

STRUCTURED THOUGHTS

NEWS FOR THE FINANCIAL SERVICES COMMUNITY



SEC CONTINUES ENFORCEMENT ACTIONS RELATING TO COMPLEX EXCHANGE-TRADED PRODUCTS

On November 13, 2020, the Securities and Exchange Commission (SEC) announced that it had settled actions against several investment advisory firms and firms dually-registered as broker-dealers and investment advisers. These actions relate to unsuitable sales of complex exchange-traded products (ETPs). The sales in question were made to retail investors, and occurred between January 2016 and April 2020. The SEC's summary of these actions may be found [here](#).

All of the actions related to sales of volatility-linked ETPs that tracked expectations of short-term market volatility, measured through derivatives based on the CBOE Volatility Index.

FACTORS CAUSING IMPROPER RECOMMENDATIONS

Generally speaking, the offering documents for these products clearly disclosed that the short-term nature of these products made it more likely that investments would experience a decline in value if held over time, as opposed to a single trading day. However, in each case, representatives of the relevant firms recommended that their customers buy and hold these products for longer periods. These faulty recommendations arose from a variety of flaws.

The orders describe a variety of actions and inactions that the SEC has previously cited when sanctioning firms in connection with sales of complex products. Among the problematic actions or omissions of the brokers and advisers in these orders were:

- Failing to make a reasonable investigation of the products they were recommending.
- Failing to adopt or implement policies and procedures regarding suitability of the sales of these products.
- Failing to conduct a review process for these products prior to offering them.
- Failing to train representatives prior to offering the products, resulting in representatives making recommendations without adequately understanding the products.
- Registered representatives failing to document their recommendations as required by internal policies and procedures.
- In cases where internal policies banned or limited the sales of these products, inconsistently applying that ban.

- In the case of advisory firms, purchasing the securities for discretionary accounts, even where the products were not approved for that purpose, or making the purchase even though the products were not consistent with the customer’s risk profile.
- Failing to have any procedures at all, or adequate procedures, to review the sales of these products.

RELEVANT REGULATORY PROVISIONS

The cases indicate how unsuitable sales of securities can result in a violation of a variety of relevant statutes and rules, forming the basis for many of the SEC’s recent enforcement actions in this area.

STATUTE OR REGULATION	ACTION
Securities Act Sections 17(a)(2) and 17(a)(3)	Negligently misrepresenting the risks and characteristics of an investment.
Exchange Act Section 15(b)(4)(E)	Failure to supervise registered representatives, including to avoid violations of Securities Act Sections 17(a)(2) and 17(a)(3).
Investment Advisers Act Section 203(e)(6)	Failure to supervise advisory representatives as to their unsuitable representations.
Investment Advisers Act Section 206(4) and Rule 206(4)-7	Failure to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules by the investment adviser and its supervised persons.

STATEMENT OF THE OCIE

On November 16, 2020, the SEC’s Office of Compliance Inspections and Examinations (OCIE) issued a [statement](#) about these actions. The statement reminds regulated firms that they need to implement robust and effective policies and procedures reasonably designed to prevent violations of the federal securities laws, and ensure that their personnel follow these policies and procedures. The statement indicates that a compliance program that is not dynamic, but that is instead based on specific product features, such as leverage or inverse correlation, is more susceptible to fail to maintain appropriate controls on the products available to their financial professionals.

The OCIE noted that, when making recommendations with respect to complex products, SEC Regulation Best Interest and an investment adviser’s fiduciary duty require financial professionals to apply heightened scrutiny to ensure that they understand the terms, features and risks of a product, and whether the product fits within the client’s risk tolerance and specific-trading objective. The OCIE also stated that it intends to continue to evaluate the design and effectiveness of firms’ policies and procedures with respect to ensuring that financial professionals:

- Understand the risks and purpose of the products they recommend.
- Apply the necessary heightened scrutiny for complex products.
- Only recommend products in compliance with legal standards.
- Where appropriate, monitor investments in volatile products on a daily basis.

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