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Compliance Alert 2022-03

To:	All Dually Registered PCS Registered Representatives, Support Staff, Home Office Personnel
Date:	February 23, 2022
Re:	**Non-Traditional ETF Usage in Advisory Accounts**

The PCS Compliance Department is issuing this Compliance Alert to remind Financial Professionals who utilize non-traditional ETF securities, such as leveraged and inverse funds, of their obligation to actively monitor and record their decisions related to the holding period of these securities.

Both Finra and the SEC have provided guidance related to these products (See attached Finra Regulatory Notice 09-31, and SEC-Finra Investor Alert on Leveraged and Inverse ETFs). These products seek to realize their objective during a single trading cycle and reset their objective on a daily basis. As such a financial professional who utilizes these products within a client portfolio should evaluate the holding on a daily basis and document their position related to holding or selling the position.

While it is noted that Private Client Services does not currently allow the use of these products with brokerage accounts or within PCS advisory accounts, Finra Rules 3280 and 3270 require the firm to supervise the transaction activity of dually registered persons who place transactions away from the firm. As such the firm is obligated to remind all independently registered advisors that if you utilize inverse and/or leveraged ETF securities you should have written supervisory procedures related to the oversight of these positions, and should test your procedures as part of your annual Rule 206(4)-7 review (or annual procedures review if State registered) to ensure your financial professionals are complying with the procedures as written, and that you have accurate and complete records related to the daily decisions to buy, sell, or hold the positions.

Regulators have acted severely against both BD and Advisory firms for failure to have adequate written policies and procedures related to inverse and leverages ETFs including fines and client restitutions for losses when positions are help for periods outside of the product design.

It is the recommendation of PCS Compliance that you review your written policies and procedures as well as your daily trading activities to ensure you are protecting your client accounts and firm. If you have any questions please reach out to compliance@pcsbd.net.

Regulatory Notice 09-31

Non-Traditional ETFs

FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds

Executive Summary

Exchange-traded funds (ETFs) that offer leverage or that are designed to perform inversely to the index or benchmark they track—or both—are growing in number and popularity. While such products may be useful in some sophisticated trading strategies, they are highly complex financial instruments that are typically designed to achieve their stated objectives on a daily basis. Due to the effects of compounding, their performance over longer periods of time can differ significantly from their stated daily objective. Therefore, inverse and leveraged ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets.[1]

This *Notice* reminds firms of their sales practice obligations in connection with leveraged and inverse ETFs. In particular, recommendations to customers must be suitable and based on a full understanding of the terms and features of the product recommended; sales materials related to leveraged and inverse ETFs must be fair and accurate; and firms must have adequate supervisory procedures in place to ensure that these obligations are met.[2]

Questions concerning this *Notice* should be directed to the Office of Emerging Regulatory Issues at (202) 728-8472.

June 2009

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Retail
- Senior Management

Key Topics

- Communications With the Public
- ETFs
- Leveraged and Inverse ETFs
- Suitability
- Supervision
- Training

Referenced Rules and Notices

- IM 2310-2(e)
- NASD Rule 2210
- NASD Rule 2310
- NASD Rule 3010
- NTM 05-26

Financial Industry Regulatory Authority

Background and Discussion

ETFs are typically registered unit investment trusts (UITs) or open-end investment companies whose shares represent an interest in a portfolio of securities that track an underlying benchmark or index.[3] However, some ETFs that invest in commodities, currencies, or commodity- or currency-based instruments are not registered as investment companies. Unlike traditional UITs or mutual funds, shares of ETFs typically trade throughout the day on an exchange at prices established by the market.

Leveraged ETFs seek to deliver multiples of the performance of the index or benchmark they track. Some leveraged ETFs are “inverse” or “short” funds, meaning that they seek to deliver the opposite of the performance of the index or benchmark they track. Like traditional ETFs, some inverse ETFs track broad indices, some are sector-specific, and still others are linked to commodities or currencies. Inverse ETFs are often marketed as a way for investors to profit from, or at least hedge their exposure to, downward-moving markets. Some funds are both short and leveraged, meaning that they seek to achieve a return that is a multiple of the inverse performance of the underlying index. An inverse ETF that tracks the S&P 500, for example, seeks to deliver the inverse of the performance of the S&P 500, while a 2x leveraged inverse S&P 500 ETF seeks to deliver twice the opposite of that index’s performance. To accomplish their objectives, leveraged and inverse ETFs pursue a range of investment strategies through the use of swaps, futures contracts and other derivative instruments.

Most leveraged and inverse ETFs “reset” daily, meaning that they are designed to achieve their stated objectives on a daily basis.[4] Due to the effect of compounding, their performance over longer periods of time can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time. For example, between December 1, 2008, and April 30, 2009:

- The Dow Jones U.S. Oil & Gas Index gained 2 percent, while an ETF seeking to deliver twice the index's daily return fell 6 percent and the related ETF seeking to deliver twice the inverse of the index's daily return fell 26 percent.
- An ETF seeking to deliver three times the daily return of the Russell 1000 Financial Services Index fell 53 percent while the index actually gained around 8 percent. The related ETF seeking to deliver three times the inverse of the index's daily return declined by 90 percent over the same period.

This effect can be magnified in volatile markets. Using a two-day example, if the index goes from 100 to close at 101 on the first day and back down to close at 100 on the next day, the two-day return of an inverse ETF will be different than if the index had moved up to close at 110 the first day but then back down to close at 100 on the next day. In the first case with low volatility, the inverse ETF loses 0.02 percent; but in the more volatile scenario the inverse ETF loses 1.82 percent. The effects of mathematical compounding can grow significantly over time, leading to scenarios such as those noted above.

Suitability

NASD Rule 2310 requires that, before recommending the purchase, sale or exchange of a security, a firm must have a reasonable basis for believing that the transaction is suitable for the customer to whom the recommendation is made. This analysis has two components. The first is determining whether the product is suitable for any customer, an analysis that requires firms and associated persons to fully understand the products and transactions they recommend. With respect to leveraged and inverse ETFs, this means that a firm must understand the terms and features of the funds, including how they are designed to perform, how they achieve that objective, and the impact that market volatility, the ETF's use of leverage, and the customer's intended holding period will have on their performance.

Once a determination is made that a product is generally suitable for at least some investors, a firm must also determine that the product is suitable for the specific customers to whom it is recommended. This analysis includes making reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and "such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[5] While the customer-specific suitability analysis depends on the investor's particular circumstances, inverse and leveraged ETFs typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets.

FINRA reminds firms that, as new complex and non-traditional ETFs are introduced to the market, firms should also keep in mind IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products), which states that "[a]s new products are introduced from time to time, it is important that members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding the products." Firms recommending or selling new ETFs may also find it helpful to refer to *Notice to Members 05-26*, which highlights best practices for vetting new products.

Communications With the Public

NASD Rule 2210 prohibits firms and registered representatives from making false, exaggerated, unwarranted or misleading statements or claims in communications with the public. Therefore, all sales materials and oral presentations used by firms regarding leveraged and inverse ETFs must present a fair and balanced picture of both the risks and benefits of the funds, and may not omit any material fact or qualification that would cause such a communication to be misleading. For example, an advertisement for a leveraged or inverse ETF that is designed to achieve its investment objective on a daily basis may not omit that fact and must specifically disclose that the fund is not designed to, and will not necessarily, track the underlying index or benchmark over a longer period of time. Firms are further reminded that providing risk disclosure in a prospectus or product description does not cure otherwise deficient disclosure in sales material, even if the sales material is accompanied or preceded by the prospectus or product description.

Supervision

In accordance with NASD Rule 3010, firms should establish an appropriate supervisory system to ensure that their associated persons comply with all applicable FINRA and SEC rules when recommending any product, including leveraged and inverse ETFs. Among other things, if a firm promotes or allows its registered representatives to recommend such funds, the firm must ensure that its written supervisory procedures require that:

- the appropriate reasonable-basis suitability analysis is completed;
- associated persons perform appropriate customer-specific suitability analysis;
- all promotional materials are accurate and balanced; and
- all FINRA and SEC rules are followed.

In addition to establishing written procedures, such firms must document the steps they have taken to ensure adherence to these procedures.

Training

Firms must train registered persons about the terms, features and risks of all ETFs that they sell, as well as the factors that would make such products either suitable or unsuitable for certain investors. In the case of leveraged and inverse ETFs, that training should emphasize the need to understand and consider the risks associated with such products, including the investor's time horizons, and the impact of time and volatility on the fund's performance. Training for all persons should emphasize that, due to the complexity and structure of these funds, they may not perform over time in direct or inverse correlation to their underlying index. This is particularly important as many investors may be turning to these funds as part of a long-term strategy to weather current market conditions.

Endnotes

1 There also are mutual funds that are designed to provide inverse and leveraged performance relative to their benchmarks. These mutual funds may reset on a daily basis as well, and thus raise many of the issues discussed in this Notice on ETFs.

2 This *Notice* is being issued concurrently with an Investment Industry Regulatory Organization of Canada Notice on the same topic.

3 In 2008, the Securities and Exchange Commission began issuing exemptive orders that allow certain ETFs to be actively managed and thus not track an underlying benchmark or index. *See* SEC Rel. No. 33-8901 (Mar. 11, 2008), 73 Fed. Reg. 14618, 14620 n. 20 (Mar. 18, 2008).

4 At least one ETF sponsor has filed registration statements for leveraged and inverse ETFs that would seek to track the underlying performance of the index or benchmark for a period longer than a trading day, such as a month.

5 *See* NASD Rule 2310.

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Investor.gov

U.S. SECURITIES AND EXCHANGE COMMISSION

SEC-FINRA Investor Alert on Leveraged and Inverse ETFs

Aug. 18, 2009

Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors

The SEC staff and FINRA are issuing this Alert because we believe individual investors may be confused about the performance objectives of leveraged and inverse exchange-traded funds (ETFs). Leveraged and inverse ETFs typically are designed to achieve their stated performance objectives on a daily basis. Some investors might invest in these ETFs with the expectation that the ETFs may meet their stated daily performance objectives over the long term as well. Investors should be aware that performance of these ETFs over a period longer than one day can differ significantly from their stated daily performance objectives.

What Are Exchange-Traded Funds?

ETFs are typically registered investment companies whose shares represent an interest in a portfolio of securities that track an underlying benchmark or index. (Some ETFs that invest in commodities, currencies, or commodity- or currency-based instruments are not registered as investment companies.) Unlike traditional mutual funds, shares of ETFs typically trade throughout the day on a securities exchange at prices established by the market.

ETFs have evolved over the years, becoming more complex. Investors considering ETFs should evaluate each investment closely and not assume all ETFs are alike. In the last few years, a number of leveraged and inverse ETFs have been introduced to the market that are very different from the traditional variety of ETFs.

What are Leveraged and Inverse ETFs?

Leveraged ETFs seek to deliver multiples of the performance of the index or benchmark they track. Inverse ETFs (also called “short” funds) seek to deliver the opposite of the performance of the index or benchmark they track. Like traditional ETFs, some leveraged and inverse ETFs track broad indices, some are sector-specific, and others are linked to commodities, currencies, or some other benchmark. Inverse ETFs often are marketed as a way for investors to profit from, or at least hedge their exposure to, downward moving markets.

Leveraged inverse ETFs (also known as “ultra short” funds) seek to achieve a return that is a multiple of the inverse performance of the underlying index. An inverse ETF that tracks a particular index, for example, seeks to deliver the inverse of the performance of that index, while a 2x (two times) leveraged inverse ETF seeks to deliver double the opposite of that index’s performance. To accomplish their objectives, leveraged and inverse ETFs pursue a range of investment strategies through the use of swaps, futures contracts, and other derivative instruments.

Most leveraged and inverse ETFs “reset” daily, meaning that they are designed to achieve their stated objectives on a daily basis. Their performance over longer periods of time -- over weeks or months or years -- can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time. This effect can be magnified in volatile markets. As the examples below demonstrate, an ETF that is set up to deliver twice the performance of a benchmark from the close of trading on Day 1 to the close of trading on Day 2 will not necessarily achieve that goal over weeks, months, or years.

Real-Life Examples

The following two real-life examples illustrate how returns on a leveraged or inverse ETF over longer periods can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time.

- Between December 1, 2008, and April 30, 2009, a particular index gained 2 percent. However, a leveraged ETF seeking to deliver twice that index's daily return fell by 6 percent—and an inverse ETF seeking to deliver twice the inverse of the index's daily return fell by 25 percent.
- During that same period, an ETF seeking to deliver three times the daily return of a different index fell 53 percent, while the underlying index actually gained around 8 percent. An ETF seeking to deliver three times the inverse of the index's daily return declined by 90 percent over the same period.

How can this apparent breakdown between longer term index returns and ETF returns happen? Here’s a hypothetical example: let’s say that on Day 1, an index starts with a value of 100 and a leveraged ETF that seeks to double the return of the index starts at $100. If the index drops by 10 points on Day 1, it has a 10 percent loss and a resulting value of 90. Assuming it achieved its stated objective, the leveraged ETF would therefore drop 20 percent on that day and have an ending value of $80. On Day 2, if the index rises 10 percent, the index value increases to 99. For the ETF, its value for Day 2 would rise by 20 percent, which means the ETF would have a value of $96. On both days, the leveraged ETF did exactly what it was supposed to do – it produced daily returns that were two times the daily index returns. But let’s look at the results over the 2 day period: the index lost 1 percent (it fell from 100 to 99) while the 2x leveraged ETF lost 4 percent (it fell from $100 to $96). That means that over the two day period, the ETF's negative returns were 4 times as much as the two-day return of the index instead of 2 times the return.

Things to Consider Before Investing

The best form of investor protection is to clearly understand leveraged or inverse ETFs before investing in them. No matter how you initially hear about them, it’s important to read the prospectus, which provides detailed information related to the ETFs’ investment objectives, principal investment strategies, risks, and costs. The SEC’s EDGAR system, as well as search engines, can help you locate a specific ETF prospectus. You can also find the prospectuses on the websites of the financial firms that issue a given ETF, as well as through your broker.

You should also consider seeking the advice of an investment professional. Be sure to work with someone who understands your investment objectives and tolerance for risk. Your investment professional should understand these complex products, be able to explain whether or how they fit with your objectives, and be willing to monitor your investment. Before investing in these instruments, ask:

- **How does the ETF achieve its stated objectives?** And what are the risks? Ask about—and be sure you understand—the techniques the ETF uses to achieve its goals. For example, engaging in short sales and using swaps, futures contracts, and other derivatives can expose the ETF—and by extension ETF investors—to a host of risks.
- **What happens if I hold longer than one trading day?** While there may be trading and hedging strategies that justify holding these investments longer than a day, buy-and-hold investors with an intermediate or long-term time horizon should carefully consider whether these ETFs are appropriate for their portfolio. As discussed above, because leveraged and inverse ETFs reset each day, their performance can quickly diverge from the performance of the underlying index or benchmark. In other words, it is possible that you could suffer significant losses even if the long-term performance of the index showed a gain.
- **Is there a risk that an ETF will not meet its stated daily objective?** There is always a risk that not every leveraged or inverse ETF will meet its stated objective on any given trading day. Be sure you understand the impact an investment in the ETF could have on the performance of your portfolio, taking into consideration your goals and your tolerance for risk.
- **What are the costs?** Leveraged or inverse ETFs may be more costly than traditional ETFs. Use FINRA’s Fund Analyzer (https://tools.finra.org/fund_analyzer/) to estimate the impact of fees and expenses on your investment.

- **What are the tax consequences?** Leveraged or inverse ETFs may be less tax-efficient than traditional ETFs, in part because daily resets can cause the ETF to realize significant short-term capital gains that may not be offset by a loss. Be sure to check with your tax advisor about the consequences of investing in a leveraged or inverse ETF.

As with all investments, it pays to do your own homework. Only invest if you are confident the product can help you meet your investment objectives and you are knowledgeable and comfortable with the risks associated with these specialized ETFs.

Additional Information

SEC Fast Answers, Exchange-Traded Funds (http://sec.gov/answers/etf.htm)

FINRA Regulatory Notice 09-31 (http://www.finra.org/Industry/Regulation/Notices/2009/P118953)

FINRA Compliance Podcast, Non-traditional ETFs (http://www.finra.org/Industry/Education/OnlineLearning/Podcasts/index.htm) (July 13, 2009)

FINRA Non-Traditional ETFs FAQ (http://www.finra.org/Industry/Regulation/Guidance/P119781)

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