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STRUCTURED THOUGHTS

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CONTACTS

LLOYD S. HARMETZ
NEW YORK
(212) 468-8061

TADASHI OKAMOTO
NEW YORK
(212) 336-4078

SEC FINES BROKER-DEALER FOR UNSUITABLE SALES OF LEVERAGED ETNS

In September 2018, the SEC fined a New York-based broker-dealer in connection with unsuitable sales of leveraged ETNs linked to the price of crude oil. A copy of the SEC's order may be found here.

In this proceeding, the SEC determined that, for a period of approximately two years, the broker's representatives that made recommendations about buying and holding these securities did not properly understand these products and their risks, and that the broker did not properly supervise these representatives. As a result, the broker's retail investors lost more than 90% of their investments in the relevant ETNs.

THE INVESTMENT THESIS

During the relevant period, representatives of the broker believed that oil prices had fallen, but would recover. Based on that view, these representatives recommended that retail customers buy and hold leveraged ETNs linked to the positive performance of crude oil. They made these recommendations under the notion that increases in the price of crude oil would increase the price of the leveraged ETNs. The broker's customers held these products for periods of several months; some retail customers held these products for more than a year.

However, as we have discussed in this publication, this type of ETN does not provide direct exposure to the underlying asset and is not designed for holding periods longer than a single day. In addition, these representatives did not understand that the costs of "rolling" the relevant futures contracts to which the ETNs were linked could result in losses to the relevant reference index over time. They also did not understand that volatility in the relevant commodity futures market could lower the value of the ETNs over time, even if the index was flat or positive from the start to end of that period. The SEC concluded that the broker's representatives either did not read, or read and dismissed, these prospectus disclosures. Accordingly, they did not have a reasonable basis for making these representations.

RELEVANT POLICIES

The broker did have policies in place stating that its representatives generally should not recommend non-traditional products of this type for long or intermediate investment periods, and that its representatives should receive training and satisfy other requirements before recommending these products to customers. However, the SEC determined that the broker did not establish and implement a reasonable supervisory system for determining whether representatives had a reasonable basis for recommending that investors buy and hold this type of product. Representatives did not receive training about these products, and the broker did not implement its specific policies and procedures. For example, the broker did not adopt mechanisms to monitor or enforce the procedures it had implemented as to these products, including that representatives discuss the products with a registered principal and maintain documentation to explain the reasons for their recommendations. Some representatives continued to recommend the products even after the broker had determined that the firm would no longer offer them. The supervisory staff received internal reports showing that customers were holding these products for extended periods of time and incurring losses on these investments, but did not take action to prevent these recommendations from recurring.

VIOLATIONS AND PENALTIES

As a result of these circumstances, the SEC concluded that the broker had failed to properly supervise its representatives as required under Sections 15(b)(4)(E) and 15(b)(6), and that it violated Section 206(4) and Rule 206(4)-7 under the Investment Advisers Act as to its sales to advisory accounts. In addition, due to the negligent conduct, the SEC found that the broker violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

The SEC's order required the broker-dealer to retain a compliance consultant to conduct a review of its policies, procedures and systems relating to non-traditional exchange traded products and other related supervisory issues. The consultant is required to furnish a report to the SEC's as to its review, and recommendations for further action. The SEC also imposed monetary penalties on the broker-dealer and certain of its representatives and required the broker-dealer to compensate the relevant investors.

CONCLUSION

The risks posed by leveraged ETNs were reasonably well known the broker-dealer industry prior to this action. These circumstances illustrate once again the negative consequences that can result when the risk factors and related disclosures for a complex security are not properly digested by the broker-dealers who offer them.

The SEC's order notes the fact that the broker-dealer in question was somewhat small and had limited resources for supervision and compliance. Accordingly, this case illustrates the additional challenges that smaller broker-dealers face when adding complex products to their offerings. Smaller broker-dealers may be less likely to leverage their resources sufficiently to properly monitor and supervise these types of sales.