October 30, 2020

STRUCTURED THOUGHTS

NEWS FOR THE FINANCIAL SERVICES COMMUNITY

SEC ISSUES JOINT STATEMENT RELATING TO COMPLEX FINANCIAL PRODUCTS

On October 28, 2020, the U.S. Securities and Exchange Commission (SEC) Chairman Jay Clayton, together with the directors of three SEC divisions,[1] issued a joint statement relating to complex financial products. The statement relates to a fairly broad group of products, but addresses in particular a number of sophisticated leveraged and inverse structured products, including ETFs and exchange-traded notes (ETNs).

The joint statement may be found at the following link: https://www.sec.gov/news/public-statement/clayton-blass-hinman-redfearn-complex-financial-products-2020-10-28

The joint statement is relatively short, but addresses several potentially complex issues:

- the structural differences among these products that may impact the regulatory protections afforded to each type;
- the possible impact of market volatility and market stress on the performance of these products;
- the fact that self-directed traders may increasingly access these products; and
- the extent to which the SEC's disclosure requirements, Regulation Best Interest and an investment adviser's fiduciary duties all apply to these products.

There is quite a bit that could be said about all these issues, and we may see more in the next few months. However, in a nutshell, the joint release may be boiled down to this: leveraged and inverse products are complex, and are governed by a variety of different regulations; accordingly, the SEC seeks to engage with market participants to better understand and carefully consider whether any rule changes or other regulatory activity is needed to ensure that retail investors have appropriate protections when considering an investment.

[1] In addition to Mr. Clayton, the joint statement had the following signatories, representing SEC divisions that have jurisdiction over the rules and regulations that govern some or all of these products: Dalia Blass, Director, Division of Investment Management; William Hinman, Director, Division of Corporation Finance; and Brett Redfearn, Director, Division of Trading and Markets.

DIFFERENT REGULATORY REGIMES

The joint statement points out that different products are subject to different regulatory regimes, depending upon their "wrapper." For example, leveraged ETFs are subject to the Investment Company Act, while exchange-traded notes are subject to the registration requirements of the Securities Act of 1933. These differences, and their regulatory impact, may be well understood by the institutions that create them; however, the release points out that retail investors (and the financial professionals that advise them) may not be very familiar with these differences, and how they may impact an investment.

VOLATILITY AND MARKET STRESS

The SEC is aware that, in the second quarter of 2020, certain leveraged ETNs linked to crude oil futures prices suffered significant losses amid the COVID-19 market volatility. The joint statement underscores that retail investors in particular may not fully appreciate how these products are likely to perform under different market conditions. For example, the joint statement indicates that the SEC's Office of Investor Education and Advocacy received complaints from investors expressing concerns that, while certain leveraged/inverse products may have operated in accordance with their terms, the pricing and trading of these products during this year's market volatility was not always consistent with investor expectations.

INCREASED SELF-DIRECTED TRADING

The joint release points out that retail investors have greater options today to trade complex instruments without the aid of an investment professional. For example, shares of a leveraged ETF can be traded over a stock exchange, using an electronic brokerage account. A retail investor taking advice from an investment professional may be in a better position to assess the appropriateness of a complex investment than an investor making a purchase through a self-directed account, without the benefit of that advice. In practice, a broker-dealer may carefully restrict the types of investors to which it offers these products; many may not have been created in anticipation of individual retail investors finding these products on their own.

DISCLOSURE REQUIREMENTS AND DUTIES OF FINANCIAL PROFESSIONALS

The joint statement points out that the market for complex products exists within a wide range of existing SEC rules, including rules governing financial professionals, that are designed to help mitigate some of the risks for investors. All of these rules are designed to help ensure that investors make appropriate investment decisions. However, they may not protect all investors equally. For example, under Regulation Best Interest, a broker-dealer may only recommend an investment product to a retail investor if that broker-dealer has a reasonable basis for believing that the investment would be in the investor's best interest. Similarly, any recommendation or advice provided by an investment adviser is subject to the fiduciary duty owed by the adviser to the client. However, these protections do not apply where a retail investor acts independently and not on the basis of a recommendation or advice received from a broker-dealer or investment adviser.

REQUEST FOR COMMENT

The joint statement acknowledges that there are a wide variety of regulations impacting this market, and that market developments occur quickly. Accordingly, the joint statement, concludes:

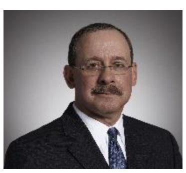
> "In light of these concerns, the staff in the Divisions of Investment Management, Corporation Finance, and Trading and Markets will review the effectiveness of the existing regulatory requirements in protecting investors—particularly those with self-directed accounts—who invest in leveraged/inverse products and other complex products. Based on this review, the staff will make recommendations to the Commission for potential new rulemakings, guidance, or other policy actions, if appropriate. As part of this review, the staff will consider whether the Commission's promulgation of any additional requirements for these products may be effective in helping to promote retail investor understanding and appreciation of these products' unique characteristics and risks. The staff may consider requirements that include, among other things, additional obligations for broker-dealers and investment advisers relating to complex products, as well as point-of-sale disclosures or policies and procedures tailored to the risks of complex products."

Accordingly, the joint statement requests comments from interested market participants and investors, and provides a designated e-mail address for comments.

CONCLUSION

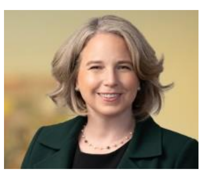
Structured products and leveraged products have been on the SEC's radar screen for several years. This year's market volatility, and well-publicized losses relating to certain products, helped lead the SEC to conduct a more detailed review. The joint statement reflects an effort by the SEC to provide a more "holistic" multidisciplinary review of these products, by involving several of its key divisions with appropriate jurisdiction.

CONTRIBUTORS



Hillel Cohn

Los Angeles
(213) 892-5251



Susan Gault-Brown

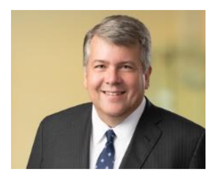
Washington, D.C.
(202) 887-1597

Lloyd Harmetz

New York
(212) 468-8061

Kelly Howes

Denver
(303) 592-2237



Dave Lynn

Washington, D.C.
(202) 778-1603