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

FINRA™

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.