

November 17, 2020

# SEC Fines Investment Advisers and Broker-Dealers in Connection With Exchange-Traded Products Initiative

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## **Charges Against Five Firms Highlight Division of Enforcement's Initiative Concerning Risks of Complex Exchange-Traded Products**

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### **SUMMARY**

On November 13, 2020, the Securities and Exchange Commission announced that it had settled actions against five firms registered as investment advisers and/or broker-dealers for violations related to the sales of complex exchange-traded products ("ETPs"). These actions are the first to arise from the Division of Enforcement's "Exchange-Traded Products Initiative" ("ETP Initiative") and focus on the firms' sale of volatility-linked ETPs.<sup>1</sup>

According to the cease-and-desist orders issued in connection with the actions, although the offering documents for these products specified that the products were intended to be held short term and were likely to experience a decline in value when held long term, the firms' registered representatives nevertheless recommended that certain investors purchase and hold the products for extended periods of time. The SEC found that the firms did not have adequate policies and procedures to ensure that their registered representatives were properly trained on or adequately understood the nature of the products.

Although these are the first actions the SEC has announced specifically in connection with the ETP Initiative, they are part of a series of SEC enforcement actions addressing the risks to investors of investment professionals' inadequate understanding of complex products. Additionally, in announcing these actions, the SEC emphasized its use of data analytics to identify unsuitable sales of complex financial products, consistent with the Division of Enforcement's increasing utilization of such processes to identify and investigate instances of potential misconduct.

## BACKGROUND

The products at issue in all five actions announced on November 13, 2020 were volatility-linked ETPs, which attempt to track short-term volatility expectations in the market.<sup>2</sup> The offering documents for the ETPs disclosed that the ETPs incurred significant costs, a result of which was that the ETPs could experience a significant decline in value over time.<sup>3</sup> The offering materials likewise made clear the limited upside potential of the ETPs if held over a longer period of time.<sup>4</sup> The SEC found that, despite these warnings, registered representatives of the firms recommended that customers and clients buy and hold the products for the long term, up to months, and in some circumstances years, to hedge against downward market turns.<sup>5</sup> The orders further assert that the firms did not adopt or properly implement policies and procedures designed to prevent violations of the Investment Advisers Act and its rules, and that the firms did not adequately supervise or train its representatives who recommended that their customers buy and hold the products at issue.

The SEC's announcement notes that the Division of Enforcement's ETP Initiative generated the investigations against these firms. Although these are the first actions announced as part of this initiative, the actions are consistent with the SEC's stated increased focus on the sale of complex financial instruments to retail investors. In October 2020, SEC Chairman Jay Clayton, alongside three agency division directors, issued a joint statement identifying ETPs as "present[ing] investor protection issues—particularly for retail investors who may not fully appreciate the particular characteristics or risks of such investments, including the risks that holding such products may pose to their investment goals."<sup>6</sup>

The November 13, 2020 settlements are not the first actions by the SEC involving the sale of complex products. In February 2020, Wells Fargo entered into a settlement with the SEC related to its brokers' and advisers' misunderstanding and recommendation of exchange-traded funds.<sup>7</sup> Similarly, in September 2018, the SEC fined Cadaret, Grant & Co., Inc. and several of its senior employees for failing to reasonably supervise registered representatives who recommended that customers buy and hold oil-linked exchange-traded notes without a reasonable basis.<sup>8</sup> Morgan Stanley and UBS Financial Services likewise entered into settlements with the Division of Enforcement in connection with similar products in February 2017 and September 2016, respectively.<sup>9</sup>

The SEC's announcement further focused on its use of data analytics to identify potential unsuitable sales, as well as the agency's intent to continue the use of such tools to surveil the market and protect retail investors. As described in the announcement, the ETP Initiative was developed in part by data analytics specialists, assisted by the Enforcement Division's Center for Risk and Quantitative Analytics. This is consistent with the Division of Enforcement's increased utilization of data analytics to identify potential misconduct and risks to retail investors.<sup>10</sup>

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Each firm agreed to cease and desist from future violations of the charged provisions without admitting or denying the findings of the orders. The civil penalties issued in connection with each of the orders ranged from \$500,000 to \$650,000, all of which the SEC indicated would be returned to investors in the ETPs at issue.

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### IMPLICATIONS

The SEC's announcement, in addition to its recent statements and other recent enforcement actions focusing on complex products, highlights the importance that the SEC places on investment advisers and broker-dealers' examining ETPs and other complex products on their platforms and ensuring that appropriate policies and procedures have been adopted and adequately implemented. The announcement further counsels in favor of such firms' implementing adequate supervision and training of their registered representatives to ensure that representatives fully understand the risks of complex products, including but not limited to those set forth in corresponding offering documents, before advising that clients purchase these instruments.

The announcement also shows that the SEC's Division of Enforcement continues to utilize data analytics to identify unusual trading activity and potential misconduct. Although the November 13 announcement highlights the use of data analytics in connection with the ETP Initiative, it is clear that the Division of Enforcement intends to utilize data analytics more widely in its efforts to protect investors and to further its enforcement program.

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ENDNOTES

- 1 Securities and Exchange Commission, Press Release, “SEC Charges Investment Advisory Firms and Broker-Dealers in Connection with Sales of Complex Exchange-Traded Products” (Nov. 13, 2020), available at <https://www.sec.gov/news/press-release/2020-282> (“Press Release”).
- 2 *Id.*
- 3 See, e.g., In the Matter of American Portfolios Financial Services, Inc. and American Portfolios Advisors, Inc., ¶ 4, available at <https://www.sec.gov/litigation/admin/2020/34-90411.pdf>; In the Matter of Benjamin F. Edwards & Company, Inc., ¶ 8, available at <https://www.sec.gov/litigation/admin/2020/34-90413.pdf>; In the Matter of Royal Alliance Associates, Inc., ¶ 8, available at <https://www.sec.gov/litigation/admin/2020/ia-5629.pdf>; In the Matter of Summit Financial Group, Inc., ¶ 8, available at <https://www.sec.gov/litigation/admin/2020/ia-5626.pdf>.
- 4 See, e.g., In the Matter of American Portfolios Financial Services, Inc. and American Portfolios Advisors, Inc., ¶ 5, available at <https://www.sec.gov/litigation/admin/2020/34-90411.pdf>; In the Matter of Benjamin F. Edwards & Company, Inc., ¶ 10, available at <https://www.sec.gov/litigation/admin/2020/34-90413.pdf>; In the Matter of Royal Alliance Associates, Inc., ¶ 9, available at <https://www.sec.gov/litigation/admin/2020/ia-5629.pdf>; In the Matter of Securities America Advisors, Inc. ¶ 11, available at <https://www.sec.gov/litigation/admin/2020/ia-5627.pdf>.
- 5 Press Release.
- 6 Securities and Exchange Commission, “Joint Statement Regarding Complex Financial Products and Retail Investors” (Oct. 28, 2020), available at <https://www.sec.gov/news/public-statement/clayton-blass-hinman-redfearn-complex-financial-products-2020-10-28>.
- 7 Securities and Exchange Commission, Press Release, “SEC Charges Wells Fargo in Connection with Investment Recommendation Practices” (Feb. 27, 2020), available at <https://www.sec.gov/news/press-release/2020-43>.
- 8 Securities and Exchange Commission, Press Release, “SEC Obtains Relief to Fully Reimburse Retail Investors Sold Unsuitable Product” (Sept. 11, 2018), available at <https://www.sec.gov/news/press-release/2018-184>.
- 9 See Securities and Exchange Commission, Press Release, “Morgan Stanley Settles Charges Related to ETF Investments” (Feb. 14, 2017), available at <https://www.sec.gov/news/pressrelease/2017-46.html>; Securities and Exchange Commission, Press Release, “SEC Charges UBS With Supervisory Failures in Sale of Complex Products to Retail Investors” (Sept. 28, 2016), available at <https://www.sec.gov/news/pressrelease/2016-197.html>.
- 10 See, e.g., Jay Clayton, SEC Chairman, “Keynote Remarks at the Mid-Atlantic Regional Conference” (June 4, 2019), available at <https://www.sec.gov/news/speech/clayton-keynote-mid-atlantic-regional-conference-2019>; Mary Jo White, SEC Chair, “A New Model for SEC Enforcement: Producing Bold and Unrelenting Results” (Nov. 18, 2016), available at <https://www.sec.gov/news/speech/chair-white-speech-new-york-university-111816.html>.

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