

Public Statement

Joint Statement Regarding Complex Financial Products and Retail Investors

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Oct. 28, 2020

Retail investors have a wide array of investment options available to them, including an increasing number and type of investment products that are more complex than conventional stock and bond investments.^[1] These complex products may be exchange-traded or sold directly to investors. Among these products are “leveraged/inverse” products, which seek to provide leveraged or inverse exposure to an underlying index by a specified multiple (e.g., 2x), generally on a daily basis, as well as products that provide investment exposure to less conventional assets, including commodity prices. We believe that these leveraged/inverse products and other complex products may present investor protection issues—particularly for retail investors who may not fully appreciate the particular characteristics or risks of such investments, including the risks that holding such products may pose to their investment goals.^[2]

Below, we discuss these issues in more detail, including (1) an overview of structural differences that may impact regulatory protections, (2) the potential impact of volatility and market stress, (3) the increase in self-directed trading, and (4) the application to these products of disclosure requirements, Regulation Best Interest and the investment adviser’s fiduciary duty. This Statement ends with a request for engagement.

1. Regulatory Requirements May Differ Based on Product Structure

Complex products currently are governed by different regulatory requirements under the federal securities laws, depending in large part on their structure. For example, complex products may be registered investment companies, such as certain exchange-traded funds or “ETFs,” that are subject to the Investment Company Act and rules thereunder, including the rule the Commission adopted in 2019 to modernize the regulatory framework for ETFs.^[3] These requirements include certain fund-based requirements designed to promote retail investor protection, including limitations on a fund’s ability to incur leverage, requirements for boards of directors and chief compliance officers and prohibitions on affiliated transactions. Other complex products, including exchange-traded notes (“ETNs”), commodity pools, and structured notes, are subject to different regulatory requirements because they are not subject to the Investment Company Act. Those other regulatory requirements provide for robust disclosure, but they do not include certain of the specific, fund-based protections that are available under the Investment Company Act. While these differences are long-standing, retail investors (and financial professionals who serve retail investors) may not appreciate that the approach to investor protection differs depending on product structure.^[4]

2. Operation of Complex Products and the Potential Impact of Volatility and Market Stress on Complex Products

We also are concerned that retail investors, and in certain cases financial professionals, may not fully appreciate how these types of products operate (e.g., how the issuer uses certain financial instruments to provide investors with the requisite investment exposure) as well as the unique risks presented by these products. These investor protection concerns are heightened, moreover, in times of market stress, which typically have a disproportionate impact on complex products, such as leveraged/inverse products and other products that use certain financial instruments that may not perform as expected in such times. For example, during the period of increased market volatility related to the COVID-19 pandemic in the spring of 2020, investors in certain leveraged products experienced significant losses.^[5] In this regard, the Commission's Office of Investor Education and Advocacy has received complaints from investors expressing concerns that, while certain leveraged/inverse products may have operated in accordance with their terms, the pricing and trading dynamics of these products during the spring market volatility was not consistent with investor expectations. During this time, several leveraged/inverse funds with 3x leverage or inverse multiples reduced their leverage multiples to 2x in response to the increased market volatility.^[6] This mismatch in product performance and investor expectations in the spring of 2020 was not limited to leveraged/inverse products. For example, in late April 2020 a large exchange-traded product ("ETP") investing in crude oil futures contracts lost 41% of its value in one week and experienced other challenges, including the inability to issue new shares.^[7]

3. The Increase in Self-Directed Trading by Retail Investors

Advances in technology have not only driven an increase in investment options for retail investors, they also have driven changes in the channels through which retail investors purchase and sell securities, including complex products. Where once it was nearly impossible for a retail investor to trade without the aid of a registered representative or investment adviser, technological advancements have increased investor access as well as investor choice. Now, retail investors have access to stocks, bonds and complex products from their desktops, tablets and phones.^[8] They also have choice with respect to the level of advice that they want to receive and how they want to pay for it.^[9] While these various developments have combined to provide retail investors with greater access to our financial markets and a variety of products, including complex products, at a lower cost, it should be recognized that self-directed retail investors are typically making investment decisions on their own accord via online trading platforms and without the assistance of a financial professional. In other words, these self-directed investors do not have the required protections that apply when they receive recommendations or advice from a broker or investment adviser, who must understand, and may explain if necessary, the characteristics and potential risks and rewards of the investment, and determine that it is in the best interest of the retail investor.

4. General Discussion of the Application of Disclosure Requirements, Regulation Best Interest and the Investment Adviser's Fiduciary Duty to Complex Products; Staff Review and Request for Engagement

As discussed above, there are various long-standing Commission rules and legal requirements – including the disclosure requirements and other protections mentioned above as well as the antifraud provisions of the federal securities laws – that operate to mitigate the investor protection concerns raised by leveraged/inverse products and other complex products. In addition, the best interest standard of conduct for broker-dealers under Regulation Best Interest and the fiduciary obligations of investment advisers, as described in the 2019 Fiduciary Interpretation, apply to transactions in complex products where the transaction is recommended to a retail customer by a broker-dealer or pursuant to the advice of an investment adviser.^[10] Under these standards, a broker-dealer or an investment adviser recommending or advising on such products must have a reasonable basis to believe that the recommendation or advice provided is in the best interest of the retail investor. A broker-dealer, moreover, cannot establish a reasonable basis to recommend complex products to

retail customers without understanding the terms, features and risks of these products.^[11] Complex products, such as leveraged/inverse products that are designed primarily as short-term trading tools for sophisticated investors, may not be in the best interest of a retail investor absent an identified, short-term, investor-specific trading objective.^[12] A similar analysis would apply in advisory relationships involving portfolio advice to retail investors.

That said, while Regulation Best Interest and an investment adviser's fiduciary duty apply to transactions in complex products, these obligations only apply where a broker-dealer is making a recommendation to a retail customer or an investment adviser is providing investment advice. As discussed above, Regulation Best Interest and an investment adviser's fiduciary duty do not apply where a retail investor invests on his or her own accord in complex products through a self-directed account.

We recognize this is a dynamic, expanding, and ever-changing marketplace, and that it is our responsibility to consider whether existing protections can be improved, including examining whether such protections, and our oversight and enforcement of those protections, are sufficient to address the investor protections concerns raised by the expanded retail investor access to self-directed accounts and complex investment products. Speaking more specifically, we are concerned that retail investors are independently selecting complex products for which they may not fully appreciate the unique characteristics and risks.

In light of these concerns, the staff in the Divisions of Investment Management, Corporation Finance, and Trading and Markets will review the effectiveness of the existing regulatory requirements in protecting investors—particularly those with self-directed accounts—who invest in leveraged/inverse products and other complex products. Based on this review, the staff will make recommendations to the Commission for potential new rulemakings, guidance, or other policy actions, if appropriate. As part of this review, the staff will consider whether the Commission's promulgation of any additional requirements for these products may be effective in helping to promote retail investor understanding and appreciation of these products' unique characteristics and risks. The staff may consider requirements that include, among other things, additional obligations for broker-dealers and investment advisers relating to complex products, as well as point-of-sale disclosures or policies and procedures tailored to the risks of complex products.

If you would like to let the staff know your views regarding these issues, we are providing an email box as a convenient method for you to communicate with the staff; we encourage you to communicate through the following address: complexproductsreview@sec.gov. We welcome the views of all market participants and members of the public. These submissions will be made publicly available, and persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. Please submit only information that you wish to make publicly available.

^[1] This Statement represents the views of Chairman Clayton and Directors Blass, Hinman, and Redfearn. It is not a rule, regulation, or statement of the Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its content. This Statement has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

^[2] We recognize that there are many retail investors who can and do understand the characteristics of these types of products and for whom these products may be an appropriate and attractive means to achieve their desired investment exposure.

^[3] Today the Commission is considering whether to adopt a new rule under the Investment Company Act governing funds' use of derivatives.

^[4] The Commission's Asset Management Advisory Committee and Fixed Income Market Structure Advisory Committee have recommended that the Commission implement a classification system designed to underscore the differences in complexity and regulatory protections among different types of ETPs. See Asset Management Advisory Committee, Recommendations Regarding COVID-19 Volatility: Exchange-Traded Products (Sept. 16, 2020); Fixed Income Market Structure Advisory Committee, Recommendation for an Exchange-Traded Product Classification Scheme (Oct. 29, 2018).

[5] See, e.g., Wall Street Journal, “‘Bankrupt in Just Two Weeks’—Individual Investors Get Burned By Collapse of Complex Securities,” (June 1, 2020), *available at* <https://www.wsj.com/articles/bankrupt-in-just-two-weeks-individual-investors-get-burned-by-collapse-of-complex-securities-11591020059>.

[6] See, e.g., “Direxion Changes Objectives of Ten Leveraged Funds to Address Extreme Market Conditions, While Also Closing Eight Funds Due to Limited Interest Since Launch” (Mar. 24, 2020), *available at* <https://www.direxion.com/uploads/Change-in-Investment-Objectives-and-Strategies-of-Ten-Daily-Leveraged-and-Daily-Inverse-Leveraged-Funds.pdf>.

[7] See, e.g., Wall Street Journal, “Oil Market’s Crisis Spreads to Individual Investors,” (Apr. 22, 2020), *available at* <https://www.wsj.com/articles/oil-markets-crisis-spreads-to-individual-investors-11587485773>.

[8] In addition, some firms have begun offering “zero commission” trading to brokerage customers engaged in self-directed trading.

[9] For example, some retail investors may choose to receive recommendations from registered broker-dealers, who are subject to a standard of conduct that the Commission enhanced beyond traditional suitability obligations and is aligned with retail customers’ reasonable expectations. Regulation Best Interest is designed to enhance the broker-dealer standard of conduct while preserving, to the extent possible, retail investor access (in terms of choice and cost) to differing types of investment services and products. See Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019) [84 FR 33318 (July 12, 2019)] (“Regulation Best Interest Adopting Release”). To help retail investors make informed choices, the Commission also adopted a requirement that broker-dealers and investment advisers deliver to retail investors a relationship summary that provides succinct information about the relationships and services the firm offers, fees and costs that retail investors will pay, and certain other important information. See Form CRS Relationship Summary; Amendments to Form ADV, Exchange Act Release No. 86032, Advisers Act Release No. 5247 (June 5, 2019) [84 FR 33492 (Jul. 12, 2019)]. Commission staff recently hosted a roundtable to discuss initial observations on Regulation Best Interest and Form CRS implementation. A webcast of the roundtable is available [here](#).

[10] Regulation Best Interest Adopting Release; Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)] (“Fiduciary Interpretation”).

[11] See Regulation Best Interest Adopting Release at nn.593–597 and accompanying text

[12] See *id.*; see also Fiduciary Interpretation at n.39 and accompanying text.