

# Legal Update

## FINRA Releases Notice on Complex Products and Options

### Evolving Retail Customer Access to These Products Raises Heightened Regulatory and Investor Protection Concerns

On March 8, 2022, the Financial Industry Regulatory Authority, Inc. ("FINRA") issued [Regulatory Notice 22-08](#) (Complex Products and Options) (the "Notice"). The Notice is FINRA's most significant statement on sales of complex products since 2012.

FINRA notes that the number of accounts trading in complex products and options has increased significantly in recent years and that important regulatory concerns arise when investors trade such products without understanding their unique characteristics and risks. Further, these concerns may be heightened when retail customers access these products through self-directed platforms without the assistance of a financial professional. In light of these concerns, FINRA cautions that trading in complex products and options requires member firm scrutiny and supervision.

The Notice (i) reminds member firms of their regulatory obligations with respect to these products, including the application of Regulation Best Interest ("Reg BI") when recommending securities or investment strategies involving securities to retail customers, and (ii) solicits comment on effective practices and potential enhancements to FINRA rules to address concerns raised by these products. FINRA intends to coordinate its response to this request for comment with the U.S. Securities and Exchange Commission's ("SEC") development of its regulatory approach.<sup>1</sup>

## Background

### COMPLEX PRODUCTS

FINRA continues to construe the term "complex product" flexibly to avoid a static definition that may not address the evolution of financial products and technology. In general, FINRA has described a complex product as a product with features that may make it difficult for a retail investor to understand the essential characteristics of the product and its risks (including the payout structure and how the product may perform in different market and economic conditions).<sup>2</sup> In addition to the types of structured retail products cited in Regulatory Notice 12-03 as "complex," the Notice identifies certain products that have emerged since, which may be considered "complex," including:

- Defined outcome exchange-traded funds ("ETFs") that offer structured retail product-type features, such as an underlying reference asset with downside protection and a cap;

- Mutual funds and ETFs that offer strategies employing cryptocurrency futures, and track futures contracts rather than the underlying cryptocurrency (but also noting that such products' exposure to cryptocurrency could be considered complex); and
- Interval funds, or tender-offer funds, which provide limited liquidity.

Although FINRA acknowledges that complex products serve a role in the financial markets, FINRA is concerned about investor confusion. For example, retail investors may not understand their features or payout structures, or may not understand how complex products perform in different market or economic conditions. Moreover, it may not be clear to investors that some complex products, such as exchange-traded products ("ETPs") registered under the Investment Company Act of 1940, have "built-in" statutory protections, while other complex products may not. Importantly, FINRA states that these concerns may be heightened when a retail customer is accessing these products through a self-directed platform, without the assistance of a financial professional who may be able to explain the key product features and risks.

## OPTIONS

FINRA states that buying and selling options similarly requires an understanding of the related terminology, strategies and risks. Again, these concerns may be heightened when retail investors make self-directed decisions. Moreover, because options and options strategies are routinely being developed, some risks are not apparent until there has been significant experience with them. In light of these concerns, member firms should consider whether investors understand the various risks of trading options before making such products available.

## Regulatory Efforts to Address Complex Products and Options

### PRODUCT-SPECIFIC FINRA RULES

FINRA discusses its comprehensive framework of rules to address complex products and options, including Rule 2360 (Options) and Rule 2220 (Options Communications). FINRA reminds member firms to review their obligations under these rules, as well as under Reg BI, and to determine whether their policies and procedures continue to reflect the investor protection goals that these rules seek to achieve.

### FINRA GUIDANCE

FINRA also reminds member firms of its prior guidance relating to the risks complex products and options pose, including Regulatory Notice 12-03, which advises member firms to apply heightened supervision for complex products, and [Regulatory Notice 21-15](#) (Options Account Approval, Supervision and Margin) (April 2021), outlining the important steps a member firm must undertake in connection with approving an investor to trade options. In addition, FINRA points to its prior product-specific notices, including notices with respect to structured products,<sup>3</sup> leveraged and inverse ETPs,<sup>4</sup> principal protected notes,<sup>5</sup> commodity futures-linked ETPs,<sup>6</sup> reverse convertibles,<sup>7</sup> volatility-linked ETPs<sup>8</sup> and oil-linked ETPs.<sup>9</sup>

### FINRA EXAMINATIONS AND ENFORCEMENT

FINRA states that its examination program employs a risk-based, dynamic approach to identify potential problematic activity involving complex products and options.<sup>10</sup> FINRA examinations may include assessments of the adequacy of related written supervisory procedures, the role of new or complex product committees, use of enhanced supervisory and compliance tools, including exception or activity reports, and any relevant training conducted by the member firm for registered representatives and

supervisors. In addition, FINRA cites recent enforcement actions involving complex products and options, including with respect to unsuitable recommendations and deficient risk disclosures.

Moreover, FINRA is in the process of conducting targeted examinations to review member firms' practices and controls related to opening options accounts and related areas, including account supervision, communications and diligence.<sup>11</sup> FINRA states that although this work is ongoing, it has identified the following themes:

- **Account Opening.** Initial observations indicate potential gaps in identification of red flags in customer representations of trading experience, where members' policies require minimum levels of experience for advanced level option accounts.
- **Disclosure Practices.** There is a wide range of practices by member firms in the provision of educational materials specific to risks surrounding complex options transactions and the mechanics of options expiration.
- **Options Exercise Procedures.** FINRA staff has noted varying practices concerning cut-off times for customers to submit options exercise instructions, including that member firms have set various early cut-off times and the communication of such cut-off times is not clear or consistently applied.

## SEC EFFORTS ON COMPLEX PRODUCTS

In October 2021, SEC Chair Gary Gensler directed the SEC Staff to study the risks of complex ETPs and to present recommendations for potential rulemaking to address those risks.<sup>12</sup> In adopting Reg BI, the SEC emphasized the importance of understanding the terms, features and risks of complex products, such as inverse and leveraged ETPs, in order to establish a reasonable basis to recommend these products to retail customers.<sup>13</sup> Additionally, in an October 2020 joint statement, then-SEC Chair Jay Clayton and the SEC Staff noted their concern that retail investors are independently selecting complex products for which they may not fully appreciate the unique characteristics and risks.<sup>14</sup>

## REGULATORY EFFORTS IN NON-U.S. JURISDICTIONS

Significantly, FINRA discusses the regulatory approaches to complex products in the European Union ("EU"), Canada and Hong Kong, and highlights product governance obligations instituted by financial regulators in the EU, Australia and the United Kingdom. FINRA notes that these regulators can, through their respective product intervention rules, prohibit or impose restrictions on the marketing, distribution or sale of certain financial products where a significant retail investor protection concern is determined to exist.

## Request for Comment

The Notice includes an extensive list of questions, soliciting comment on effective practices for managing the risks associated with complex products and options, particularly those accessible to self-directed retail investors, and whether the current regulatory framework is appropriately tailored to address those risks. The questions provide helpful indications of FINRA's regulatory focus and, therefore, warrant a close review by member firms. The questions are wide-ranging, including looking to non-U.S. jurisdictions for potential guidance and considering applying comparable standards to other investment intermediaries, such as registered investment advisers and insurance agents. The questions can be accessed [here](#). Comments must be received by FINRA by May 9, 2022.

## Conclusion

The Notice signals an increasing regulatory focus on complex products and options, including in connection with FINRA's examination and risk monitoring program. Member firms should use the Notice as an opportunity to review (and potentially enhance) their policies and procedures relating to these products. The Notice also is significant in that, in response to comments received, there is a potential for FINRA rulemaking directly affecting member firms' businesses relating to complex products and options.

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## ENDNOTES

<sup>1</sup> See SEC Chair Gary Gensler, [Statement on Complex Exchange-Traded Products](#) (Oct. 4, 2021) ("Gensler Statement on Complex ETPs").

<sup>2</sup> See FINRA [Regulatory Notice 12-03](#) (Heightened Supervision of Complex Products) (January 2012).

<sup>3</sup> See National Association of Securities Dealers [Notice to Members 05-59](#) (Structured Products) (September 2005).

<sup>4</sup> See [Regulatory Notice 09-31](#) (Non-Traditional ETFs) (June 2009).

<sup>5</sup> See [Regulatory Notice 09-73](#) (Principal-Protected Notes) (December 2009).

<sup>6</sup> See [Regulatory Notice 10-51](#) (Commodity Futures-Linked Securities) (October 2010).

<sup>7</sup> See [Regulatory Notice 10-09](#) (Reverse Convertibles) (February 2010).

<sup>8</sup> See [Regulatory Notice 17-32](#) (Volatility-Linked Exchange-Traded Products) (October 2017).

<sup>9</sup> See [Regulatory Notice 20-14](#) (Oil-Linked Exchange-Traded Products) (May 2020).

<sup>10</sup> As stated in the [2022 Report on FINRA's Examination and Risk Monitoring Program](#) (February 2022), FINRA regularly focuses on member firms' practices surrounding complex products and options. Please see our [Legal Update](#) for additional details regarding FINRA's report.

<sup>11</sup> See [FINRA Targeted Examination Letter on Option Account Opening, Supervision and Related Areas](#) (August 2021).

<sup>1</sup> See Gensler Statement on Complex ETPs, *supra* note 1. See also, SEC Asset Management Advisory Committee, [Preliminary Recommendations of ETP Panel Regarding COVID-19 Volatility: Exchange-Traded Products](#) (Sept. 16, 2020).

<sup>12</sup> See Regulation Best Interest, Securities Exchange Act Release No. 86031 (Jun. 5, 2019), 84 FR 33318 (Jul. 12, 2019).

<sup>13</sup> See SEC, [Joint Statement Regarding Complex Financial Products and Retail Investors](#) (Oct. 28, 2020).

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