforms) and potentially reduce trading volume and liquidity of products currently publicly registered and traded on U.S. exchanges.

- *Are not designed to protect investors and the public interest.* Our understanding is that the intent of the measures is to protect investors by requiring them to demonstrate that they understand key features of complex products before they will be allowed to invest in such products. While ProShares supports investor education and other efforts to improve investor understanding, we do not believe the measures in the notice are reasonably designed to protect investors.

  As discussed in Section IV.A., we believe the measures contemplated by FINRA have the potential to harm investors rather than protect them. For example, the measures could deny many investors access to valuable products that can help diversify their portfolios, hedge against market downturns, and achieve long-term financial goals. Some of the measures – such as net worth requirements – would not seem to advance the public interest concern (investor understanding) FINRA cites in the release. Other measures, such as knowledge tests and pre-qualification requirements, have the potential for bias and subjectivity, which could unfairly discriminate against certain investors.

  Also, it is not clear why "complexity" and "understanding" by self-directed investors are even appropriate regulatory concerns for FINRA. FINRA states that "complexity" does not necessarily entail greater risk. Nor does "complexity" necessarily consider other factors, such as market exposure, liquidity, transparency or volatility. A product that FINRA has labeled "complex" could be more (or less) liquid, transparent, volatile or risky than a product that FINRA has not labeled "complex." FINRA's approach could potentially cause investor confusion about which product features and risks should concern them. Even worse, labels (such as "complex" or "non-complex") that ignore key differences among products (*e.g.*, exposure, liquidity, transparency, volatility) potentially could lead investors to ignore these key differences when making investment decisions – lulling investors into a false sense of security that "non-complex" products are "safe" while "complex" products are "risky." [31]

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[31] Footnote 5 of the Notice references an ETP classification system. FINRA lacks authority to adopt such a system for essentially the same reasons FINRA lacks authority to adopt the restrictions on investor choice and access set forth in the Notice. Any such classification system would likely suffer from the deficiencies noted above with respect to complex/non-complex labeling.

In addition, the measures would contravene the authority granted to FINRA by Section 15A because they:

- *Would permit unfair discrimination between customers.* The measures FINRA is considering are designed in a manner that would permit unfair discrimination between customers. As discussed in Section IV.A.3., minimum wealth requirements, tests of investor knowledge (and the possibility of testing bias), as well as other contemplated mechanisms that require brokers to make subjective judgments of investor understanding, all raise the risk of unfair discrimination and unequal treatment of investors. As thoroughly discussed in the comment letter submitted by the Digital Assets Council of Financial Professionals, the practical difficulties that brokers would face in implementing these measures also could lead to arbitrary and unfair treatment of customers.[32] We believe these risks may be higher for investors in traditionally underserved communities.

- *Would be designed to regulate matters not related to the purposes of the Exchange Act.* FINRA may not adopt rules that run counter to the purposes of the Exchange Act. As discussed herein, the measures contemplated by the Notice, if adopted, would make FINRA a merit-regulator and gatekeeper of investors and products. The measures would impose a form of merits-based regulation on self-directed investors that could prevent or deter these investors from accessing public securities that FINRA has labeled "complex." In essence, FINRA would be creating its own "accredited" investor standard for a subset of investors and a subset of publicly registered securities. Such merits-based regulation has been repudiated repeatedly by the SEC and is contrary to the purpose of the federal securities laws.

In summary, there is nothing in the Exchange Act that provides support for the power that FINRA seeks to exercise over self-directed investors, that would permit FINRA to act as a merit-regulator or gatekeeper of individual investors or products, or that would otherwise provide a statutory basis for the restrictions that FINRA would impose on self-directed investors.

2. *Congress has repeatedly limited FINRA's regulatory authority.*

In authorizing self-regulatory organizations, Congress recognized the potential for overreaching by those organizations and expressly limited the scope of their regulatory authority. Congress' amendments to the Exchange Act have repeatedly limited the authority of SROs in order to avoid regulatory overreach by private organizations.

Initially, FINRA's predecessor – the National Association of Securities Dealers ("NASD") – was created and registered in 1939 in response to the Maloney Act. The Maloney Act amended the Exchange Act to allow the SEC to register and oversee SROs that would "regulat[e] among over-the-counter brokers and dealers."[33] According to Senator Maloney himself, the Maloney Act would "enable the people of this business *to guide and direct the affairs of their own industry*

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[32] Comment of Digital Assets Council of Financial Professionals, Regulatory Notice 22-08 (2022).

[33] Pub. L. No. 75-719, § 15A, 52 Stat. 1070 (1938).

under government supervision (emphasis added)."[34] Under these amendments, the NASD was only authorized to design rules to prevent fraud by broker-dealers, promote just and equitable principles of trade by broker-dealers, and protect investors and the public interest from broker-dealer misconduct, as well as having capacity to enforce compliance by broker-dealers with such rules.[35]

The role of SROs and the limits on their regulatory authority was again addressed by Congress as part of amendments to the Exchange Act in 1975 (the "1975 Amendments").[36] Those amendments mandated that brokers and dealers join an SRO, but placed the organizations firmly under the supervision of the SEC and carefully delineated the scope of the organizations' regulatory authority.[37]

The 1975 Amendments clarified the scope of an SRO's authority to regulate its members. As was noted at the time, these amendments were intended to lay out what the rules of an SRO "must be, and what they may not be, designed to accomplish."[38]

At that time, members of Congress were specifically concerned that Section 6(c) of the Exchange Act – which then gave exchanges extensive authority to regulate their members – would be too broad under the new regulatory structure they were enacting.[39] As a result, Congress expressly constrained SRO authority to matters related to the purposes of the Exchange Act. Specifically, as explained by the legislative history: "The bill would eliminate the present 6(c) and the open-ended authority it grants…and would limit by sections [6(b)(5)] and [15A(b)(6)] the scope of the self-regulatory organization's authority over their members to matters related to the purposes of the Exchange Act."[40]

In summary, Congress anticipated that organizations like FINRA would seek to extend their authority beyond just their members and into matters unrelated to their delegated purpose. Congress crafted Section 15A(b)(6) to forbid and prevent such overreach. Section 15A(b)(6) withholds from FINRA the authority it now seeks to assert. FINRA should not be permitted to override this express limitation on its authority set down by Congress.

3. *FINRA is not authorized to regulate decisions by self-directed investors.*

While the measures FINRA is considering purport to regulate only "member" behavior, the

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[34] Senator Francis Maloney, Radio Address on Over-the-Counter Securities Markets (Feb. 25, 1938), *in* 83 Cong. Rec. App. at 789–90 (1938).

[35] Pub. L. No. 75-719, § 15A, 52 Stat. 1070 (1938).

[36] Pub. L. No. 94-29. § 15A, 89 Stat. 97 (1975).

[37] S. Rep. No. 93-865 (1974), at 25.

[38] *Id.* at 24.

[39] *Id.* Prior to the 1975 Amendments, Section 6(c) provided: "Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which is located." Pub. L. No. 73-291, 48 Stat. 881 (1934).

[40] S. Rep. No. 93-865 (1974), at 25. Notably, this intentional limit on FINRA's authority originates from a bill introduced by President Joe Biden, then a Senator on the Senate Banking, Housing, and Urban Affairs Committee. *Id.* at 1.

measures are *de facto* regulation of investors. For example, one of the measures identified in the Notice would require self-directed investors to sit for an exam before they may qualify to purchase a public security identified as "complex."[41] If the investor were to fail this exam, the investor might be forced to sit out a "cooling-off" period or take a learning course and pass another exam before being permitted to transact. This would be the case even where the investor is making their own investment decision and is acting without any broker recommendation or advice.[42]

Because of the pivotal role FINRA and its members occupy in the financial markets, individual investors who want to invest in securities determined to be "complex" would be forced to comply with qualification requirements, forgo trading securities designated as complex, or open a different type of (and potentially more expensive) account with a separate broker or with a registered investment adviser.[43]

The Exchange Act provides no hint that Congress has provided FINRA with the authority to do any of these things.

All of this has simply been proposed from whole cloth in the Notice, without referencing any legal authority, of which there is none.

4. *The options rules do not provide a basis for FINRA to adopt sweeping restrictions on investor access and public securities.*

The Notice attempts to establish precedent for FINRA's sweeping regulation of investor access and complex products by analogizing the contemplated measures to FINRA's existing option rules.[44] However, this analogy misses the mark. The options rules, which were driven by clear direction from Congress to the SEC, do not support a claim that FINRA has statutory authority acting on its own accord to adopt the measures restricting self-directed investor choice and access contemplated in the Notice.

As part of the 1975 Amendments, Congress directed the SEC to study and prepare a report on the options market. In 1978 the SEC released the Special Study of the Options Markets (the "Report").[45] The extensive Report ran over 1,000 printed pages and analyzed the history of the options market, the use of options, the market structure, the existing regulatory structure that governed the options market, and the reasons additional regulations were considered necessary.

It was only after this exhaustive analysis that the SEC considered and approved the substantive measures now included in Rule 2360.[46] Rather than providing precedent that FINRA acting on its own accord has authority to adopt sweeping new rules governing investor access and "complex

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41 Notice, 13-15.

42 Notice, 15.

43 An investor might also (depending on how any final rules, if any, are drafted) choose to "forum shop" until they find a broker with an easier test or who does not label the target product as "complex."

44 *See* FINRA Rule 2360.

45 *See* Report of the Special Study of the Options Markets to the SEC, 96th Cong., 1st Sess. (Comm. Print No. 96-IFC3, Dec. 22, 1978).

46 *See e.g.,* Proposed Rule Changes and Order Approving Proposed Rule Changes, 45 Fed. Reg. 35056 (1980).

products," the history of Rule 2360 demonstrates that such regulation should not be undertaken by FINRA absent a clear congressional direction. And such regulations should not be considered without a thorough and comprehensive study of the market for each product and the potential impact of such regulations.

5. *Regulatory actions by foreign regulators do not provide a basis for FINRA to adopt sweeping changes to the federal securities laws.*

The Notice describes efforts by regulators outside the United States in an apparent attempt to bolster its claim that the measures it is considering are within the scope of its regulatory authority. However, regulatory actions by foreign securities regulators cannot form the basis for FINRA's regulatory authority. As former FINRA Chair and CEO Ketchem expressed in connection with the regulation of complex products in 2012:

> *"Some countries have implemented a form of merit regulation, in which they prohibit certain speculative products from reaching the retail market. This approach would be a significant departure from the product disclosure model on which the federal securities laws are based."*[47]

FINRA must look to the statute from which its authority originates and not to the actions of foreign regulators.

B. ***Construing FINRA's authority to empower it to act as a regulator of investors would raise serious constitutional concerns.***

Construing FINRA's authority to include the power to impose merits-based restrictions on investment decisions by individual investors would raise grave constitutional concerns.

FINRA is a private SRO, created to monitor and supervise its broker-dealer member firms. However, the adoption of measures that potentially prevent or deter investors' access to products designated by FINRA as complex would transform FINRA from a *self*-regulatory organization of its members into a merit regulator of investors and registered securities. This power far exceeds the statutory authority given to FINRA and is inconsistent with FINRA's mission, history, and expertise.

Moreover, vesting regulatory authority over the investment decisions of self-directed investors and their ability to access public securities and public markets in a private entity whose members compete in the regulated market would constitute an impermissible delegation of governmental power and would violate due process. To the extent there is any ambiguity in the limits of FINRA's authority, constitutional avoidance mandates an interpretation that stops short of this constitutionally forbidden territory.[48]

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[47] Chair and CEO Richard G. Ketchum, Remarks from the SIFMA Complex Products Forum, FINRA (2012).

[48] *Richmond Screw Anchor Co. v. United States*, 275 U.S. 331, at 346 (1928) ("It is [a court's] duty in the interpretation of federal statutes to reach a conclusion which will avoid serious doubt of their constitutionality.").

1. *FINRA was never meant to be a regulator of market access.*

The merits-based restrictions that FINRA is currently contemplating would represent a wholesale departure from FINRA's original mission. Instead of "regulat[ing] among" its "broker-dealers"[49] and "directing the affairs of [its] own industry under government supervision,"[50] FINRA would claim the authority to regulate investors' decisions and access to public securities and public markets. Under the approach contemplated by the Notice, FINRA would wield governmental power to direct the affairs of investors, restrict the purchase of publicly registered securities, deprive issuers and funds of the full benefits of SEC registration, and deny access to the public markets.

"Court[s] often look[] to 'history and purpose' to divine the meaning of language."[51] The history and purpose of the Exchange Act – as amended by the Maloney Act and the 1975 Amendments – make clear that FINRA was never meant to serve in this capacity.

Nor does FINRA have any history of attempting to act as a general regulator of self-directed investors or of determining which products self-directed investors can or cannot buy. As already noted herein, the former Chairman and CEO of FINRA has stated, in the specific context of prior FINRA considerations of complex products, that: "*we do not engage in 'merit' regulation. Federal regulators do not deny retail investors the opportunity to invest in risky or complicated products*."[52] Rather, in its 80 years of existence, FINRA has steadfastly stayed in its lane – issuing rules governing its own broker-dealers in accordance with the plain language of its mandate to "prevent fraudulent and manipulative acts and practices" and "discipline[]" its members.[53] Without any track record of the expansive regulation contemplated in the Notice, FINRA wholly lacks the expertise to assume that responsibility, and should resist attempting an (unauthorized) foray into this unknown terrain.[54]

2. *FINRA may not constitutionally act as a regulator of market access.*

Nor would the Constitution permit Congress to entrust the authority to issue merits-based requirements for investor access to public securities and public markets to a private, inward-facing entity like FINRA. The Constitution provides: "All legislative Powers herein granted shall be vested in a Congress of the United States."[55] The Supreme Court has "long recognized that the nondelegation doctrine does not prevent Congress from seeking assistance, within proper limits,

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49 Exchange Act § 15A.

50 Senator Francis Maloney Radio Address, *in* 83 Cong. Rec. App. at 789.

51 *Gundy v. United States*, 139 S. Ct. 2116, 2126 (2019) (alteration omitted).

52 Chair and CEO Ketchum, Remarks from the SIFMA Complex Products Forum, FINRA (2012) (emphasis added).

53 Exchange Act § 15A(b)(6)–(7).

54 The Notice even hints at the possibility of promulgating standards for investment advisors and insurance agencies—matters even further afield from FINRA's core competency. Indeed, Congress contemplated giving FINRA authority over investment advisors as part of the Dodd-Frank Act, but decided against doing so. *See* House Passes Wall Street Reform Legislation, 16 No. 7 Money Manager's Compliance Guide Newsletter 2 (2010) (stating that "[t]he Wall Street Reform and Consumer Protection Act had a provision that would have given [FINRA] 'sweeping rule-making authority'" over investment advisers).

55 Art. I, § 1.

from its *coordinate Branches*."[56] Yet the Court has drawn the line at delegations to persons or entities *outside* the government.

For more than 85 years, the Supreme Court has recognized that Congress may not delegate to private individuals or companies the power to promulgate regulations governing the conduct of other private parties. In *Carter v. Carter Coal Co*., 298 U.S. 238, 310–11 (1936), the Court struck down a statute that granted certain coal producers and miners the power to issue rules setting maximum labor hours and minimum wages. The Court explained that a delegation of rulemaking authority to a private party "is legislative delegation in its most obnoxious form; for it is not even delegation to an official or an official body, presumptively disinterested, but to private persons whose interests may be and often are adverse to the interests of others in the same business."[57] The Court emphasized that "one person may not be entrusted with the power to regulate the business of another, and especially of a competitor. And a statute which attempts to confer such power undertakes an intolerable and unconstitutional interference with personal liberty and private property."[58]

Since *Carter Coal*, the Supreme Court has repeatedly recognized the existence of the so-called "private non-delegation doctrine."[59] Just two months ago, three Justices signaled interest in clarifying the scope of the private non-delegation doctrine "in an appropriate future case."[60]

Were the Exchange Act to authorize FINRA to adopt the merits-based restrictions on investors contemplated by the Notice, the statute would be a paradigmatic private delegation. FINRA is not a governmental entity. It is not funded by political branches; it is not headed by someone appointed by the President or confirmed by the Senate; it lacks any political accountability; and its "priorities, operations, and decisions" are set substantially independently from the SEC.[61] Authorizing an entity like FINRA – "whose interests may be and often are adverse to the interests of others in the same business" – to regulate beyond its own members through merits-based restrictions on individual investors' decisions to invest in public securities would present precisely the sort of "intolerable and unconstitutional interference with personal liberty and private property" at the

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56 *Touby v. United States*, 500 U.S. 160, at 165 (1991) (emphasis added).

57 *Carter Coal, 298 U.S.* at 311.

58 *Id.; see also A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, at 537 (1935) ("But would it be seriously contended that Congress could delegate its legislative authority to [private] groups so as to empower them to enact the laws they deem to be wise and beneficent for the rehabilitation and expansion of their trade or industries? . . . The answer is obvious. Such a delegation of legislative power is unknown to our law and is utterly inconsistent with the constitutional prerogatives and duties of Congress.")

59 *See*, *e.g.*, *Mistretta v. United States*, 488 U.S. 361, at 373 n.7 (1989) (noting that the challenged statute did not "delegate regulatory power to private individuals"); *Dep't of Transp. v. Ass'n of Am. R.Rs.*, 575 U.S. 43, 55 (2015) (upholding a delegation of authority because the recipient was "a governmental entity, not a private one"); *see also id.* at 62 (Alito, J., concurring) ("there is not even a fig leaf of constitutional justification" for private delegations).

60 *Texas v. Comm'r*, 142 S. Ct. 1308, at 1309 (2022) (statement of Alito, J., respecting denial of certiorari, joined by Thomas and Gorsuch, JJ.).

61 *Ass'n of Am. R.Rs.*, 575 U.S. at 52–53.

heart of the private non-delegation doctrine.[62]

Similarly, due process would not tolerate vesting such broad regulatory authority in the hands of a market participant like FINRA. Due process demands that individuals or corporations granted governmental authority be "presumptively disinterested"; they cannot regulate when they have a commercial self-interest in the subject of the regulation.[63] As a case in point, FINRA's members have a pecuniary interest in whether FINRA rules permit self-directed investors to make their own investment decisions and engage in commission-free, online trades. They also have an interest in whether regulations drive such investors to other types of (potentially more expensive) accounts. These are the types of concerns that motivate the non-delegation doctrine.

Simply put, FINRA cannot regulate individual investors, complex products, and market access as described in the Notice without running roughshod over the constitutional guardrails meant to preserve liberty. Should FINRA pursue merits-based restrictions, a reviewing court would reject those rules as inconsistent with the text, structure, history, and purpose of the Exchange Act. If some shred of doubt remained, constitutional concerns would put the nail in the coffin.

3. *Even the SEC lacks the authority to implement the merits-based regulations that FINRA is contemplating.*

The measures contemplated in the Notice could impact millions of investors, dozens of product types, thousands of funds, and trillions of dollars in assets. The power to implement such landscape-altering changes to the regulatory scheme should not be casually presumed. It is "highly unlikely" that Congress has empowered FINRA to wield such extraordinary power – without ever saying so explicitly.[64]

FINRA seemingly claims the authority to deny market access to investors who cannot, or do not wish to, demonstrate (to FINRA's satisfaction) their understanding of public securities labeled as "complex products." This denial of investor choice and access, among other things, could deprive SEC registered issuers and funds of the full benefits of SEC registration (*i.e.*, the ability to sell their shares to the public). FINRA's claimed authority is undoubtedly a power of "vast economic and political significance."[65] Accounting only for the registered fund products FINRA has historically labeled as "complex" or "difficult to understand" the relevant market covers more than $7.6 trillion in assets and 40 percent of funds in the investment company industry.[66]

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62 *Carter Coal*, 298 U.S. at 310–11.

63 *Id.* at 311; *see also Tumey v. Ohio*, 273 U.S. 510, at 532 (1927) (holding that due process bars a statutory scheme in which the adjudicator receives a portion of the fine); *Gibson v. Berryhill*, 411 U.S. 564, 578–79 (1973) (due process violated when individuals wield governmental authority in an area where they have pecuniary interests).

64 *MCI Telecomms. Corp. v. AT&T Co.*, 512 U.S. 218, 231 (1994).

65 *Util. Air Regul. Grp. v. EPA*, 573 U.S. 302, 324 (2014) (internal quotation marks omitted).

66 As noted in footnote 4 above, according to the Investment Company Institute, approximately 5,600 funds registered under the Investment Company Act would be impacted with over $7.6 trillion of assets. This means that approximately 2 out of every 5 registered funds and 22 percent of total U.S. fund assets would be deemed complex products, potentially subject to enhanced investor qualification or other requirements. ICI Comment Letter, 2-3. This actually underestimates the potential impact of the measures FINRA is considering since the

Merits-based restrictions on complex products would dictate which securities are labeled as "complex," which investors may access this market, and how investors can access such markets, thereby placing "a significant portion of the American economy" under FINRA's direct control.[67]

Accordingly, the impact that merits-based regulation would have on investors and the massive (and potentially limitless) market for securities that FINRA or its members may deem complex implicates the major questions doctrine. That doctrine requires Congress "to speak clearly when authorizing an agency to exercise powers of vast economic and political significance."[68] Generally, Congress "does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions – it does not, one might say, hide elephants in mouseholes."[69] Thus, the "sheer scope" of an agency's claimed regulatory authority demands a correspondingly explicit congressional authorization.[70]

The federal securities laws contain no indication that Congress intended to give the SEC, the primary regulator of the financial markets, much less FINRA, such "unprecedented power."[71] The Securities Act does not condition investor access to public securities or issuer access to the public markets on any merits-based approval by the SEC of either investors or issuers. Instead, the distinction between public and private securities is based solely on registration and disclosure.[72] Similarly, the Exchange Act never so much as hints at the possibility of merits-based restrictions on investors or transactions in registered securities. Rather, the Exchange Act is replete with disclosure requirements – with transparency and investor choice serving as the Exchange Act's guiding stars.[73]

Unsurprisingly then, the SEC walked back its only prior attempt to impose merits-based restrictions on the purchase of certain "complex products." In 2020, the SEC published a proposed rule that would have required investors to possess a baseline level of "knowledge and experience in financial matters" to purchase leveraged and inverse ETFs – products that the SEC deemed to be "complex."[74] As grounds for the rule, the agency invoked a statutory provision authorizing it to "promulgate rules prohibiting or restricting certain sales practices."[75] But comments on the proposed rule demonstrated that the "vague terms" of that "ancillary provision" – which never mentions merits-based restrictions and is nestled under a heading entitled "Other Matters" – could

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term "complex" product as described by FINRA includes a number of securities and product types not registered under the Investment Company Act.

67 *Util. Air Regul. Grp.*, 573 U.S. at 324.

68 *NFIB v. Dep't of Labor, Occupational Safety & Health Admin.*, 142 S. Ct. 661, 665 (2022) (per curiam).

69 *Whitman v. Am. Trucking Ass'ns, Inc.*, 531 U.S. 457, 468 (2001).

70 *Ala. Ass'n of Realtors v. Dep't of Health & Hum. Servs.*, 141 S. Ct. 2485, 2489 (2021) (per curiam).

71 *Indus. Union Dep't, AFL-CIO v. Am. Petroleum Inst.*, 448 U.S. 607, 645 (1980).

72 *Compare* Securities Act §§ 7 and 10, *with* Securities Act § 4(2) (providing different statutory treatment of public and private offerings).

73 *See e.g.*, Exchange Act §§ 10C(c), 13(a), 14(a), 15(h)(3)(A).

74 Use of Derivatives by Registered Investment Companies and Business Development Companies, 85 Fed. Reg. 4446, 4493–95 (2020).

75 Exchange Act § 15(l)(2).

not possibly justify the SEC's claim to such sweeping authority.[76] Likely recognizing its lack of authority, the agency abandoned the proposal.[77]

If the SEC lacks this major power, it is doubtful that the power resides with FINRA – a private self-regulatory organization under the SEC's purview. Indeed, FINRA has not independently proposed such a sweeping merits-based restrictions on registered security transactions in its 83 years of existence, and the idea that FINRA may now "discover in a long-extant statute an unheralded power to regulate a significant portion of the American economy" is appropriately met "with a measure of skepticism."[78] And as discussed in Section III.A., this skepticism is merited – the Exchange Act does not grant FINRA the authority to adopt merits-based restrictions on securities transactions.

4. *FINRA's scheme would be rigorously scrutinized by the SEC and the courts and would not receive deference.*

Finally, FINRA should not expect that its contemplated measures, if proposed as a rule change, would receive superficial or deferential review by the SEC and the courts. Quite the contrary, because the proposed measures would raise many significant legal and constitutional questions – questions both as to FINRA's power to adopt the measures and the SEC's power to approve them – they would be reviewed *without* deference to FINRA's limited role as a self-regulator. Simply put, FINRA has no expertise to decide which financial products are "complex" and which investors are worthy of accessing them, and any attempt by FINRA to regulate these issues would be far outside its authority and core competency. The SEC and the courts could not simply rubber-stamp the radical measures that FINRA is contemplating.

For its part, the SEC may approve a proposed rule change only if it is consistent with the requirements of the Exchange Act. FINRA bears the burden of demonstrating that its proposed rules are consistent with the Exchange Act.[79] When considering SRO rulemaking, Courts require the SEC "to make an independent review" of whether the requirements of the Exchange Act are met. In doing so, the SEC may not simply take FINRA's "word for it" or "trust the process" that FINRA undertook in developing the rule. Rather, there must be support in the record for the SEC's conclusions.[80] In practice, the SEC has engaged in rigorous, impartial review of an SROs' proposed rules.[81] Nor would a court defer to any of FINRA's conclusions. For starters, courts do

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[76] *See Whitman*, 531 U.S. at 468; Comment of ProShare Advisors LLC, File No. S7-24-15, at 27–47 (2020).

[77] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, 85 Fed. Reg. 83162, 83216 (2020).

[78] *Util. Air Regul. Grp.*, 573 U.S. at 324 (internal quotation marks omitted).

[79] Exchange Act § 19(b)(C)(i); 17 C.F.R. § 201.700(b)(3).

[80] *Susquehanna Int'l Grp., LLP v. SEC*, 866 F.3d 442, 446–47 (D.C. Cir. 2017); *NetCoalition v. SEC*, 615 F.3d 525, 541 (D.C. Cir. 2010) (SEC order finding that the SRO's proposed rule was consistent with the Exchange Act was arbitrary and capricious because there was a "lack of support in the record for the SEC's conclusion" beyond the SRO members' say-so).

[81] *See*, *e.g.*, Order Disapproving a Proposed Rule Change To List and Trade Shares of the Global X Bitcoin Trust, 87 Fed. Reg. 14912, 14914–15 (2022) (disapproving an SRO's proposed rule change that failed to meet the requirements of the Exchange Act); Order Disapproving Proposed Rule Change To Amend FINRA Rule 6140, 76 Fed. Reg. 9062, 9063 (2011) (same).

not have the authority to review FINRA's decisions directly; only an SEC final order approving FINRA's proposed rule is subject to judicial review.[82] In any event, well-settled deference principles would prohibit deferring to FINRA's conclusions of law under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

First, *Chevron* deference is appropriate only for the agency to which Congress has delegated authority to administer the Exchange Act.[83] FINRA is neither an agency nor has it been given any "specific grant of authority from Congress" over these matters.[84]

Second, *Chevron* deference is inappropriate where the agency interpreting the statute lacks the relevant expertise.[85] FINRA lacks the expertise to evaluate the relative merits of securities and financial products or to make inherently subjective conclusions of what investors may understand – it is only a self-regulatory agency intended to regulate its member firms.[86]

Third, to the extent the rule FINRA ultimately proposes imposes merits-based restrictions on transactions in regulated securities, the proposed rule implicates a major question, rebutting any presumption that Congress intended to delegate the question to an agency.[87]

Fourth, a proposed rule containing merits-based restrictions potentially would further the self-interest of certain FINRA members since many FINRA members, either directly or through advisory affiliates, might have a pecuniary interest in merits-based restrictions, making the rule ineligible for *Chevron* deference.[88]

In summary, FINRA should not expect a rubber stamp on review. The searching inquiry of the SEC or a reviewing court will expose the shortcomings in FINRA's statutory authority to issue merits-based restrictions and the incompatibility of those restrictions with the Exchange Act.

IV. FINRA's scheme would harm investors, is unnecessary, and would be arbitrary and unworkable.

The restrictions on investor access and choice contemplated by the Notice, if adopted, would create harmful and counterproductive consequences for investors. Investors could be denied access to many popular mutual funds, ETFs, and other investments, including funds that can be used to mitigate risk and diversify portfolios. The contemplated measures could drive investors towards riskier and more costly strategies. Despite this, the Notice does not present any evidence to justify the extreme measures it puts forth. Further, the use of subjective (and potentially biased) tests and minimum wealth requirements to determine investor qualifications increases the likelihood of

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82 Exchange Act § 25; *Susquehanna Int'l Grp.*, 866 F.3d, at 446–47.

83 *United States v. Mead Corp.*, 533 U.S. 218, 229 (2001).

84 *Morgan Keegan & Co. v. Johnson*, at 7 (E.D. Va. 2011); *North v. Smarsh, Inc.*, 160 F. Supp. 3d 63, 78 (D.D.C. 2015).

85 *Gonzales v. Oregon*, 546 U.S. 243, 267 (2006).

86 *See supra* sec. III.B.1.

87 *King v. Burwell*, 576 U.S. 473, 486 (2015); *see supra* sec. III.B.3.

88 *Amalgamated Sugar Co. v. Vilsack*, 563 F.3d 822, 834 (9th Cir. 2009); *see supra* sec. III.B.2.

arbitrary and unequitable treatment of investors, particularly among members of communities that have historically been underserved in financial markets. For these and other reasons, the measures contemplated by FINRA would be unworkable.

A. ***Limiting or restricting self-directed investors from accessing the public markets harms investors.***

FINRA concedes in the Notice that the products as to which it would impose restrictions are valuable to investors. For example, many such products provide retail investors with portfolio diversification tools, with downside protection against market movements or with exposure to assets in which they would individually be unable to invest, such as a diversified pool of real estate assets. Yet having in a single sentence conceded the value of the products, FINRA then entirely ignores the benefits to investors of the dozens of product types with a market capitalization of over $7.5 trillion that FINRA has labeled as complex products. Somewhat remarkably, FINRA seems to view the fact that these products are increasingly purchased by retail investors as evidencing a problem with the products, rather than as testament to the value that they potentially provide.

1. *FINRA's measures may prevent or deter investor access to beneficial products.*

FINRA's measures could deprive millions of investors access to valuable products, many of which are used to diversify portfolios, reduce risk, and help achieve long-term financial goals. According to the ICI, approximately 5,600 funds registered under the Investment Company Act with over $7.6 trillion of assets would be impacted. This means that approximately 2 out of every 5 registered funds and 22 percent of total U.S. fund assets would be deemed complex products, potentially subject to enhanced investor qualification or other requirements.[89] The ICI figures apply only to registered funds, and actually underestimate the potential impact of the measures FINRA is considering – since the term complex product as described by FINRA includes a number of securities and product types not registered under the Investment Company Act.

The Notice begins by acknowledging that "[t]he availability of complex products and options can potentially expand the investment opportunities for retail investors and, if properly understood, offer favorable investment outcomes (*e.g.*, enhancing returns, limiting losses or improving diversification)."[90] However, the Notice fails to consider these benefits beyond this perfunctory statement.

We believe it is therefore useful to highlight some of the potential benefits provided by these products and how investors might use them as one part of a well-constructed investment portfolio.

Portfolio Diversification. FINRA[91] and the SEC[92] have repeatedly emphasized the importance of diversification both within and among asset classes. Diversification helps to limit losses and reduce

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89 ICI Comment Letter, 2-3.

90 Notice, 1.

91 Diversifying Your Portfolio, FINRA (*n.d.*).

92 Beginners' Guide to Asset Allocation, Diversification, and Rebalancing, U.S. Securities and Exchange Commission (2009).

volatility in investment performance, but the average retail investor's portfolio is highly concentrated, holding just a handful of individual stocks.[93]

Some of the products identified in the Notice can be used to provide investors with diversification benefits.[94] Defined outcome funds, for example, often offer diversified market index exposure with reduced downside exposure in exchange for capped upside exposure.[95] Commodity funds,[96] real estate funds,[97] and cryptocurrency funds[98] each can help provide asset-class diversification, a recognized building block in a well-diversified portfolio.[99]

Rather than restricting access to these valuable tools for diversification, FINRA should focus on educating investors about the importance of diversification. Presumably FINRA's concerns about complex products would be alleviated if it recognized that investors often use these products as a component of a well-diversified portfolio.

Downside Protection. Limiting investment losses can be just as critical for investors as securing investment gains.[100] Yet many of the products that FINRA is seeking to restrict offer investors the opportunity to hedge their exposure or limit losses quickly and effectively. For example, investors have repeatedly expressed that inverse funds provide these critical hedging benefits.[101]

Other loss-limiting strategies, like those that provide protection against rising interest rates, are similarly an important component of a well-diversified portfolio. As one commentor succinctly put it: "The market does not always go up. Private investors need access to affordable hedg[ing] tools in order to protect and insure the wealth they have accumulated."[102]

Importantly, the purpose of these products is not necessarily to secure gains. On the contrary, investments designed to provide a hedge against adverse market movements should be expected to lose money when markets are not adverse. If a well-structured hedge increases in value, it is

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93 Seth L. Elan, Behavioral Patterns and Pitfalls of U.S. Investors, Federal Research Division, Library of Congress (2010); Meir Statman, The Diversification Puzzle. Financial Analysts Journal, 44–53 (2004).

94 Diversifying Your Portfolio, FINRA (*n.d.*).

95 Defined Outcome ETFs, ETF Database (2022).

96 Thomas Schneeweis *et. al.*, The Benefits of Commodity Investments, Investment Management Consultants Association (2008).

97 REITs and Diversification, Nareit (*n.d.*).

98 Exchange-Traded Funds, 84 Fed. Reg. 57162 (2019).

99 Beginners' Guide to Asset Allocation, Diversification, and Rebalancing, U.S. Securities and Exchange Commission (2009).

100 Limiting Losses Increases Your Gains, Capital Group (*n.d.*).

101 *See, e.g.,* Comment of Lee Schloss, Regulatory Notice 22-08 (2022) ("The ability to freely buy inverse funds is absolutely crucial for investors, as they are among the best things that can protect against a down market."); Comment of Russell Laux, Regulatory Notice 22-08 (2022) ("Inverse funds are an important investment vehicle that should be made and kept available to the average investor. They offer investors the ability to hedge other investments and protect themselves from adverse market moves. To remove this tool from investors would be short sighted and negatively impact the average investor.")

102 Comment of Steven Sterner, Regulatory Notice 22-08 (2022).

likely because the overall portfolio has experienced a loss that the investor prudently sought to mitigate. Conversely if a well-structured hedge declines in value, it is likely because the overall portfolio did not experience the loss the investor *just as prudently* sought to mitigate.

Restricting investor access to these products would potentially make investors' portfolios more risky, not less.

Potential for Enhanced or Non-Correlated Returns. The benefits of seeking investment gains appear obvious. Gains help investors meet their financial objectives. However, reaching those objectives is not a foregone conclusion. Approximately 60% of Americans may be investing too conservatively to meet their financial goals.[103] Investors who are essentially under-exposed to risk may experience investment shortfalls due to inflation and opportunity costs.

As FINRA acknowledges, products like smart beta funds or custom index funds, for example, "may seek to achieve better performance than a particular market or sector."[104] Other funds, such as commodity funds or thematic funds, may seek returns that are not closely correlated with the overall stock market. Limiting investor access to only "plain vanilla beta exposure to stocks and bonds"[105] denies investors the ability to take on the risk they may need to meet their investment goals.

Ease of use. Many of the investment products FINRA targets as complex were designed to provide investors with a convenient, liquid, and cost-efficient mechanism to obtain access to specific investment strategies. For example, many target date funds are designed to provide investors with expert portfolio management that will manage not only security selection and diversification, but also appropriate asset allocation based on the investor's preferred retirement date. Certainly, these products may have complex operational details, but from an investor's perspective they are relatively straightforward. Investors have determined to entrust the fund, its board, and its adviser with the technical details of managing their assets up to and sometimes through retirement.

The same observation applies to strategic allocation funds, opportunistic funds, and many other products that FINRA has identified as complex. Investors are looking to these products to provide them with convenient access to investment strategies that may be difficult to implement or which they do not have the time or inclination to manage for themselves.[106]

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[103] Many Americans May Be Investing Too Conservatively to Meet Their Retirement Goals, According to Wells Fargo Study, Wells Fargo (2016).

[104] Custom-Built Index Funds—Are You the Right Customer? FINRA (2018).

[105] Dave Nadig, FINRA's Complex Product Proposal: Bad Policy, Nasdaq (2022).

[106] *See e.g.,* Comment of Conrad Kockerbeck, Regulatory Notice 22-08 (2022) (noting that funds "provide excellent opportunities for smaller investors to participate in otherwise difficult to implement investment strategies").

Sophistication. Finally, it is unclear why FINRA should target products that are "complex" at all. As one commentator observed, "what you call complexity, I call sophistication."[107] In many cases, the products that FINRA labels as "complex" are intentionally designed to provide investors with targeted investment exposure or other potential benefits.

Complexity itself is not a flaw; it permits investors to tailor their investment portfolios to meet their investment needs. Historically, that type of customized investment strategy was only available to investors who could afford to pay an investment adviser to customize a portfolio specific to the investors' needs, monitor and respond quickly to micro- and macro-economic trends, and develop sophisticated hedging strategies to mitigate downside risk.

Often, what FINRA identifies as complex are products designed to put those powerful investment tools in the hands of all investors. Whether those investors rely on a financial professional to guide them through those decisions or not, all investors deserve the opportunity to access the full range of investment strategies.

2. *FINRA's measures could force investors to embrace riskier, more costly strategies.*

As discussed in more detail in Section IV.A.4., FINRA's measures, if adopted, may lead brokerage firms to stop offering a wide range of investment products to self-directed investors. Investors seeking the important benefits these products can provide may be forced to embrace riskier, more costly strategies.

For example, an investor who believes an equity market downturn is imminent may currently seek to hedge their portfolio with an inverse fund, defined outcome fund, or commodity fund – just to name a few examples. Without the ability to protect their portfolio using these products, an investor might have to forgo hedging their portfolio or potentially utilize other strategies, such as liquidating a portion of their portfolio or short selling.[108] When an investor liquidates a portion of their portfolio they may incur negative tax consequences. When an investor sells short, they are exposed to unlimited risk if the stock price unexpectedly rises. In contrast, the risk for an investor in a fund is limited to the amount of their investment.

Similarly, an investor seeking exposure to cryptocurrency may currently invest in a registered investment company that holds cryptocurrency futures. If this type of investment were no longer available, the investor might seek to invest directly in cryptocurrency, incurring the cost and risks of investing in cryptocurrency directly.

3. *FINRA's measures could lead to discrimination and unfair treatment of investors, particularly investors from underserved communities.*

Measures that introduce subjectivity, testing bias, or net worth requirements have the potential to treat investors differently and unfairly. For example, the inherent bias in standardized testing is

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[107] Phil Bak, ETF Veteran Phil Bak's Comment Letter On FINRA Proposal, ETF Trends (2022).

[108] *See e.g.,* Comments of Mark Meyerowitz, Regulatory Notice 22-08 (2022) ("These regulations would be taking a valuable tool away from investors. They would impinge on our ability to hedge our accounts against loss. We would need to become short sellers, which is much more risky and unavailable in retirement accounts. Your proposed rules would increase market risk.")

well-documented.[109] Yet, FINRA's measures could require broker-dealers to develop and administer written tests of investor understanding or pre-qualify investors based on undefined standards.[110] The vague and amorphous concept of complexity put forth by FINRA increases the risk that subjective evaluations of investor understanding will result in biased or unfair treatment of investors.

Similarly, the minimum net worth requirements considered by the Notice potentially exacerbate income inequality and racial inequality.[111] The financial services sector is not immune to the challenge of securing equitable treatment for all participants in our financial markets.[112] But over the last decade progress has been made to reduce the so-called "investment gap."[113] FINRA's 2020 study shows signs of that same progress. Based on their data, the rise in new self-directed accounts was disproportionately driven by increased participation by diverse investors.[114] Yet, the measures FINRA is suggesting could erect barriers that would undermine this progress.

FINRA is statutorily barred from adopting rules that discriminate between investors.[115] It should not seek to regulatorily mandate measures that would entrench bias and inequality in the public securities markets.

4. *FINRA's measures could impede capital formation and stifle innovation, depriving investors of future opportunities.*

Section 3(f) of the Exchange Act directs regulators, including FINRA, to promote efficiency, competition, and capital formation alongside investor protection. As Chair Gensler recently observed, "[w]e are blessed with the largest and most innovative capital markets in the world."[116] The arbitrary and unworkable measures FINRA has put forth could stifle that innovation and impede competition and capital formation in a number of different ways.

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109 Saul Geiser, Norm-Referenced Tests And Race-Blind Admissions: The Case for Eliminating the SAT and ACT at the University of California, UC Berkeley (2017).

110 Notice, 15.

111 Nick Noel, et. al., The economic impact of closing the racial wealth gap, McKinsey & Company (2019); Annual Report For Fiscal Year 2019. U.S. Securities and Exchange Commission, Office of the Advocate for Small Business Capital Formation, 42-43 (2019) (SEC noted, when discussing changes to the definition of "accredited investor," that women, minorities, and rural communities express "disproportionate challenges" when raising capital or accessing markets from such test-based standards. The SEC 2019 Report also notes the criticism that access to high-growth potential investments is limited and that a common complaint is that "you have to be rich to get rich").

112 *See e.g.,* Neil Bhutta, et. al., Disparities in Wealth by Race and Ethnicity in the 2019 Survey of Consumer Finances, Federal Reserve (2020); Sarah Lyons-Padilla, et. al., Race Influences Professional Investors' Financial Judgments, PNAS (2019); Song Han, S. On The Economics of Discrimination in Credit Markets, Federal Reserve (2001).

113 Nick Noel, et. al., The economic impact of closing the racial wealth gap, McKinsey & Company (2019).

114 Mark Lush, et. al., Investing 2020: New Accounts and the People Who Opened Them, FINRA (2021).

115 Exchange Act § 15A(b)(6).

116 Chair Gary Gensler, A Century with a Gold Standard, U.S. Securities and Exchange Commission (2022).

First, FINRA's vague and subjective description of complex products would likely make it more difficult for products to be added to distribution platforms. The additional hurdle of having to determine the complexity of every product a self-directed investor may wish to trade is likely to increase costs for brokers (as they would need to develop new systems and processes) and reduce the overall number of products that brokers allow investors to trade on a self-directed basis, particularly given the absence of any clear standard for "complexity." These reductions in market access would "raise the bar" for new product development and could make it more difficult for all new products to raise sufficient asset levels. This could impede both capital formation and innovation. Consequently, all investors may be denied the benefit of financial innovation – even in products that FINRA would not define as complex.

Additionally, products labeled as "complex" would, in essence, be required to "prove" themselves indefinitely – at least until such time, if ever, as FINRA or the brokers it regulates determine those products are no longer too complex for investors to understand. During that period, self-directed investors may be denied the benefits of those products. Additionally, by disincentivizing new and novel products, FINRA potentially would further strengthen the position of established market participants potentially reducing competition to the disadvantage of investors.[117]

An instructive example is the regulatory treatment of ETFs. The SEC authorized the operation of the first ETF in 1992. It took more than 25 years before the SEC adopted a rule to standardize the regulatory treatment of ETFs.[118] Presumably during those 25 years, FINRA might have decided that the unique characteristics of the ETF structure made them "complex." During that 25-year period, ETFs became some of the most popular and broadly owned financial products because investors, including individual, self-directed investors, were able to recognize their value and had access to such investments.

Had FINRA imposed additional barriers on investment in ETFs, retail investors might have been denied significant investment opportunities and benefits. The overall development of the product category could have been dampened. The likely impact of FINRA imposing additional barriers to investment in ETFs would have been to discourage product innovation, to discourage new sponsors and new types of funds from coming to the market, and to limit competition among ETFs and mutual funds.

B. ***FINRA has not demonstrated any need for placing unprecedented regulatory burdens on self-directed investors' access to public securities and markets.***

Despite considering a radical, unprecedented scheme, FINRA does not actually put forward any evidence to justify such extreme measures. Instead, it throws out a number of supposed justifications for the restrictions on investor access put forth in the Notice. None of these justifications actually supports the unprecedented move to merits-based regulation and restrictions on investor access contemplated by FINRA.

1. *FINRA makes no effort to quantify investor understanding of complex products.*

The purported justification for the measures being considered by FINRA is that "important

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[117] Phil Bak, ETF Veteran Phil Bak's Comment Letter On FINRA Proposal, ETF Trends (2022).

[118] Exchange-Traded Funds, 84 Fed. Reg. 57162 (2019).

regulatory concerns arise when investors trade complex products without understanding their unique characteristics and risks." Yet, despite this focus on investor understanding, the Notice makes no effort to measure or quantify investor understanding of products that FINRA believes are complex (or for that matter any other product). FINRA merely states as fact its unsubstantiated belief that "features of these products are such that they ***may*** be difficult for a retail investor to understand (emphasis added)."[119] The Notice cites no studies to support this belief that investors may not understand these features. It also cites no studies to support its claim that the features of complex products it identifies are misunderstood by investors. Indeed, as discussed in Section IV.C., the Notice fails even to present any coherent definition or description of complex products upon which these judgments could be made.

2. *FINRA fails to provide evidence that complex products are more difficult to understand than other products.*

Given FINRA's failure to articulate a coherent description of complex products, it is unsurprising that they were similarly unable to articulate how so-called complex products differ from other products available to the public that FINRA has not labeled complex.

For example, one "feature" of complex products identified by FINRA is that such products may behave in "unexpected ways in various market or economic conditions."[120] As with so many of FINRA's assertions in the Notice, no analysis was done to support this claim that complex products are unique in this regard. Indeed, it would be impossible to prepare such an analysis, not because a complex product could never behave in an unexpected way, but rather, because *any* security or financial instrument can behave in unexpected ways. This is true for the products that FINRA has identified as "complex" – as well as other types of securities, such as bonds and equity securities. For example, technology companies may have multiple patents and other intellectual property. The utility and value of this intellectual property may go up or down in unexpected ways depending on market conditions, competition, government regulation, and the pace of technological innovation. Other types of operating companies can have leveraged balance sheets and various other contingencies whose performance impact in various market conditions may not be readily apparent. Even conservative investments such as U.S. Treasury securities can sometimes behave in unexpected ways.[121]

In short, every security has its own distinct features and complexities. Every security can behave in unexpected ways from time to time. Attempts to measure investor expectations and understanding are entirely subjective and do not afford FINRA any justification to favor one type of security over another.

3. *FINRA fails to provide any evidence that the existing disclosure-based regulatory regime is inadequate for complex products.*

FINRA's contemplated new impediments to, and restrictions on, investor access to publicly registered securities are based on an implied assumption that the statutory disclosure scheme

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[119] Notice, 3.

[120] Notice, 4.

[121] Alex Aronovich, et al., *The Treasury Market Flash Event of February 25, 2021*. Federal Reserve (2021).

devised by Congress, and implemented for almost 90 years by the SEC, is inadequate to protect investors. But FINRA provides no evidence to support that assumption.

Securities that are registered under the Securities Act are subject to extensive initial and ongoing disclosure requirements, including ongoing reporting requirements with respect to disclosure of material risks and events. Many of the products that FINRA has labeled complex are registered investment companies subject to additional ongoing disclosure requirements and other protections under the Investment Company Act, including mandatory disclosure of investment strategies and risks. Issuers and funds that do not comply with the disclosure requirements of the federal securities laws are subject to potentially significant legal and regulatory liability.

FINRA fails to provide any evidence that the existing disclosure-based regulatory regime is inadequate for complex products. Given the sweeping changes it contemplates, FINRA should at least try to identify what aspects of the disclosure regime are inadequate for complex products and why. However, given FINRA's failure to articulate a coherent definition of complex products, it is not surprising that it cannot explain which features of the disclosure regime are sufficient for products that FINRA has not labeled as complex, while inadequate for products that FINRA has labeled complex.

4. *The enforcement actions cited by FINRA relate solely to recommendations and are unrelated to investor understanding.*

FINRA also cites as support a number of enforcement actions where registered representatives of a broker-dealer made unsuitable recommendations to customers. These cases demonstrate that some member firms may need better supervisory procedures and that some registered representatives acted improperly with respect to recommendations. The fact that FINRA was able to successfully bring such actions further demonstrates that FINRA has sufficient regulatory and enforcement tools to deal with any problems that it might perceive with respect to broker recommendations. These cases, however, provide no evidence as to the ability of *self-directed* investors to understand complex products. They certainly do not support the sweeping changes to the disclosure-based regime and investor access that FINRA contemplates.

5. *FINRA provides no evidence that complex products create unspecified market structure issues.*

The Notice asserts that complex products may create unspecified market structure issues. To support this claim, the Notice cites to SEC Chair Gensler having "recently suggested" that this was the case.[122] The Notice implies that these purported issues are a reason FINRA should adopt "well-conceived protections in the sale and trading of complex products."[123] However, the Notice provides no evidence to support these claims.

Even assuming FINRA has the authority to adopt such measures, any attempts to address market

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[122] Notice, 5 (*see* footnote 11 and accompanying text citing Chair Gary Gensler, Statement on Complex Exchange-Traded Products (2021)).

[123] "Trading in complex products may also affect underlying assets. Thus, well-conceived protections in the sale and trading of complex products benefits market integrity in underlying markets." Notice, 5.

structure issues that would establish barriers to the purchase of trillions of dollars of retail products (such as the measures contemplated in the Notice) should be grounded in significant and substantive economic analysis. At a minimum, FINRA would need to identify the market problem, how restricting investor access to complex products would alleviate the problem, and the costs of doing so, including the market impact of the contemplated measures on such investors and products. Such a position would be difficult to substantiate given that certain of the product types that could be deemed "complex" have operated since before the adoption of the Investment Company Act.

Additionally, we also observe that if "complex" products create market structure issues, there would seem to be no basis for permitting institutional investors to own them while denying access to a subset of retail investors. Presumably, institutional investors would have much larger positions that would be more likely to have market impacts than small investors, which makes it particularly unfair to disfavor small investors. Any such favoritism of large investors over small would be in direct contravention of FINRA's authorizing statute and would not seem to be a "well-conceived protection."[124]

Further, FINRA would need to consider the "downstream impact" of measures that could limit investor access to certain products. For example, rather than decreasing market structure issues and systemic risk, FINRA's concept could increase potential issues and risk by driving assets to products that FINRA has not labeled "complex," thereby increasing market concentration risk. In addition, measures that resulted in large numbers of investors being ineligible to purchase certain types of securities, could fragment the market for trillions of dollars' worth of investments, reducing the liquidity and increasing the volatility of the impacted securities.

C. ***FINRA's contemplated measures would be arbitrary and unworkable.***

FINRA's contemplated measures are vague, arbitrary, and unworkable. The tests and criteria it suggests are highly subjective and costly and could lead to unfair and discriminatory treatment of investors.

In the Notice, FINRA concedes that a "static" definition of complex products is not feasible and instead suggests that the term needs to be construed "flexibly" to adjust to "the evolution of financial products and technology."[125] To address this, FINRA's description of complex products is based on the amorphous concept of investor understanding – whether a product contains "features that ***may*** make it difficult for a retail investor to understand the essential characteristics of the product and its risks (emphasis added)."

This vague and subjective description provides brokers and investors with no meaningful guide to what is or is not a complex product. Indeed, as shown in Exhibit A, FINRA has labeled as complex products a vast array of investments across a wide range of structures, asset classes, and investment strategies. FINRA does not appear to have a clear unifying principle in making these determinations, once again leaving investors and brokers to guess as to its meaning.

Given that FINRA has declined to either define the term "complex product" or to provide any

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[124] *See* Exchange Act § 15A(b)(6) (rules of FINRA must not "permit unfair discrimination between customers").

[125] Notice, 3.

unifying principle, it would necessarily be left to individual broker-dealers to make this determination. Without coherent guidance, broker-dealers would be required to adopt their own idiosyncratic definitions. The contemplated measures would require broker-dealers to analyze all investments available on their platforms to determine whether each investment available for purchase is "complex." One firm might label a product "complex" while another does not. Inconsistent treatment of these products by brokers would potentially add to investor confusion. It would also promote "forum shopping" – where investors go from broker to broker looking for the one who makes the product available. Moreover, there is nothing to stop FINRA from making after-the-fact determinations in situations where investors have lost money that a product is "complex" and declaring that the broker-dealer ought to have prevented a self-directed investor's investment decision.

In addition, as noted elsewhere herein, one measure FINRA is contemplating would require brokers to test self-directed investors' "understanding" of the complex products in which they seek to invest. Testing investor understanding on the full range of products that would fall within FINRA's flexible description of complex product would be wholly impractical.[126] Moreover, the fact that FINRA's description of "complexity" is a completely subjective and open-ended "we'll know it when we see it" approach means that it would be almost impossible for brokers to devise any test of investor understanding in a fair manner. As discussed in Section IV.A.3., any such tests, particularly one based on such a broad and amorphous concept, could result in unfair and discriminatory treatment of investors. Net worth standards would also be arbitrary and would not advance the investor protection purposes set forth in the Notice.

If FINRA's measures are adopted, the added administrative and compliance costs, as well as the potential legal, regulatory, and reputational risks to brokers, would be significant. Investors would undoubtedly bear many of these costs. Currently, many self-directed investors trade on a zero-commission basis.[127] Brokers often make little or no money when executing these transactions.[128] Consequently, brokers are likely to pass these costs on to investors, eliminate certain products from their platforms, or elect not to permit self-directed trades at all.

D. *A rule that does not advance its purpose is arbitrary and capricious.*

Even if FINRA were justified in its concern that investors do not understand complex products, the measures FINRA is considering would do little or nothing to advance the cause of investor understanding. Regulations that do not advance their purpose are arbitrary and capricious. For example, some components of FINRA's scheme – such as minimum wealth requirements – have nothing to do with investor understanding at all. Is there a reason to believe that an investor with more wealth has a better understanding of a lifecycle fund or a cryptocurrency fund than an investor of less wealth? FINRA presents no evidence to support this unfounded assumption.

Other components of FINRA's scheme are poorly tailored to achieve the stated goals. Investments

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[126] FINRA seems to have given little thought as to how this would actually work in practice and the likelihood of unfair results. *See* Comment of Digital Assets Council of Financial Professionals, Regulatory Notice 22-08 (2022).

[127] Mark Lush, et. al., Investing 2020: New Accounts and the People Who Opened Them, FINRA (2021).

[128] Bruce Kelly, What Zero Commissions Mean for B-Ds, InvestmentNews (2019).

in individual stocks – which FINRA has never labeled as "complex" – may be more complex and may have more features that may make it difficult for a retail investor to understand than the products that FINRA has identified as complex. A rule that does not account for this would not address the problem FINRA asserts and would not advance its purpose. Other features of FINRA's contemplated measures described herein – such as the potential harm to investors or the potential for discrimination due to vague standards and testing bias – would likely cause any rule based on these measures to be deemed arbitrary and capricious.

V. The SEC could not approve a FINRA rule proposal featuring the measures identified in the Notice.

If FINRA proposes the measures limiting investor choice and access contemplated in the Notice as rules for SEC approval, the SEC would lack authority under the Exchange Act to approve that rule change. The measures would exceed not only FINRA's authority under the Exchange Act, but also the SEC's own approval authority under the Exchange Act.

In addition, in order to approve such a proposal, the SEC would be required to satisfy the applicable requirements of the Administrative Procedure Act (the "APA"). Among other things, the SEC would be required to explain why it is reversing course from the core premises of the federal securities laws and its long-held positions that disclosure adequately protects and empowers the public and that investors should be free to make their own investment decisions. It would also need to explain why it is reversing course on prior Commission orders (some quite recent), concluding that securities that would be considered "complex products" by FINRA are consistent with the Exchange Act, in the public interest, and consistent with the protection of investors. The SEC would be required to evaluate all significant and viable alternatives, and there are less restrictive measures that could accomplish FINRA's aims.

A. *The SEC would be unable to approve the proposal because it is contrary to section 15A of the Exchange Act.*

The SEC may approve a proposed FINRA rule change only if it finds that the proposed rule change is consistent with the applicable requirements of the Exchange Act.[129] Those requirements, including the restrictions listed in section 15A of the Exchange Act, supply ongoing limitations on FINRA's rulemaking authority.[130] Under 17 C.F.R. § 201.700(b)(3), FINRA has the burden to show that any proposed rule is consistent with these requirements. But for the reasons previously discussed in Section III.B.4., FINRA would be unable to provide "analysis or evidence" to meet that burden here.[131]

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[129] Exchange Act § 19(b)(2)(C)(i); *see supra* sec. III.B.4.

[130] *See Domestic Sec., Inc. v. SEC*, 333 F.3d 239, at 242 (D.C. Cir. 2003) ("NASD must maintain rules that" comport with section 15A); Order Disapproving a Proposed Rule Change To List and Trade Shares of the Global X Bitcoin Trust, 87 Fed. Reg. at 14,914–15 (2022) (disapproving a new rule because it failed to meet the "fraudulent and manipulative acts" requirement of section 6(b)(5)).

[131] Order Disapproving a Proposed Rule Change To List and Trade Shares of the NYDIG Bitcoin ETF, 87 Fed. Reg. at 14,936 (2022). Accordingly, the SEC would be obligated to disapprove FINRA's proposal. Exchange Act § 19(b)(2)(C).

B. ***SEC approval of FINRA's proposal likely could not survive arbitrary and capricious review.***

In proposing rule changes, FINRA itself must satisfy "the same standards of policy justification that the [APA] imposes on the SEC."[132] And in approving FINRA's proposed rule changes, the SEC must independently comply with the APA's prohibition on arbitrary and capricious agency action.[133] Under that standard, a reviewing court would be required to evaluate whether the SEC, in approving the proposal, "examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choices made."[134] Given the prior positions the SEC has taken on the adequacy of disclosure and the existence of viable alternatives to protect the public interest, the arbitrary and capricious standard would present a substantial obstacle to approving a proposal based on these measures.

1. *The SEC would be required to explain why it reversed course from its longstanding position that disclosure-based regulation is adequate.*

If the SEC were to approve such a proposal, it would be required to justify why it has "reverse[d] course" from its longstanding position that disclosure-based regulation is adequate to protect investors and the public interest – a position that has "engendered serious reliance interests" among investors, investment companies, broker-dealers, and investment advisers.[135]

The SEC has long made clear that its principal mission is not to protect investors from themselves, but to empower investors to engage in informed decision making. Toward that end, the SEC has developed a regulatory regime built around disclosure: "Ours is a disclosure-based system. And it is our job to promote clear, accurate and timely disclosures – proactively."[136] As an early SEC Chief Counsel once put it, "If [a fund is] going to be a speculative investment trust, and they disclose that fact to their investors, and the investors want to invest in that type of investment company, who are we to say, 'No; you shall not invest in that type of company'?"[137]

The measures FINRA is considering turn that disclosure-based regime on its head. Rather than

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[132] S. Rep. No. 93-865, at 26 (stating with respect to Section 19(b)(1) that "[i]t is the Committees intention in adopting this standard to hold the self-regulatory organizations to the same standards of policy justification that the Administrative Procedure Act imposes on the SEC").

[133] *See* 5 U.S.C. § 706(2)(A); Exchange Act § 25(a)(4); *Susquehanna Int'l Grp.*, 866 F.3d at 443, 445 (holding that SEC order approving the proposed rule of SRO was arbitrary and capricious) (internal quotation marks omitted).

[134] *Motor Vehicles Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, at 43 (1983); *See Susquehanna Int'l Grp.*, 866 F.3d at 445.

[135] *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 514 (2009); *see also Dep't of Homeland Sec. v. Regents of the Univ. of Cal.*, 140 S. Ct. 1891, 1913 (2020) ("When an agency changes course . . . it must be cognizant that longstanding policies may have engendered serious reliance interests that must be taken into account." (internal quotation marks omitted)).

[136] Chair Harvey L. Pitt, Testimony Concerning Financial Literacy, U.S. Securities and Exchange Commission (2002); *see also* Commissioner Paul S. Atkins, Recent Experience With Corporate Governance in the USA, U.S. Securities and Exchange Commission (2003) ("the SEC "is a disclosure-based agency, not a merit regulator"). Commissioner Laura S. Unger, Securities Law and the Internet, U.S. Securities and Exchange Commission (2000) ("the SEC is "a disclosure-based agency").

[137] *Investment Trusts and Investment Companies: Hearings Before the Subcomm. on Sec. & Exch. of the S. Comm. on Banking & Currency*, 76th Cong. 233 (1940) (statement of David Schenker, Chief Counsel, SEC).

informing and empowering investors to make decisions for themselves, FINRA contemplates creating a gantlet of roadblocks. For example, FINRA proposes requiring an "[e]nhanced account approval process[] before an account may trade in complex products," "[r]equirements that a customer complete training or a learning course before approval to trade in certain complex products," "[r]equired customer attestations regarding knowledge and experience," and – if all that were not enough to dissuade an investor – an outright ban on access to complex products for investors who are not "high-net worth."[138]

This paternalistic approach, which presumes that investors need to be protected from themselves at every turn, is the precise opposite of the disclosure-based regime on which the federal securities laws are based and which the SEC has long embraced. And, as discussed above, that upheaval of prior policy would unsettle the expectations of investors who structured their retirement plans around the availability of products labeled complex, broker-dealers who established their businesses presuming a low cost to sell such products, and issuers that created complex products presuming that with appropriate disclosure, they could be made widely available. The SEC would be required to explain why a system that has worked for investors for almost 90 years has suddenly become inadequate.

2. *The SEC also would need to explain its reversal from its previous conclusions that complex products are consistent with the Exchange Act, in the public interest, and consistent with the protection of investors.*

If the SEC were to adopt FINRA's proposed restrictions, it would likewise need to explain its reversal from its prior positions that the trading of products labeled complex is consistent with the public interest and the securities laws. The SEC has repeatedly found, under section 6(c) of the Investment Company Act, that granting exemptions from the Act's requirements for ETFs, fund of funds, and funds that invest in derivatives "is *appropriate in the public interest and consistent with the protection of investors* and the purposes fairly intended by the policy and provisions of the Act (emphasis added)."[139] Likewise, "[a]fter careful review, the Commission" has found on numerous occasions "that [an] Exchange's proposal to list and trade [certain ETFs] is consistent with the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange."[140]

Despite these findings, FINRA's proposals would treat many products covered by the Commission orders described above as, in essence, fundamentally dangerous – inappropriate for any self-directed retail investor to trade without elaborately regulated gatekeeping and ongoing professional supervision. Before adopting any rule implementing those proposals, the SEC would be required to explain its departure from its previous determination that offering these products to the public

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138 Notice, 13.

139 *See, e.g.*, Exchange-Traded Funds, 84 Fed. Reg. 57162, 57165 (2019); Fund of Funds Arrangements, 85 Fed. Reg. 73924, 73931 (2020); Use of Derivatives by Registered Investment Companies and Business Development Companies, 85 Fed. Reg. 83162 (2020).

140 *See, e.g.*, Self-Regulatory Organizations, Exchange Act Release No. 86532, at 6 (2019); *accord, e.g.*, Self-Regulatory Organizations, Exchange Act Release No. 57884, at 13 (2008); Self-Regulatory Organizations, Exchange Act Release No. 55117, at 16 (2007); Self-Regulatory Organizations, Exchange Act Release No. 54040, at 22 (2006).

without such measures is in the public interest and consistent with the protection of investors.

3. *The SEC would need to explain why it reversed course from its 2020 decision not to adopt similar restrictions on leveraged and inverse funds.*

The SEC would also need to explain its departure from its decision less than two years ago not to adopt a proposed rule that would have imposed similar restrictions on retail investors' access to leveraged and inverse funds. In January 2020, the SEC published several proposed rules relating to the subject matter of FINRA's current proposals – retail investors' access to leveraged and inverse investment vehicles.[141] Those rules would have "require[d] broker-dealers and investment advisers to exercise due diligence on retail investors before approving retail investor accounts to invest in leveraged/inverse investment vehicles."[142] Among other things, the proposed rules would have prohibited firms from allowing retail investors to buy or sell leveraged or inverse investment vehicles unless the firm had established a "reasonable basis for believing that the retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles."[143] In other words, the SEC proposed a paternalistic gatekeeping regime wholly at odds with its traditional disclosure-based approach – just like the regime FINRA contemplates in the Notice.

The SEC's proposed rules provoked a firestorm of critical comments. Those comments included a 164-page submission from ProShares, which explained in detail why the proposed rules represented "a radical break with history," were "a solution in search of a problem," and would ultimately harm investors "by reducing choice, driving up costs, forcing investors into riskier alternatives, and ultimately undermining ordinary investors' confidence in the fairness of markets by sending the message that only the wealthy may access certain products."[144] Commentors included respected legal organizations and others questioning the SEC's legal authority to adopt the proposed rules and criticizing the proposed rules on substantive grounds.[145]

The SEC was responsive to those criticisms. It acknowledged that "[m]ost commenters categorically opposed the adoption of the proposed sales practices rules" for a host of reasons, including that the proposed rules would "restrict investor choice," impose additional "operational burden and expense," would not advance the SEC's investor-protection goals, and would exceed the SEC's statutory authority.[146] In light of those concerns, the SEC "determined not to adopt the proposed sales practices rules."[147]

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[141] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, 85 Fed. Reg. 4446 (2020).

[142] *Id.* at 4493.

[143] *Id.* at 4494.

[144] Comment of ProShare Advisors LLC 1, File No. S7-24-15 (2020).

[145] Comment of the American Bar Association. File No. S7-24-15 (2020). Comment of the New York City Bar. File No. S7-24-15 (2020). Comment of the Managed Funds Association. File No. S7-24-15 (2020).

[146] Use of Derivatives by Registered Investment Companies and Business Development Companies, 85 Fed. Reg. 83162, 83215 (2020).

[147] *Id.* at 83216.

FINRA's proposed requirements would resurrect the worst aspects of the SEC's defunct proposals – such as the retail investor approval requirement – and would expand them to a significantly broader group of products. If the SEC were to approve FINRA's proposals, it would need to explain why it has suddenly changed its mind and reversed course less than two years after carefully considering and rejecting proposed rule changes contemplating many of the same requirements.

4. *The SEC would be required to give adequate consideration to reasonable and less restrictive alternatives.*

Moreover, the SEC would be required to evaluate all "significant and viable alternatives" to FINRA's proposed requirements.[148] The Notice fails to take that step – overlooking several possible alternative approaches that would protect investor interests while remaining consistent with the SEC's longstanding disclosure-based approach. For example, the SEC would be required to consider the alternatives noted below.

First, the SEC would be required to consider whether FINRA can achieve its investor-protective goals through its existing enforcement powers. The Notice offers several examples of FINRA sanctioning members for engaging in recommendations and sales that were not in the best interest of the customer. For instance, FINRA explains that in 2021 it sanctioned "a broker who recommended concentrated investments in high-risk business development companies to customers (including customers over the age of 60), resulting in more than $1 million in losses."[149] FINRA also relates that it sanctioned members for failing to supervise its brokers' recommendations of complex products, including leveraged and inverse products.[150] As these examples demonstrate, FINRA already has sufficient tools at its disposal to protect investors from inappropriate recommendations of complex products. The SEC would be required to evaluate whether stricter enforcement of FINRA's existing rules would be sufficient to protect investors' legitimate interests.

Second, the SEC also would be required to consider the alternative of waiting until the effects of other rules addressing the relationship between broker-dealers and investors – in particular, Regulation Best Interest ("Reg BI") and Consolidated Audit Trail – can be fully assessed. The SEC issued Reg BI in 2019 – "after years of deliberation."[151] Reg BI requires "broker-dealers to make recommendations that are in the best interest of a customer, 'based on [the customer's] investment profile and the potential risks, rewards, and costs associated with the recommendation.'"[152] Because Reg BI directly addresses potential concerns over inappropriate

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148 *Shieldalloy Metallurgical Corp. v. Nuclear Reg. Comm'n,* 624 F.3d 489, 493 (D.C. Cir. 2010) (internal quotation marks omitted).

149 Notice, 5 (citing Kevin Marshall McCallum, AWC No. 2019062569501 (June 17, 2021)).

150 *Id.* (citing Calton & Associates, Inc., AWC No. 2018060466201 (May 17, 2021); Independent Financial Group, LLC, AWC No. 2018059223401 (Apr. 8, 2021); American Independent Securities Group, LLC, AWC No. 2018060267902 (March 292021)).

151 Commissioners Hester M. Peirce & Elad L. Roisman, Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices, pt. II.B (2019) ("Peirce and Roisman Statement"); *see* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318 (2019).

152 Peirce & Roisman Statement, pt. II.B (alteration in original) (quoting 84 Fed. Reg. at 33491).

broker-dealer recommendations (including recommendations relating to complex products), the SEC should allow sufficient time to analyze the effects of the regulation on investor behavior regarding complex products before adopting FINRA's proposals.

In 2012, the SEC adopted Rule 613, which required the creation of a Consolidated Audit Trail ("CAT") that would "allow[] regulators to efficiently and accurately track all activity in [National Market System] securities throughout the U.S. markets."[153] CAT has taken years to fully operationalize, and only in December 2021 were all FINRA members dealing in exchange-traded stocks required to report their transactions with CAT.[154] Now that it is fully functional, CAT "tracks orders throughout their life cycle and identifies the broker-dealers handling them, thus allowing regulators to efficiently track activity in [e]ligible [s]ecurities throughout the U.S. markets."[155] CAT promises to give FINRA and other regulators new tools for understanding patterns in investment decisions and tracking down broker-dealers engaged in misconduct. The SEC should wait to consider how the availability of these tools affects FINRA's concerns over complex products before approving FINRA's proposal.

Third, the SEC would need to consider whether enhanced disclosure-based rules would be adequate to address FINRA's concerns in this area, particularly in light of the existing disclosure reform measures the SEC is considering in other areas. For example, the SEC has recently proposed specialized disclosure requirements to enhance investor protections in initial public offerings and subsequent business combination transactions by special purpose acquisition companies.[156] Before approving FINRA's proposal, the SEC would need to evaluate whether similar enhanced disclosure requirements would be sufficient to address FINRA's concerns over retail investors' use of products labeled complex.

VI. The benefits of FINRA's proposal would not outweigh its costs.

If FINRA proposes the measures restricting investor access and choice contemplated in the Notice as rules for SEC approval, FINRA is required by Section 19(b)(1) to provide a "concise general statement of the basis and purpose" of any proposal. This provision was intended to "hold the self-regulatory organizations to the same standards of policy justifications that the [APA] imposes on the SEC."[157] The APA requires agencies to take cost into consideration when promulgating rules.[158] Moreover, rigorous cost-benefit analysis is required both under the Exchange Act and FINRA's longstanding policy. Therefore, FINRA must conduct an appropriate cost-benefit

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153 Consolidated Audit Trail, 77 Fed. Reg. 45722, 45723 (2012).

154 Regulatory Notice 19-19: Consolidated Audit Trail. FINRA (2019).

155 Consolidated Audit Trail National Market System Plan, CAT (*n.d.*).

156 *See* Special Purpose Acquisition Companies, Shell Companies, and Projections, Release Nos. 33-11048, 34-94546, IC-34549 (2022).

157 S. Rep. 93-865, at 26; *see also Fiero v. FINRA*, 660 F.3d 569, 578 n.11 (2d Cir. 2011) (quoting same).

158 *See, e.g.*, *Michigan v. EPA*, 576 U.S. 743, 752–53 (2015) ("Agencies have long treated cost as a centrally relevant factor when deciding whether to regulate. Consideration of cost reflects the understanding that reasonable regulation ordinarily requires paying attention to the advantages and the disadvantages of agency decisions."); *see also id.* 769 (Kagan, J., dissenting) ("Cost is almost always a relevant—and usually, a highly important—factor in regulation."); *Mingo Logan Coal Co. v. EPA*, 829 F.3d 710, 733 (D.C. Cir. 2016) (Kavanaugh, J., dissenting).

analysis before proposing any rule to the SEC.

A. *When proposing a rule change, FINRA must perform a rigorous cost-benefit analysis that is supported by economic data.*

Recognizing that "a careful understanding of how [its] rulemaking impacts markets and market participants" is "[k]ey" to its work, FINRA has expressly committed itself to conducting rigorous economic impact assessments of its proposed rules.[159] By its own account, FINRA has long considered "the costs and burdens of its rulemaking."[160] And in 2013, FINRA "committed to enhancing its economic impact assessments of rules going forward" under specific guidelines.[161]

In outlining this framework for conducting economic impact assessments, FINRA explained that "strong economic impact analysis provides a number of benefits."[162] With respect to regulators, economic impact analysis "helps ensure that rules are well explained; well designed to provide a regulatory solution that is appropriately flexible, targeted and effective; and well considered, including their potential direct and indirect costs."[163] And with regard to the public, economic impact analysis "makes clear the regulatory intent of a rule proposal, describes the anticipated effects of the options considered, and provides the rationale and evidence that support the action" – in addition to allowing commenters "to provide more directed and impactful comments."[164]

Toward these ends, FINRA established clear guidelines for its conduct of economic impact assessments. FINRA emphasized the importance of transparency to the process: "Rule filings should provide insight into [FINRA's] evaluation of the economic impacts to help the public understand why FINRA reached its position."[165] And, because "the public interest is best served by rulemaking when it is evidence-based where practicable," FINRA pledged to "seek to obtain reliable and pertinent information to develop its rules."[166] FINRA further explained its expectation that "in significant future rule proposals we will address, as appropriate," questions including:

- What is the baseline against which to measure the likely economic consequences of the proposed regulatory action?
- What are the reasonable alternative options available?
- What are the anticipated economic impacts associated with the options, including the costs and benefits and distributional impacts, in particular as to efficiency, competition and

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159 Framework Regarding FINRA's Approach to Economic Impact Assessment for Proposed Rulemaking 1, FINRA (2013).

160 *Id.* at 3.

161 *Id.*

162 *Id.*

163 *Id.*

164 *Id.*

165 *Id.* at 5.

166 *Id.*

capital formation?[167]

"In future rulemakings," FINRA elaborated, "the development of this analysis will be part of our presentations to and discussions with committees and our Board, as part of the governance process."[168] Moreover, FINRA made clear that "[t]he analysis will be evaluated by our Chief Economist and reflected in the rule filings we submit to the SEC."[169]

Thus, FINRA is required to conduct a rigorous economic impact assessment, "including the costs and benefits and distributional impacts," before submitting any proposed rule concerning the regulation of complex products to the SEC.[170]

B. ***The SEC also must perform a cost-benefit analysis when approving a FINRA rule.***

The SEC is also obligated to take economic considerations into account when reviewing FINRA's proposals. Under the Exchange Act, whenever the SEC reviews a FINRA rule "and is required to consider or determine whether an action is necessary or appropriate in the public interest," the SEC "shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[171]

The SEC has a "statutory obligation to determine as best it can the economic implications of [its] rule[s]."[172] Indeed, the SEC "has a unique obligation to consider the effect of a new rule upon efficiency, competition, and capital formation, and its failure to apprise itself – and hence the public and Congress – of the economic consequences of a proposed regulation makes promulgation of the rule arbitrary and capricious and not in accordance with law."[173] As part of this obligation, the SEC must accurately "frame[] the costs and benefits of the rule," adequately "quantify the certain costs," "support its predictive judgments," and "respond to substantial problems raised by commenters."[174]

The SEC has recognized that this obligation applies when it considers whether proposed FINRA rules are consistent with the requirements of the Exchange Act under Section 19(b)(2)(C).[175]

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167 *Id.* at 6.

168 *Id.*

169 *Id.* In addition to these self-imposed constraints, SEC Form 19b-4 requires each FINRA rule filing to include a statement regarding the burden on competition to assist the SEC in its consideration of rule proposals. *See Id.* at 3.

170 *Id.* at 6.

171 Exchange Act § 3(f).

172 *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).

173 *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (internal quotation marks omitted); *see Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 167–68 (D.C. Cir. 2010) (vacating SEC rule for failing to comply with analogous requirement of Securities Act); *see also Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004) (rule is arbitrary and capricious if agency fails to consider factors it "must consider under its organic statute").

174 *Bus. Roundtable*, 647 F.3d at 1148–49.

175 *See* Order Disapproving Proposed Rule Change To Amend FINRA Rule 6140, 76 Fed. Reg. 9062, 9063 n.16 ("In disapproving the proposed rule change, the Commission has considered the proposed rule's impact on efficiency,

Consequently, if FINRA were to submit its proposals to the SEC, the SEC would be required to conduct a rigorous economic assessment of the proposals in order to determine their effect on efficiency, competition, and capital formation.

C. ***FINRA's measures ignore significant costs and disregard investor interests.***

To comply with its own internal guidelines for rulemaking, and to facilitate the SEC's required economic analysis of its ultimate proposal, FINRA must undertake a rigorous economic assessment of the costs and benefits of its proposals before proceeding. But the Notice fails to address even the most basic economic aspects of the measures FINRA is contemplating.

1. *FINRA must quantify the costs to investors of losing access to products that FINRA concludes are too complex.*

The Notice raises the possibility of introducing several gatekeeping mechanisms for complex products, such as requiring retail customers to complete "knowledge check[s]" or "learning course[s] and additional assessment[s]" before being "approved to transact in complex products."[176] These restrictions, if adopted, would inevitably cause some retail investors to lose access to complex products, both because investors would avoid these burdensome box-checking requirements and because broker-dealers would avoid dealing in products labeled complex rather than implement these procedures and risk enforcement actions.

Losing access to these complex products would inflict serious costs on investors. Complex products are legitimate investment tools with numerous beneficial uses. By restricting investors' ability to use complex products, FINRA's proposals could drive investors to pursue riskier, more costly strategies to achieve their investment goals, such as trading on margin or short selling stock. While FINRA properly recognizes that "many complex products serve a role in our financial markets,"[177] its proposal makes no attempt to quantify the value of these products as part of an overall investment strategy or the cost to investors of losing access to these products – much less the potentially vast economic effects of imposing an entirely new regulatory regime on such a substantial portion of the market.

2. *FINRA must quantify the costs to broker-dealers of complying with the proposals.*

If the measures outlined in the Notice were adopted, they would impose an onerous new testing and compliance regime on broker-dealers who wish to make available products that *might* be deemed complex. For example, broker-dealers would be required "to make a reasonable assessment of whether a product is 'complex' before allowing a retail customer to transact in the product."[178] Broker-dealers would also be required to "implement an account approval process before the retail customer's account may transact in any product that the firm has reasonably assessed to be complex."[179] And broker-dealers would have further obligations, including

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competition, and capital formation. *See* 15 U.S.C. [§] 78c(f).").

176 Notice, 14.

177 Notice, 4.

178 Notice, 14.

179 *Id.*

requiring "[r]etail customers to demonstrate their understanding of th[e] common characteristics and risks of complex products by completing a knowledge check," and, if necessary, completing "a learning course and additional assessment."[180] The list goes on: broker-dealers would be required to obtain "[p]rincipal approval for a retail customer account to transact in complex products," and "periodically reassess the retail customer's account to ensure that the initial account approval remains appropriate."[181]

This battery of gatekeeping requirements would require broker-dealers to reconfigure their trading platforms in complex and substantial ways. For instance, to implement such measures all broker-dealers likely would be required to develop FINRA-approved knowledge checks and remedial learning courses. Allowing the purchase of these products by self-directed investors would subject firms to indeterminate regulatory risks, particularly as there is no definition of what products FINRA might assert are "complex" or how to measure investor understanding.

At best, broker-dealers who decide that it is worth the trouble to continue trading complex products would incur substantial up-front and ongoing costs to accommodate these requirements. FINRA must quantify and account for these costs before submitting any proposal to the SEC.

3. *FINRA must quantify the costs to investors of being forced to engage investment advisers.*

More realistically, substantial numbers of broker-dealers will simply choose to abandon trading products potentially deemed "complex" rather than develop an expensive and cumbersome system for a particular family of securities. As a result, retail investors who want to continue to purchase complex products as part of their overall investment strategy would need to engage investment advisers to obtain access to these products. Doing so could represent a significant cost to middle- and working-class retail investors. Investment advisers typically charge asset-based fees.[182] Those fees can be substantial. For example, a recent study determined that the average advisory fee for all clients is .98% of assets under management, and for clients with less than $100,000 in assets, the average fee rises to 1.24%.[183] That cost would push some investors out of the market for products that are potentially "complex" entirely. And even for those investors who could afford the cost of engaging an investment adviser, the additional fees would impose a significant new expense, with attendant effects on those investors' long-term investment returns. FINRA must account for these costs in its economic analysis as well.

4. *FINRA must quantify the costs of chilling product innovation, protecting entrenched incumbents, and discouraging competition.*

FINRA's proposal also threatens to impose serious widespread costs on innovation and competition. As previously discussed in Section IV.A.4, FINRA's proposal offers an exceedingly vague description of "complex products" that could potentially encompass many different types of financial instruments. If FINRA ultimately adopts this vague definition and, at the same time,

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180 *Id.*

181 *Id.*

182 *See* The Price of Advice: Modernizing Fees to Remain Competitive, Cerulli Associates (2021).

183 *See id.* at 16.

imposes onerous restrictions on the trading of "complex products," it will have a chilling effect on the innovation of all kinds of financial instruments that FINRA might interpret as complex. By stifling innovation with an unpredictable and restrictive regulatory regime, FINRA will further protect entrenched market incumbents from potential disruption, which will discourage competition across the financial markets. FINRA must take these market-wide economic effects into account before proposing any rule to the SEC.

5. *FINRA must quantify the costs to society of embracing a discriminatory market access rule.*

FINRA's proposal suggests the possibility of restricting or limiting "retail customer access to complex products (*e.g.*, limiting access to high-net worth or other categories of customers)."[184] If FINRA were to adopt wealth-based restrictions on access to complex products, it would send an undeniable message that complex products are a tool for the elite, not Main Street. Similarly, biased and subjective testing and other qualification requirements may result in discriminatory treatment of investors, including investors from traditionally underserved communities. By telegraphing the message that markets are only for certain types of investors or that certain investors have an unfair edge, FINRA could lead disadvantaged investors to recede from the market, with harmful consequences for investors, markets, and overall capital formation. As the SEC has explained in the context of selective disclosures, "[b]y enhancing investor confidence in the markets" through creating a level playing field, "[the SEC can] encourage continued widespread investor participation in our markets, enhancing market efficiency and liquidity, and more effective capital raising."[185] By the same token, establishing a discriminatory market access rule promises to have the exact opposite effect – alienating middle- and working-class investors and driving them from participating in what they view as a rigged game. FINRA's economic assessment must take into account the likely market-wide effects of embracing these novel discriminatory rules.

6. *FINRA must quantify the potential reduction in demand for products deemed "complex" and the resultant impact on such products.*

Another likely effect of FINRA's proposal is to reduce demand for complex products. Retail investors will be less likely to buy those products because, among other reasons, (1) they are barred by discriminatory restrictions, (2) they are put off by FINRA's burdensome and potentially biased requirements, (3) they are deterred from investing by the "complex" label, (4) broker-dealers cease to offer those products, or (5) it is cost prohibitive to engage an investment adviser. The result of the above is likely to be reduced demand for securities labeled as complex products. FINRA would need to quantify the impact of reduced demand on products and investors. This could include, for example, lower trading volumes, less liquidity, wider bid/ask spreads, higher transaction costs for investors, and higher fund fees as a result of lower economies of scale. FINRA must consider these impacts and costs on investors as part of its overall assessment of the economic impact of its proposals.

As the foregoing discussion shows, FINRA lacks authority to propose the harmful, unprecedented,

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[184] Notice, 13.

[185] Selective Disclosure and Insider Trading. 65 Fed. Reg. 51716, 51731 (2000).

and unnecessary measures contemplated in the Notice, and the costs of those measures would far outweigh any purported benefits. Section 19(b)(1) of the Exchange Act requires FINRA to provide a "concise general statement of the basis and purpose" of any proposal – a requirement that mirrors an analogous provision of the APA requiring agencies to promulgate a "concise general statement of [their rules'] basis and purpose."[186] In enacting this requirement, Congress sought to "hold the self-regulatory organizations to the same standards of policy justifications that the [APA] imposes on the SEC."[187] That means, among other things, that FINRA must address all significant comments on its proposed rule, including the significant legal limitations and substantial costs discussed above.[188]

VII. Reg BI fully protects investors with respect to recommendations of complex products; FINRA's measures with respect to recommendations of complex products are unnecessary.

Reg BI applies to transactions in complex products where a broker makes a recommendation to a customer.[189] When making recommendations, brokers must not only understand all relevant risks and features themselves, but also must have a reasonable basis to believe that the recommendation is in the best interest of the particular customer based on that customer's investment profile and the potential risks, rewards, and costs associated with the recommendation.

When investors engage a broker to make recommendations they are paying for their broker's expertise. Reg BI "appropriately recognizes that customers may rely on a broker-dealer's "investment expertise and knowledge."[190] Investors should not be required to demonstrate product-specific expertise themselves – such as by passing an exam or taking a course – to be able to follow their broker's recommendations. These and similar measures place arbitrary and unnecessary constraints on the traditional broker-client relationship.

Reg BI provides sufficient protections to retail investors with respect to recommendations of complex products. Additional FINRA rules with respect to such recommendations are not necessary.

VIII. Conclusion.

We respectfully submit that FINRA should not proceed along the path set forth in the Notice. As we have shown herein, FINRA's contemplated measures are an unprecedented, unauthorized, unwarranted, and ultimately harmful intervention in the public securities markets. FINRA should

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186 5 U.S.C. § 553(c).

187 S. Rep. 93-865, at 26; *see also Fiero* 660 F.3d at 578 n.11 (quoting same).

188 Under the APA's analogous requirement in 5 U.S.C. § 553(c), it is well settled that agencies must "address significant comments" to their proposed rules. *Cigar Ass'n of Am. v. FDA*, 964 F.3d 56, 64 (D.C. Cir. 2020). Satisfying this requirement means that agencies "with reasonable fullness" must "explain the actual basis and objectives of the rule," *Nat'l Wildlife Fed'n v. Costle*, 629 F.2d 118, 134 (D.C. Cir. 1980) (quoting S. Rep. No. 752, 79th Cong., 1st Sess. 15 (1945)), and satisfactorily explain how they have resolved any legal or procedural objections. These same requirements apply to FINRA under Section 19(b)(1) of the Exchange Act.

189 Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318 (2019).

190 *Id.* at 33339.

not start down the perilous path of denying investors access to publicly traded financial products based on its own view of investor understanding and product complexity. The measures being considered by FINRA have the potential to harm investors and are contrary to the statutorily mandated interests of investor protection, capital formation, and promotion of competition.

ProShares appreciates the opportunity to comment on the Notice. If you have any questions or would like additional information, please contact me at (240) 497-6400.

Respectfully yours,

Richard F. Morris

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General Counsel

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FINRA Complex Products

The Notice describes "complex products" as any product with "features that may make it difficult for a retail investor to understand the essential characteristics of the product and its risks."

Products that FINRA has identified as "complex" or difficult for investors to understand.

- Interval funds[1]
- Closed-end funds[2]
- Global real estate funds[3]
- Opportunistic, tactical, multi-strategy funds[4]
- Funds using derivatives for hedging or leverage[5]
- Funds using cryptocurrency futures[6]
- Defined outcome funds[7]
- Geared funds[8]
- Commodity funds[9]
- Exchange-traded notes[10]
- Principal protected notes[11]
- Market-linked CDs[12]
- Structured notes[13]
- Variable annuities[14]
- Asset-backed securities[15]
- Target date funds[16]
- High yield bond funds[17]
- Nontraditional index funds: Smart beta; Quant; Custom index; ESG[18]
- Investment trusts investing in cryptocurrency[19]
- Currency funds[20]
- Leveraged loan funds[21]
- Funds selling short[22]
- Start-up company (IPO) funds[23]
- Funds investing in unlisted securities[24]
- Floating-rate loan funds[25]
- Distressed debt funds[26]
- Absolute return funds[27]
- Funds of hedge funds[28]
- Volatility-linked funds[29]
- Non-traded REITs[30]
- Business development companies[31]
- Reverse convertible notes[32]
- Range accrual notes[33]
- Emerging market funds[34]
- Unconstrained bond funds[35]
- Insurance-linked securities[36]

[1]FINRA Regulatory Notice 22-08: *Complex Products and Options* 4 (March 9, 2022) ("Complex Product Notice").

[2]FINRA Investor Alert: *Closed-End Fund Distributions: Where is the Money Coming From?* (October 28, 2013).

[3]Complex Product Notice, supra note 40 (citing FINRA Investor Alert: *Alternative Funds Are Not Your Typical Mutual Funds* (June 11, 2013) ("Alternative Funds Alert")).

[4]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[5]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[6]Complex Product Notice, at 4.

[7]Complex Product Notice, at 3.

[8]Complex Product Notice, at 3,7.

[9]Complex Product Notice, at 7.

[10]Complex Products Notice, supra note 10 and 40 (citing FINRA Investor Alert: *Exchange Traded Notes – Avoid Unpleasant Surprises* (July 10, 2012)).

[11]Complex Products Notice, supra note 40 (citing FINRA Investor Alert: *Structured Notes with Principal Protection* (June 2, 2011). See also FINRA Regulatory Notice 12-03: *Complex Products, Heightened Supervision of Complex Products* ("12-03 Notice").

[12]FINRA Virtual Event: *Introduction to Complex Products*, 20 (January 2021) ("FINRA Complex Products Training").

[13]Complex Product Notice, supra note 10. See also 12-03 Notice.

[14]FINRA Complex Products Training, at 20.

[15]12-03 Notice.

[16]FINRA Learn to Invest: *Target-Date Funds—Find the Right Target for You*.

[17]FINRA News Release: *FINRA Warns Investors About Chasing Returns in Structured Products, High-Yield Bonds and Floating-Rate Loan Funds* (July 25, 2011) ("Chasing Returns Release").

[18]FINRA Investor Insights: *Custom-Built Index Funds—Are You the Right Customer?* (August 23, 2018). See also SEC Investor Bulletin: *Smart Beta, Quant Funds and other Non-Traditional Index Funds* (August 6, 2018); FINRA Investor Alert: *Smart Beta—What You Need to Know* (September 23, 2015).

[19]Complex Product Notice, supra note 6.

[20]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[21]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[22]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[23]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[24]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[25]Chasing Returns Release.

[26]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[27]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[28]Complex Product Notice, supra note 40 (citing Alternative Funds Alert).

[29]Complex Product Notice, at 7.

[30]Complex Product Notice, at 3.

[31]Complex Product Notice, at 5.

[32]Complex Product Notice, supra note 40 (citing FINRA Investor Alert: *Reverse Convertibles: Complex Investment Vehicles* (July 29, 2011). See also 12-03 Notice.

[33]12-03 Notice.

[34]FINRA: *Regulatory and Examination Priorities Letter* 6 (January 5, 2016).

[35]Axelrod, Susan F., *Remarks from the SIFMA Complex Products Forum* (October 29, 2014).

[36]FINRA Investor Insights: *Insurance-Linked Securities* (July 2021).