

# STRUCTURED THOUGHTS

NEWS FOR THE FINANCIAL SERVICES COMMUNITY

## IN THIS ISSUE

FINRA FINES BROKER-DEALER FOR UNSUITABLE SALE OF COMPLEX SECURITIES

Page 1

NASAA ISSUES REPORT ON BROKER-DEALER POLICIES AND PROCEDURES FOR LEVERAGED/INVERSE EXCHANGE-TRADED FUNDS

Page 3

FINRA'S 2019 REPORT ON EXAMINATION FINDINGS AND OBSERVATIONS

Page 4



## FINRA FINES BROKER-DEALER FOR UNSUITABLE SALE OF COMPLEX SECURITIES

In September 2019, FINRA censured and fined a Florida-based broker-dealer, including for failing to reasonably supervise sales of complex securities such as structured products and leveraged, inverse and inverse-leveraged exchange-traded funds (“Non-Traditional ETFs”). The broker and its Director of Investment Banking, without admitting or denying FINRA’s findings, accepted FINRA’s sanctions in a Letter of Acceptance, Waiver, and Consent (the “AWC”). A copy of the AWC can be found [here](#).

### FAILURE TO REASONABLY SUPERVISE SALE OF STRUCTURED PRODUCTS

According to the AWC, for a period of approximately two years, a significant portion of the

broker's business consisted of the sale of structured products, including mainly non-principal protected structured notes (most commonly, "steepeners"), which are often understood to carry much greater risk compared with, for example, principal protected products.

According to FINRA's findings, the broker established a system to supervise the suitability of recommendations of structured products. The system centered on "product profiles" that described the risks and characteristics of each structured product, and restricted the sale of each such product to certain types of customers. However, the broker failed to have supervisory system or written procedures in place to ensure that its representatives would comply with the product profiles when making structured product recommendations.

### **FAILURE TO REASONABLY SUPERVISE SALE OF NON-TRADITIONAL ETFs**

Non-Traditional ETFs are designed to offer a return that is a multiple of an underlying index or benchmark, the inverse of that benchmark, or both over the course of one trading session (usually a single day). Because the performance of Non-Traditional ETFs over periods longer than a single trading session can correlate poorly with the performance of their underlying index or benchmark, these products carry significant risks and are typically not suitable for retail investors who plan to hold them for more than one trading session.

The broker apparently appreciated the risks associated with Non-Traditional ETFs, and prohibited solicited sales of Non-Traditional ETFs. However, according to FINRA's findings, for approximately three years, the broker failed to reasonably enforce this prohibition, as it allowed its surveillance software relating to Non-Traditional ETFs to become outdated. As a result, at least 95 undetected prohibited Non-Traditional ETF sales were executed during the relevant period.

With no supervisory system in place other than the prohibition, FINRA determined that the broker

failed to supervise recommendations by its representatives to purchase these undetected sales of Non-Traditional ETFs; in a majority of these sales, customers held these products for extended periods – up to two years or more.

### **PENALTIES**

The AWC confirmed FINRA's censure of the broker for violating FINRA and NASD rules and the imposition of a \$250,000 fine.<sup>1</sup>

### **CONCLUSION**

This case illustrates the importance for broker-dealers to establish and enforce proper surveillance systems and written procedures to ensure the suitability of its sale recommendations, especially when dealing with complex securities. In this case, the risks associated with structured products and Non-Traditional ETFs were generally understood and appreciated by the broker. However, due to an inadequate surveillance system, which was not properly updated, the broker's representatives, who made the relevant sale recommendations, did not similarly understand the high risk and were allowed to make undetected unsuitable sales.

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<sup>1</sup> The penalties also relate to other FINRA violations, which are not as closely related to sales of complex products.

# NASAA ISSUES REPORT ON BROKER-DEALER POLICIES AND PROCEDURES FOR LEVERAGED/INVERSE EXCHANGE-TRADED FUNDS

In July 2019, the North American Securities Administrators Association (“NASAA”) issued a report that provided a warning as to the risks of leveraged and/or inverse exchange-traded funds. The report urges broker-dealers to tailor their supervisory procedures if they allow ETF transactions in these products.

The report is based in part on information that was collected through an inquiry sent to broker-dealers, which was designed to obtain a better understanding of whether broker-dealers are recommending these products, and how these broker-dealers are supervising these transactions. This inquiry resulted in 118 responses. Of the responding firms, 86 (73%) allowed leveraged and/or inverse ETFs to be held in retail customer accounts. With respect to these 86 firms:

- 52% permitted representatives to recommend leveraged and/or inverse ETFs to their customers; and
- 83% of the firms allowing leveraged and/or inverse ETFs in customer accounts confirmed that they have policies and procedures to address ETFs that are leveraged and/or inverse.

However, the report noted that only 59% of the respondents address the review of customer suitability and only 26% generate an exception report for positions held longer than one trading session. These responses resulted in a recommendation that firms review and update their

supervisory procedures as they apply to these products.

The full text of the report, including its additional analysis of the practices of other broker-dealer responses, may be found at the following link: <https://s30730.pcdn.co/wp-content/uploads/2019/07/2019-BD-Study-of-Exchange-Traded-Funds-FINAL.pdf>.

The report concludes with recommendations for broker-dealers who offer these products. In particular, they should consider:

- establishing customer eligibility (suitability) criteria for these purchases;
- providing customers with educational materials regarding the risks of leveraged and/or inverse ETFs prior to the first sale;
- requiring mandatory training and a formal approval process prior to permitting representatives to recommend a leveraged and/or inverse ETF;
- reviewing recommendations of leveraged and/or inverse ETFs based on a customer’s investment objective, risk tolerance, age, and financial profile;
- imposing holding period time frames to prompt a supervisory review when leveraged and/or inverse ETFs are held longer than the appropriate period; and
- creating trade reports, exception reports, and alerts designed to attract supervisory attention when leveraged and/or inverse ETFs are held for longer than the recommended period, and/or are held by customers who do not meet specific suitability criteria.

The report also concludes that broker-dealers should carefully consider whether to permit purchases of leveraged and/or inverse ETFs in retail customer accounts. If permitting transactions in leveraged and/or inverse ETFs, a firm’s supervisory

procedures should be sufficiently tailored to address the risks associated with these products.

Of course, many of the conclusions of the report are appropriate to consider in connection with sales of other leveraged and inverse products, including exchange-traded notes, which typically raise comparable considerations.

## FINRA'S 2019 REPORT ON EXAMINATION FINDINGS AND OBSERVATIONS

In October 2019, FINRA published its 2019 Report on FINRA Examination Findings and Observations. The full report may be found at the following link: <https://www.finra.org/rules-guidance/guidance/reports/2019-report-exam-findings-and-observations>.

The report reflects FINRA's key findings and observations identified in its recent examinations of broker-dealers. The report sets forth what FINRA believes to be effective practices that could help these firms improve their compliance and risk management programs. The report also summarizes findings and observations across a range of topics. In this article, we focus on a number of issues that are of particular interest to the structured products market.

*Insufficient Written Supervisory Procedures ("WSPs") for New or Amended Rules* – FINRA reports that some broker-dealers did not adequately address recently adopted or amended rules to address the new requirements applicable to their business and update their WSPs accordingly. In particular, FINRA references its:

- fixed income mark-up disclosure requirements under FINRA Rule 2232 (Customer Confirmations)<sup>2</sup>; and
- trusted contact person information requirements under FINRA Rule 4512 (Customer Account Information), and temporary holds, supervision and record retention requirements under new Rule 2165 (Financial Exploitation of Specified Adults)<sup>3</sup>.

*Limited Supervision and Internal Inspections* – FINRA indicated that some firms did not maintain reasonably designed branch supervision and inspection programs. In particular, some firms did not adequately understand the activities being conducted through their branch offices, including products and services that were offered only at certain branch locations; this factor could prevent such firms from effectively supervising and addressing the specific risks of each branch location. For example, some branch offices may offer products with a greater degree of complexity than other offices with the firm. FINRA noted that many firms:

- did not conduct periodic inspections of non-branch locations as required by FINRA Rule 3110(c) (Internal Inspections);
- did not determine relevant areas of review at branch offices or non-branch locations, taking into consideration the nature and complexity of the products and services offered or any indicators of irregularities or relevant misconduct;

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<sup>2</sup> We discuss these issues in our November 2017 issue of this publication, which may be accessed here: <https://media2.mofo.com/documents/171115-structured-thoughts.pdf>.

<sup>3</sup> We discuss these issues in our article at the following link: <https://www.bdiaregulator.com/2018/01/finra-publishes-faqs-on-new-measures-to-prevent-the-financial-exploitation-of-seniors/>.

- failed to set forth the inspections and reviews to a written report; or
- did not follow through on corrective action determined to be necessary based upon their branch inspections.

*Limited Supervision to Identify “Red Flags” for Suitability* – FINRA indicated that some broker-dealers’ supervisory systems were not reasonably designed or used to detect “red flags” of possible unsuitable transactions. For example, some firms did not identify or question patterns of similar recommendations by representatives or branch offices across many customers with different risk profiles, time horizons, and investment objectives. In some cases, multiple customers of a representative or branch office appeared to have made “unsolicited” transactions in identical securities. These factors, according to FINRA, could

raise questions around whether the transactions were actually “unsolicited.”

*Unsuitable Options Strategy Recommendations* – FINRA identified registered representatives who recommended complex options strategies to customers who did not have the sophistication to understand the features of an option or the associated strategy, or recommended such strategies without adequately considering the customers’ individual financial situations and needs, as well as other investment profile factors. Further, some firms did not implement trade limits and controls to identify and prevent options trading that exceeded customer pre-approved investment levels.

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