

Complex Products: Are They Investments?

Earlier this month the Commission approved two new complex financial products. Despite the approval, the new products sparked comments from Chair Gensler and, in a separate but joint statement, Commissioners Allison Herren Lee and Caroline A. Crenshaw. While each of the Commissioners reaffirmed the decision to approve the products, each expressed concern about investor use of complex products. The comments also follow recent enforcement actions where brokers with inadequate training and/or information recommended complex products to investors who appear to have been ill-prepared at best to utilize them. See, e.g., *In the Matter of American Financial Services, Inc.*, Adm. Proc. File No. 3-20151 (Nov. 13, 2020)(settled action based on on IPath S&P 500 VIX Short-term Futures ETN or VXX).

Chair Gensler essentially cautioned investors about the use of complex products such as those recently approved. Products such as leveraged ETFs and inverse ETFs, for example, are more complex than “typical stocks and bonds” the Chair noted. In other instances, the Office of Investor Protection, such as in 2009, highlighted the fact that a product should not be held for longer than one day – the situation presented with a complex product in the *American Financial* case cited above. More recently Chair Clayton expressed concern that ETPs “may present investor protection issues – particularly for retail investors who may not fully appreciate the particular characteristics or risks of such investments.” (Internal quotations omitted). All of this suggests that investors need to be cautious about the use of such products.

Commissioners Lee and Crenshaw concur with the Chair’s concerns but went further in their comments. The two Commissioners advocated a three-part approach to the situation. First, there should be a “strong, consistent regulatory oversight of all complex exchange-traded products,” according to the Commissioners. There may be significant differences among the various products. Some exchange traded products, for example, are registered investment companies. Others are registered only under the 1933 Securities Act and are not subject to the same requirements as those governed by the Investment Company Act. Nevertheless, the products may have similar objectives but

Related Capabilities

- Securities & Financial Services Litigation & Enforcement

different structures. These might include exchange traded notes, commodity pools, and structure notes, many of which refer to themselves as funds although they are not. The point is that the Commission “should endeavor to adopt a consistent approach to managing such risks [presented by these products] to ensure that our rules do not needlessly create opportunities for regulatory arbitrage.”

Second, the agency must adopt a “consistent, holistic approach to the review of exchange-traded products.” This approach must address the various risks posed by the products. Finally, it is critical that the approach adopted be based on heightened protections for investors trading these products.

All of the comments highlight the fact that trading the variety of complex financial products available today presents significant risks and the potential for huge losses by average investors even if the three step process advocated by Commissioner’s Lee and Crenshaw is adopted. While building investor protections based on the risks posed by the complex products is a worthy goal, the ultimate question is if it is sufficient. The federal securities laws are built on the idea that full disclosure of the facts is sufficient. There is no doubt that in many instances it is. In many instances, however, the products are complex to the point of being opaque. In many instances the warnings issued with the products, while well intended, in probability do little to aid the typical investor or even many financial professionals. Under these circumstances it may be appropriate to consider a second question – is disclosure sufficient? Stated differently, if the product is so opaque, is it actually a financial investment product at all or has it crossed the line and become something else? If investor protection is the goal, perhaps this question should be asked before new products are authorized when appropriate modifications can be made.