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SEC Steps Up Enforcement For Unsuitable Sales Of Complex ETPs

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Over the past decade, exchange traded funds (ETF) have grown in popularity, with investors putting literally trillions of dollars into such funds. This growth has given rise to a new SEC rule to modernize ETF regulation—Rule 6c-11 of the Investment Company Act of 1940. In addition, the industry has undertaken self-regulatory efforts to ensure a fair and transparent market. Finally, as emphasized by an enforcement action announced on Friday, Nov. 13, 2020, the Securities and Exchange Commission's Division of Enforcement's Complex Financial Instruments Unit continues to pursue its Exchange Traded Products Initiative, which seeks to ensure that the risks of such investments are understood by investment advisers and investors alike.

What is an ETF?

A traditional ETF is a vehicle that holds a basket of securities or commodities across a discrete sector, giving investors a cost-effective way to gain diversified exposure to an industry, a region, or even market. An example of such a standard vehicle is BlackRock's iShares S&P 500 Value ETF, which

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provides exposure to large-cap equities with value characteristics, like Berkshire Hathaway Inc. and Cisco Systems.

Such vehicles typically perform like the underlying securities, moving up or down as market results would suggest. Of course, they are themselves exchange traded, so enthusiasm for the basket of investments or the performance of the ETF itself can result in a product trading at a higher or lower value than the net asset value of the assets within it may suggest. Ordinary ETFs are often held in investment portfolios just as traditional stocks might be—on a long-term basis, for long-term gain.

But, this generalized umbrella covers a number of products that do not always perform in a predictable manner. As the Securities and Exchange Commission's Office of Investor Education and Advocacy puts it, "[o]ther ETFs may have unusual investment objectives or use complex investment strategies that may be more difficult to understand and fit into an investor's investment portfolio." These types of ETFs include leveraged ETFs, inverse ETFs, exchange traded notes and even pooled vehicles investing in hard assets. Put simply, these products include complexities that are not always clear to investment professionals and, as a result, present market exposure that are likely to surprise ordinary investors.

The VXX

One example of such complex products is the iPath S&P 500 VIX Short-Term Futures ETN (VXX), which was brought to the market originally in 2009. The VIX is a volatility index offered by the Chicago Board Options Exchange, or CBOE, that is intended to reflect the market's estimate of the expected volatility of the S&P 500 index. In and of itself, a volatility option is a complex investment that can produce unexpected results—such as the February 2018 "volmageddon."

But the VXX is even more complex than the VIX itself, in that its value is based on an index that manages a hypothetical portfolio of the two VIX contracts closest to expiry—making it the derivative of a derivative. This causes the VXX to imperfectly track the VIX, due to a phenomenon known as "contango loss." As a result, nearly 20 percent of the time, the VXX—which is expected to move inversely to the S&P 500—actually moves in the same direction of the S&P 500.

In other words, various components of the VXX make it risky in ways that the average investor—without experience with options concepts like contango and backwardation, for example—would not appreciate. As one commentator has stated, "[u]nless your timing is especially good you will lose money." From the VXX's own prospectus, it is clear that a VXX investment "may experience a significant decline in value over time, the risk of which increases the longer that the ETNs are held." The timing around such investments is certainly sufficiently critical that a VXX investment is likely not appropriate for traditional buy-and-hold investors—as the SEC's recent enforcement action makes plain.

SEC Enforcement for Unsuitable Sales of Complex ETPs

On Nov. 13, 2020, the SEC unveiled a settled Order Instituting Administrative and Cease-and-Desist Proceedings against five firms "for violations that related to unsuitable sales of complex exchange-traded products to retail

investors." Specifically, the SEC alleged that these firms failed "reasonably to supervise certain [representatives] who made unsuitable recommendations to its retail brokerage customers and advisory clients that they buy and hold for extended periods two complex exchange traded products that were intended for short-term holding." The settlement resulted in the five firms paying a combined $3 million in fines, penalties and disgorgement.

The gist of the SEC's action is that these firms did not provide sufficient training to their representatives to ensure that they understood the nature of the products and their risks and made appropriate recommendations to their clients. In addition, the SEC alleges that the firms did not institute procedures to ensure that their representatives did not put retail customers into unsuitable investments. Finally, the SEC alleged that two of the firms failed to ensure their representatives did not recommend these time-sensitive exchange traded products as long term holdings.

According to Stephanie Avakian, the director of the SEC's Division of Enforcement, "[i]t is important for firms to put the appropriate protections in place to ensure complex products are properly evaluated and understood by their representatives. Failing to do so puts investors at risk." Director Avakian emphasized that this area of law would remain a priority for the division. To this end, she said, "we will continue to look for sales that expose customers to unsuitable investments."

In light of the SEC's heightened scrutiny, firms that recommend complex exchange traded products to their customers should consider implementing:

- Training for representatives about the risks of such products
- A procedure to ensure the representatives obtain and retain documentary evidence that such risks have been conveyed to the customer
- A procedure to ensure that customers have sufficient investment experience to understand the risks posed by such products
- Ongoing supervision to provide reasonable assurance that the procedures are being followed