

REVERSE inquiries

Structured and market-linked product news for inquiring minds.

Poor Supervision of Sales of Complex Exchange Traded Products

Broker-dealers must have in place, and implement, written supervisory policies designed to prevent unsuitable sales of complex exchange traded products to retail investors. Two recent regulatory actions illustrate how this guidance can be imperfectly applied.

In a recent Securities and Exchange Commission (“SEC”) cease and desist order (the “Order”), investment advisers (“RIAs”) registered under the Investment Advisers Act of 1940 (the “Advisers Act”) in a dual registered broker-dealer were found exercising their discretionary authority over their clients’ advisory accounts to purchase exchange-traded notes (“ETNs”) linked to short-term VIX futures and keeping these ETNs in the clients’ accounts for inappropriately long periods of time.¹

The ETNs were “designed to provide exposure to the implied volatility of the S&P 500 by replicating a strategy of continuously maintaining a rolling portfolio of one- and two-month futures contracts on the CBOE volatility index (the “VIX”).”² As fully disclosed in the prospectus for the ETN, the buying and selling of futures contracts created roll costs, which had a negative effect on the ETNs’ returns. Due to these roll costs, and the historical tendency for the futures contracts to be in “contango” (during which it is more expensive to replace the current futures contract with the new futures contract), the value of the ETN would, and did, decrease over extended periods, even if the VIX remained flat or positive during the same period. Consequently, these ETNs were an inappropriate investment for an investor with a “buy and hold” strategy.

This was well known in the broker-dealer arm of the firm. Indeed, there were internal communications on the broker-dealer side discussing how the ETN was an inappropriate investment if held for a period of greater than two days. Associated persons of the broker-dealer described the ETN as “only meant as an extremely short trading vehicle, not a way to hedge equity products.”³

However, this guidance (and the associated written supervisory procedures) on the broker-dealer side of the firm did not prevent the RIAs from purchasing the ETNs for their advisory clients, and holding the ETNs for

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¹ The Order is available at: <https://www.sec.gov/litigation/admin/2021/ia-5781.pdf>.

² See the Order at 2.

³ See the Order at 4.

long periods of time, many for over one year. The supervisory procedures for the RIAs were focused more on concentration limits, rather than holding periods. The monitoring system was also faulty, in that after the ETN's CUSIP changed due to a reverse stock split, holdings of the ETNs in the RIAs advisory accounts were not monitored for a period of five years. Even then, the system did not look back at the clients' holding periods of the ETNs during the preceding five years, but started counting days from when the system was fixed. According to the SEC, these procedures were not reasonably designed to prevent holding period risk.

In addition to the concerns regarding the supervisory procedures, some of the RIAs did not understand the appropriate use of the ETNs, with a misunderstanding of the investment time horizon. As stated in the Order, the RIAs "could not make a reasonable determination as to whether [the ETN] was a suitable investment for their clients. ... [the RIAs] could not determine whether it was reasonable to hold [the ETN] for extended periods as a hedge against a potential market downturn or other unpredictable future events."⁴

The failure of the firm to require the RIAs to adopt and implement written policies and procedures to prevent violations of the Advisers Act and its rules were violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

In a separate matter, the Financial Industry Regulatory Authority, Inc. ("FINRA") disciplined one of its member firms in a letter of acceptance, waiver and consent relating to the failure to establish and maintain a supervisory system reasonably designed to achieve compliance with the firm's suitability obligations in connection with sales of non-traditional and volatility-linked exchange traded products.⁵ Non-traditional and volatility-linked exchange traded products ("ETPs") are described by FINRA as "complex products intended to be held for short periods of time as part of a trading strategy rather than as buy-and-hold investments."⁶ FINRA has advised its members that non-traditional ETPs are not suitable for retail investors who plan to hold them for more than one trading session.⁷

As a FINRA member, the broker-dealer was required, under FINRA Rule 3110(a), to establish and maintain a system to supervise the activities of each associated person, which system is reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA rules. The broker-dealer's supervisory obligations included establishing a reasonable system to supervise for compliance with FINRA Rule 2111 (Suitability), under which the firm and its associated persons must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer.

Although the broker-dealer did adopt written procedures requiring it to conduct a reasonable basis suitability review of each non-traditional ETP that it offered and to establish written supervisory guidelines for each product, no suitability reviews were conducted, and the written supervisory guidelines were not produced. A portion of the non-traditional ETP transactions were reviewed only on an ad hoc basis. The firm did not have systems in place to identify non-traditional ETPs. Instead, supervisory principals conducted a manual review, which required them to recognize the ticker symbol for each non-traditional ETP. All inverse leveraged ETPs

⁴ See the Order at 7.

⁵ The Letter of Acceptance, Waiver and Consent (the "FINRA Letter") can be found at: <https://bit.ly/3jNmZ0t>.

⁶ See the FINRA Letter at 1.

⁷ See the FINRA Letter at 2, citing FINRA Regulatory Notice 09-31.

escaped review under this system, as did many leveraged ETPs. Consequently, customers held these ETPs for inappropriately long periods of time.

Last, the registered representatives were not trained to understand the features of non-traditional ETPs, despite a requirement for such training in the firm's written supervisory procedures.

As a result, unsuitable recommendations of non-traditional ETPs were made to customers, without the registered representatives understanding that these products were only meant to be held on a short-term basis. The customers held the ETPs for long periods of time, incurring losses.

The broker-dealer was found to be in violation of FINRA Rule 3010(a) (Supervision), 2010 (Standards of Commercial Honor and Principles of Trade) and 2111 (Suitability).

Conclusion

Inverse, leveraged and inverse leveraged exchange-traded products have been a focus of regulators for years. Sales of these types of products to investors with a buy and hold viewpoint regularly bring negative attention to the industry. Given this, firms recommending and selling these products need to have in place and consistently enforce written supervisory procedures designed to prevent sales to investors who do not understand exactly how these products work.

Index Providers Move Away from LIBOR

Several of the larger index providers have published consultations or other publications about removing IBORs from their indices. A number of indices, particularly those with a volatility or risk control theme, have a "cash" element, typically three-month USD LIBOR. Some of the index methodologies for these types of indices have LIBOR fallback provisions to a replacement rate, while others would have to be amended to change out the USD LIBOR component.

Each of S&P Dow Jones Indices LLC ("S&P"), MSCI Inc. and IHS Markit, published consultations requesting feedback from market participants on an appropriate replacement rate. Wherever an IBOR was used in an index, the relevant risk-free replacement rate was suggested as an alternative. For example, the SOFR was the suggested replacement for USD LIBOR, while the Euro Short-Term Rate ("ESTR") was suggested as a replacement for EURIBOR. The desirability of a forward-looking risk-free term rate was expressed in these consultations as a replacement for a similar tenor of the IBOR, while it was noted in at least one publication that daily SOFR would be a suitable replacement for overnight USD LIBOR.⁸

Since these original publications, MSCI announced on August 19, 2021 that it has amended eleven methodologies to replace LIBOR and EONIA in the MSCI indices. S&P issued a further consultation on July 28, 2021, in which it sought further market feedback and also stated that the IBOR replacements would be effective as of the October 2021 rebalancing. In that consultation, S&P stated that USD LIBOR would be replaced with SOFR, overnight and term.

⁸ See generally S&P Dow Jones Indices FAQ LIBOR Transition (Mar. 2021) at: [FAQ: LIBOR Transition](https://www.spglobal.com/faq-libor-transition) (spglobal.com); S&P Dow Jones Indices' Consultation on Potential Replacement Rates for Key London Interbank Offered Rates – Updated (July 28, 2021) at: <https://bit.ly/3CsJCPu>; Consultation on the Potential Replacement Rates for LIBOR and EONIA in the MSCI Indexes (Dec. 2020) at: [PowerPoint Presentation](https://www.msci.com/powerpoint-presentation) (msci.com); and IHS Markit – Findings and Request for Feedback (Jul. 2020) at: <https://bit.ly/3GvxAau>.

Term SOFR is here; where is the joy?

On July 29, 2021, the Alternative Reference Rates Committee (“ARRC”) formally recommended the CME Group’s forward-looking term SOFR rates (“Term SOFR”).⁹ For the floating rate note market, this seemed to be a perfect replacement for LIBOR. Term SOFR is forward-looking, like LIBOR, allowing the interest rate and payment to be determined well in advance of the interest payment date, without the complicated compounding formulae required to transform daily SOFR into a term rate in arrears. A spread could be used to make up for the other differences between LIBOR and SOFR.

The ARRC made several statements about their view of the best uses of Term SOFR:

- The ARRC supports the use of Term SOFR for the business loan market, particularly multi-lender facilities, middle market loans, trade finance loans and certain securitizations;
- The ARRC does not support the use of Term SOFR for most derivative transactions. Term SOFR should be used only for end-user facing derivatives intended to hedge cash products that reference Term SOFR;
- The ARRC supports Term SOFR in the replacement fallback waterfall in existing USD LIBOR floating rate notes, and as the first SOFR rate that would be recommended by the ARRC under Article 18-C of the New York General Obligations Law; and
- For new floating rate notes, the ARRC recommends overnight SOFR and SOFR averages.¹⁰

These statements are somewhat disappointing for those looking forward to using Term SOFR in new issuances of floating rate notes. We will have to await market developments and practices to see if issuers (particularly corporates) start issuing Term SOFR floating rate notes.

Chair Gensler’s Statement on Exchange-Traded Products

Over the years, there have been many SEC and FINRA statements warning of issues relating to sales of inverse, leveraged exchange traded notes and exchange traded funds (together, “ETPs”) to retail investors. In 2015, the SEC issued a request for comment on ETPs, but took no subsequent action.

On October 4, 2021, SEC Chair Gary Gensler directed the SEC Staff to study the potential risk of complex ETPs and to present recommendations for potential rule making proposals to address those risks. Chair Gensler referenced the various SEC and FINRA warnings about leveraged and inverse ETPs, and also noted that even sophisticated investors are potentially at risk. He also stated that simply because these products meet the NYSE listing standards, it does not mean that they are right for all investors.

It seems like rules governing ETPs are on the horizon. Chair Gensler said, in his statement, “I believe that potential rulemaking could strengthen the investor protections around these products.”¹¹

⁹ [ARRC Press Release Term SOFR.pdf](#), (newyorkfed.org).

¹⁰ See generally ARRC Best Practices Relating to the Scope and Use of the Term Rate at: [ARRC Scope of Use.pdf](#), (newyorkfed.org).

¹¹ Chair Gensler’s statement is available at: [SEC.gov | Statement on Complex Exchange-Traded Products](#).

FINRA 2210: Frequently Asked Questions About Advertising Regulation Updates

In February 2021, FINRA released its report on its Examination and Risk Monitoring Program (see Mayer Brown's [REVERSEInquiries Newsletter, Volume 04, Issue 02](#)); it addressed Communications with the Public, FINRA Rule 2210. The report reminds firms that all communications must be fair, balanced and not misleading, and explain, if applicable, associated risks. It also reflects FINRA's concerns relating to the use of digital communications and digital assets. On September 30, 2021, FINRA updated its "Frequently Asked Questions ("FAQs") About Advertising Regulation" to provide further guidance. These updates include additions in Section D., "Content Standards," and also updated Section F., "Public Appearances."

The FAQs cover other issues, but the following focuses on areas of interest to the structured products industry.

Section D. Content Standards

D.5 USE OF HYPERLINKS IN ELECTRONIC COMMUNICATIONS

D.5.1 Q. Does FINRA Rule 2210(d)(1)(A) permit a firm to include in electronic communications hyperlinks to content that provides additional information related to the communication in a fair and balanced manner?

The response by FINRA states that yes, a firm can use a hyperlink to provide additional information or explanations. This is permitted if the initial communication itself that contains the hyperlink is consistent with FINRA Rule 2210(d)(1)(A), which requires firm communications to be fair, balanced and not omit any material fact or qualification that would make the communication misleading. FINRA's response clarifies that a firm may not use linked information to correct a misleading, exaggerated or promissory communication (FINRA Rule 2210(d)(1)(B)). Additionally, within the communication, the text that introduces the link or the link itself should, to the extent practicable, explain what will be provided in the link.

The response also mentions FINRA's previous interpretations of Rule 2210 to permit hyperlinks to provide further information, including using hyperlinks within banner advertisements in order to generate interest and provide further information. FINRA Rule 2210 also permits firms to link to required information about testimonials. FINRA notes that their treatment of hyperlinks is similar to the SEC's recent Investment Adviser Marketing rule; the SEC's release states that this rule is closely related to FINRA's use of "fair and balanced" in Rule 2210 standards.

D.7 PROHIBITION ON PREDICTIONS OR PROJECTIONS OF INVESTMENT PERFORMANCE

D.7.1 Q. May a firm include in a private placement communication a "target return" if the communication also includes assumptions and key risks underlying the return?

In response, FINRA states that, consistent with FINRA Rule 2210(d)(1)(F), firms cannot include metrics that reflect targeted returns to investors in communications regarding private placements. That rule prohibits predictions or projections of performance, implications that past performance will recur, and exaggerated or unwarranted claims, opinions or forecasts. FINRA claims that targeted returns promote assumed receipt of

future cash flows by investors and warns that forward-looking cash flows may have unknown risks and uncertainties, and that actual performance may differ from projections.

Section F. Public Appearances

F.1 SUPERVISION

F.1.2 Q. Our firm's registered representatives may meet with groups either in person or using online conferencing platforms. How should firms supervise these meetings?

FINRA states that firms must supervise registered representatives' live meetings with customers, both online and in-person. They must do so in a way that follows relevant securities laws and FINRA rules. In their response, FINRA specifically cited Rule 2210(f), which sets supervision and content standards for public appearances, such as various forms of public speaking activities that are not retail communications or institutional communications or correspondence.

F.1.3 Q. If a registered representative uses visual aids, such as a whiteboard or dynamic charts, or a chat or instant messaging feature during a live, unscripted online conference, how should a firm supervise these aspects of the presentation?

FINRA states that it depends on the number of persons, nature of the meeting, and the purpose of these visual aids. Visual aids may be considered correspondence, retail communications or institutional communications and must comply with applicable FINRA standards. For instance, under Rules 2210(a), 2210(b) and 3110(b)(4), content must also comply with standards set in FINRA Rule 2210(d).

FINRA provides three examples:

- 1) If a representative meets with less than 25 retail investors and uses the chat feature online for a live question and the content of the chat is defined as correspondence (see FINRA Rule 2210(a)(2)), the firm must review the chat under FINRA Rule 3110(b) and 3110.06 through 3110.09.
- 2) If in a meeting of more than 25 retail investors, a representative uses the chat feature to post an electronic file of a new mutual fund, this is considered a retail communication under FINRA Rule 2210(a)(5). The firm must also submit the electronic file within ten business days to FINRA's Advertising Regulation Department, as required by FINRA Rule 2210(c)(3), since it promotes a registered investment company. However, if in a similar meeting, a representative responds to the audience using a whiteboard feature, such as showing differences between a bond and stock, it would also be considered a retail communication under FINRA Rule 2210(a)(5). Although it would not have to be approved prior to use because the whiteboard content was created and posted during an online interactive electronic forum, it would be reviewed under the supervising rules (FINRA Rule 3110(b) and 3110.06 through 3110.09).
- 3) If a broker-dealer of ETFs hosts a webinar attended by 100 other broker-dealers and the distributor uses an interactive poll and then shows the results to the attendees, this would be deemed an institutional communication under FINRA Rule 2210(a)(3). The poll would need to be reviewed under the firm's supervisory procedures that comply with Rule 2210(b)(3).

F.1.4 Q. If a third party, such as a fund distributor or program sponsor, presents information or speaks with clients during a presentation, either in person or using an online conferencing platform, during which a representative of a broker-dealer also speaks or presents, what must the representative disclose about that third party?

In reference to FINRA Rule 2210(f)(1), in unscripted public appearances, persons associated with broker-dealers must follow the standards of FINRA Rule 2210(d)(1). The registered representative should clearly explain the intent of the meeting, the identity of the third party, whether a third party paid for the meeting and the relationships between the parties.

F.1.5 Q. If our registered representatives use communications with the public that direct customers to in-person or online presentations hosted by a third party, what supervision requirements apply?

Under FINRA Rule 2210, firms are responsible for third-party content if it is adopted or entangled with the content. If a firm directs investors to third-party presentations relating to securities or other products, FINRA considers the firm to have adopted the content. If it also includes involvements such as paying for, arranging for, or being involved in the presentation in another manner, the firm would still be responsible even if they did not direct customers to the event, as the firm would have been entangled with the presentation. FINRA reiterates that the event would need to comply with its content and supervision standards.



As of October 4, New 2021 ISDA Definitions Are Now In Effect

For more, read "***Updating MTN Program Disclosures for the 2021 ISDA Definitions***" in our [REVERSEinquiries Newsletter, Volume 04, Issue 03](#).

Events

UPCOMING

- **Where are we now and where are we going? The Transition Away from IBORs** | November 10, 2021 | *Registration link forthcoming*

Here we are at the eleventh hour of the transition away from IBOR, with the looming December 31, 2021 date. With that in mind, this REVERSEinquiries Workshop intends to provide a recap of where we currently stand and what is to be expected in the shift. Our speakers will cover the following:

- An overview of current trends and developments with the IBOR transition;
- SOFR notes, CME Term SOFR Licensing;
- Status of tough legacy contract legislation in the US, UK, and EU;
- The ARRC's fallback recommendations related to LIBOR;
- The path to Synthetic LIBOR; and
- Tough old gut: EONIA to ESTR and Fed Funds to SOFR in ISDA Credit Support Annexes.

IN CASE YOU MISSED IT...

- **Financing Alternatives for Banks** | October 27, 2021 | [Materials](#)
- **Advanced Swaps & Other Derivatives 2021** | October 19 - 20, 2021, *Hosted by PLI* | [Recording](#)
- **Fundamentals of Swaps & Other Derivatives 2021** | October 18, 2021, *Hosted by PLI* | [Recording](#)
- **Requirements of Regulators Around the World – UK, EU, Asia, & US** | September 30, 2021 | Part 2 of Mayer Brown's LIBOR Transition Series
- **SRP Americas Conference 2021** | September 28 - 30, 2021 | [Recording](#)
- **IBOR Transition: an introduction to conduct risk** | September 16, 2021 | Part 1 of Mayer Brown's LIBOR Transition Series
- **SOFR Deals** | September 13, 2021 | [Materials](#), [Recording](#)

GlobalCapital Derivatives Awards

Mayer Brown is pleased to have been named **European Law Firm of the Year – Transactions** at *GlobalCapital's* **GLOBAL DERIVATIVES 2021 AWARDS**, following our win earlier this year as **US Law Firm of the Year – Regulatory** at *GlobalCapital's* **AMERICAS DERIVATIVES AWARDS 2021**. This is the second year in a row we have received both European and US transactional awards and the sixth consecutive time *GlobalCapital* has recognized Mayer Brown at its Global and Americas Derivatives Awards.

ANNOUNCEMENTS



Capital Markets Tax Quarterly. Mayer Brown's Capital Markets Tax Quarterly provides capital markets-related US federal tax news and insights. In our [latest issue](#), we cover Info Letter 2020-0033, Cum-Ex developments, tax changes in Biden's American Jobs Plan and American Families Plan, the Corporate Transparency Act, and more.

Derivatives Blog: *The Long and Short of It.* Mayer Brown has launched "[The Long and Short of It](#)," a blog providing comment and analysis on the latest legal and regulatory developments in derivative products.



You'll find everything from topical ISDA developments and the divergence between EU and UK derivatives regulation post-Brexit, to derivatives regulatory capital issues, to US and Asia derivative regulatory developments and the implementation of global margin rules. Mayer Brown lawyers in Asia, Europe and the US make regular contributions. Content ranges from detailed and technical to practical and digestible, appealing to both product specialists and generalists.

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At the Crossroads: CFTC and DOJ Enforcement

At the Crossroads: CFTC and DOJ Enforcement. "[At the Crossroads: CFTC and DOJ Enforcement](#)" is a video series hosted by Mayer Brown partners, Matt Kluchenek and Glen Kopp. In each episode, the two discuss a topic at the intersection of enforcement by the Commodity Futures Trading Commission (CFTC) and the Department of Justice (DOJ). *The goal:* help legal and compliance departments protect their organizations in an increasingly rigorous regulatory environment.



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Suggestions? REVERSEinquiries is committed to meeting the needs of the structured and market-linked products community, so you ask and we answer. Send us questions that we will answer on our LinkedIn anonymously or topics for future issues.



To request to join the LinkedIn group or to send us suggestions/comments, scan this QR code with your phone's camera, which will notify us via email at REVERSEinquiries@mayerbrown.com.

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