Regulatory Notice 20-14

Oil-Linked Exchange-Traded Products

Sales Practice Obligations With Respect to Oil-Linked Exchange-Traded Products

Summary

Exchange-traded products (ETPs) provide different types of exposure to the oil market through several product structures, which some investors or investment professionals might not understand.[1] Moreover, the performance of such products may be linked to unfamiliar indices or reference benchmarks, making them difficult for the average investor to comprehend. In particular, a number of these ETPs are designed to track daily price movements of specified crude oil futures contracts, such as those on West Texas Intermediate (WTI) light, sweet crude oil (referred to herein as "oil-linked ETPs").[2] Due to recent extraordinary conditions in crude oil markets, combined with the manner in which the products are structured, several oil-linked ETPs have experienced significant volatility and lost a substantial percentage of their value, with at least one ETP liquidating and another forced to halt the issuance of new shares and adjust its investment objective.

These concerns are not limited to oil-linked ETPs: some other commodity-linked products, such as natural gas ETPs, as well as volatility-linked ETPs, may share similar features and have been the subject of prior FINRA guidance and regulatory action.[3] Based on FINRA's experience with complex products broadly, some investors—as well as investment professionals recommending them—may not understand oil-linked ETPs' investment objectives, how their performance relates to the "spot" (or cash) price of oil, or how the different product structures can impact their performance and the investor experience.[4]

This *Notice* reminds firms of their sales practice obligations in connection with oil-linked ETPs, including that recommendations to customers must be based on a full understanding of the terms, features, and risks of the product recommended; communications with the public must be fair and accurate; firms must have reasonably designed supervisory procedures in place to ensure that these obligations are met; and firms that offer oil-linked ETPs must train registered representatives who sell these products about the terms, features and risks of these products.

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Notice Type

- Guidance

Suggested Routing

- Legal and Compliance
- Registered Representatives
- Retail
- Senior Management

Key Topics

- Communications with the Public
- Oil-Linked Exchange-Traded Products
- Suitability
- Supervision
- Training

Referenced Rules & Notices

- FINRA Rule 2111
- FINRA Rule 2210
- FINRA Rule 3110
- Notice to Members 05-26
- Regulatory Notice 09-31
- Regulatory Notice 10-51
- Regulatory Notice 12-03
- Regulatory Notice 17-32
- SEC Regulation Best Interest

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Background and Discussion

Given the practical difficulties of investing directly in commodities such as oil, commodity-linked ETPs often track commodity futures or futures indices rather than the underlying spot commodity. As with other commodity-linked ETPs, such as those linked to natural gas, oil-linked ETPs generally provide exposure to the price of oil by tracking oil futures through two different ETP structures—ETNs and commodity pools.

Oil-linked ETNs, which are debt obligations of an issuer and do not hold any underlying portfolio, promise to pay the note holder a return linked to the performance of an index at note maturity. ETN issuers have significant discretion in the creation (*i.e.,* issuance) of new notes as well as note redemption (*e.g.,* early termination), which can impact the performance that a note holder experiences and the extent to which the market price of the note reflects its value.[5]

In contrast to ETNs, commodity pools do hold an underlying portfolio of futures (or other commodity interests). While similar to ETFs, a commodity pool ETP has unique structural features that can introduce additional risks. For example, a commodity pool ETP must update its registration statement with the SEC once every three years and must file a new registration statement for new shares if the existing share limit under the effective registration statement is reached. An ETP structured as a commodity pool also may be subject to position limits in terms of the number of futures contracts that it may hold or issues related to margin. These features can limit the ETP's ability to create shares, which can result in a tendency for the ETP's market price to deviate from the underlying value of the ETP, or cause the ETP to change investment holdings (*e.g.,* using different futures contracts or swaps).

As lockdowns related to the coronavirus disease (COVID-19) remain in force, oil demand has declined precipitously and excess storage capacity has reportedly decreased significantly as well, pushing crude oil prices to record lows. Recently the June 2020 WTI crude oil futures contract fell 43 percent to close at $11.57 per barrel—only one day after the expiring May 2020 WTI contract price dropped below zero and settled at *minus* $37.63 per barrel.[6] This plunge in market value has significantly impacted ETPs tracking WTI futures.

For example, as of April 22, 2020, the largest oil-related ETP had lost 41 percent of its value in one week. This ETP also subsequently adjusted its investment focus from near-dated futures to longer-dated contracts.[7] Reports suggest that retail investors have been investing in oil-linked ETPs during this volatile period. Surging investor demand for this oil-linked ETP in particular led to a dramatic increase in new share issuance, which ultimately exhausted the number of available shares permitted to be issued under the ETP's existing registration statement.

As a result, this ETP was unable to issue new shares until a new registration statement was filed with the SEC and became effective. With its normal share creation mechanism non-operational, there have been significant variations between the market price at which shares are traded and the shares' net asset value.

Separately, the issuer of another oil-related ETN tracking WTI futures announced an early liquidation.[8] Leveraged and inverse oil-linked ETPs that seek to deliver multiples or the opposite of the return of an oil-linked index likewise have been extremely volatile during these market conditions.

Experience with similar complex products suggests that some retail investors and investment professionals recommending oil-linked ETPs, including commodity pools and ETNs, may have mistakenly thought that these ETPs are a proxy for the spot price of oil, when in fact their investment objectives are to track oil futures contracts.[9] Rather than tracking the spot price, oil-linked ETPs generally provide exposure to oil by tracking short-term or other oil futures or futures indices. These ETPs may track or hold futures contracts on a rolling basis, meaning that they will replace shorter-term contracts or contracts about to expire with contracts that have more distant or deferred expiration dates in order to maintain the desired exposure.

An ETP whose objective is to provide exposure to the near-month futures contract may roll out of the near-month contract as it approaches expiration and into the next-month contract over a series of days. If the prices of futures contracts with more distant expiration dates are higher than those with shorter dates, the market is often said to be in "contango." Other things being equal, rolling out of shorter-term contracts into longer-term contracts in such a market can lead to losses. If the opposite is true, the market is often said to be in "backwardation," and rolling out of shorter-term contracts into longer-term contracts can lead to gains.

The oil futures market has experienced both periods of backwardation and contango over the last decade. Over longer time horizons, these features of the futures market can be a factor that leads to a divergence in the performance of a futures-linked ETP and that of the spot commodity, and in some cases that divergence can be significant. Recently, the oil futures market has been in "super-contango," as oil storage capacity has diminished, which can exacerbate losses to investors who hold oil-linked ETPs for extended periods of time.

Sales Practice Obligations

Over the years, FINRA has published guidance to firms about the risks of recommending complex products, such as oil-linked ETPs, to retail customers, particularly buy-and-hold retail investors with an intermediate- or long-term time horizon. *Regulatory Notice 10-51* reminded firms of their sales practice obligations with regard to commodity futures-linked securities.[10] That *Notice* discussed the volatility of oil prices and the risk that commodity futures-linked securities can perform differently than the spot price for the commodity itself, which can lead to unexpected results for investors who do not understand the product or who mistakenly believe the product will replicate the performance of the commodity's spot price. *Regulatory Notice 12-03* addressed similar issues in the context of complex products generally.[11]

As detailed in *Regulatory Notice 12-03*, investments tied to the performance of securities, indices, commodities or markets that may not be well known or well understood by investors, such as oil-linked ETPs, are "complex" products. Firms should review *Regulatory Notice 12-03* and consider whether to use the type of heightened scrutiny and supervision suggested therein for these complex products.[12] Firms are similarly reminded that they must comply with the obligations discussed below when offering oil-linked ETPs.

Suitability and Regulation Best Interest

FINRA Rule 2111 (Suitability) requires a firm or associated person making a recommendation to have a reasonable basis to believe that the recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. Two of the main suitability obligations delineated in Rule 2111 that are particularly relevant to oil-linked ETPs are customer-specific and reasonable-basis suitability.

Customer-specific suitability requires a firm or its associated persons to have a reasonable basis to believe that a recommendation is suitable for a particular customer based on the customer's investment profile, including the customer's investment experience, risk tolerance, liquidity needs, investment objectives, and financial situation and needs.[13] For example, depending on the facts and circumstances, an oil-linked ETP might be suitable for an experienced customer with a speculative investment objective, but it likely would not be suitable for a less experienced customer or a customer with a more conservative or a buy-and-hold investment objective.

Reasonable-basis suitability requires that the firm or associated person recommending a securities transaction or investment strategy involving securities perform reasonable diligence to understand the nature of that transaction or strategy, as well as potential risks, and then determine whether there is a reasonable basis to believe, based on the reasonable diligence, that the recommendation is suitable for at least some investors. The level of reasonable diligence that is required will rise with the complexity and risks associated with the transaction or strategy.

With regard to a complex product such as an oil-linked ETP, an associated person should be capable of explaining, at a minimum, the product's main features and associated risks.[14] These would include, for example, understanding generally how products tracking futures contracts or futures indices work, how contango and backwardation may affect their performance, and how such products may perform relative to the spot asset (*e.g.,* oil), especially over extended periods of time.

Oil-linked ETPs may employ various strategies (*e.g.,* focusing on short-term futures versus more diversified exposure), so understanding the differences among the various offerings is important as well. Some products are designed to be used more tactically—on a shorter-term basis—such as geared (*i.e.,* leveraged or inverse) ETPs, and such products would be particularly unsuitable for customers intending to buy and hold securities. An associated person should understand the differences in product structures (*e.g.,* commodity pool versus ETN) and how the structural features of different ETPs may present additional risks (*e.g.,* suspension of new issuance or accelerated termination).

Starting on June 30, 2020, recommendations of securities, including oil-linked ETPs, to retail customers will be governed by SEC Regulation Best Interest ("Reg BI").[15] Reg BI enhances firms' standard of conduct beyond existing suitability obligations by, among other things, requiring firms to act in the retail customer's best interest at the time the recommendation is made, without placing the financial or other interests of the firm ahead of the interests of the retail customer.[16] Firms should ensure that any recommendations of oil-linked ETPs made after the compliance date comply with their Reg BI obligations.

Communications with the Public

FINRA Rule 2210 (Communications with the Public) requires, among other things, that all communications with the public be based on principles of fair dealing and good faith, be fair and balanced, and provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service. Communications regarding oil-linked ETPs that present the benefits of the products must be balanced by a clear description of the risks, and may not omit any material fact or qualification that would cause such a communication to be misleading. For example, communications that present the benefits of oil-linked ETPs must include key risks such as the inherent fluctuations of oil prices and the speculative nature of futures investments, and must explain clearly that the ETP's price will not track directly the spot price of oil.

Communications that present the benefits of oil-linked ETPs or other investments that rely on futures must explain how the investment may be impacted by contango and backwardation. Further, communications concerning an ETP that is designed to achieve its investment objective on a short-term basis (*e.g.,* daily) must state that fact and specifically disclose that the ETP is not designed to, and will not necessarily, track the underlying index or benchmark over a longer period of time. FINRA reminds firms that providing risk disclosure in a separate document such as a prospectus does not cure otherwise deficient disclosure in sales material, even if the sales material is accompanied or preceded by the prospectus.

Supervision

FINRA Rule 3110 (Supervision) requires that firms establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. A reasonably designed system must be tailored specifically to a member's business, taking into account among other things, the nature and complexity of the products offered and the customer base.

Oil-linked ETPs are complex products that could be easily misunderstood and improperly sold by registered representatives. As discussed in *Regulatory Notice 12-03* and noted above, firms should consider whether to use heightened scrutiny and supervision of these ETPs. Firms must act reasonably to ensure that their registered representatives and supervisors understand the risks presented by such products.

Training

Firms that offer oil-linked ETPs must train registered persons about the terms, features and risks of these products, as well as the factors that would make such products either suitable or unsuitable for certain investors, particularly retail investors.[17] Training should emphasize the need to understand and consider the risks associated with such products, including the investor's time horizon, and the impact of time and volatility on the ETP's performance. Training should emphasize that, due to the complexity and structure of these products, they may not perform over time in direct correlation to their underlying index or benchmark. Additionally, when recommending complex products such as oil-linked ETPs, firms and associated persons should consider whether less complex or less costly products could achieve the same objective for their customers.

Conclusion

Oil-linked ETPs are complex products that may not be suitable for some investors, such as retail investors with conservative investment objectives and long time horizons. Given the heightened risks that these products raise, firms must be diligent in ensuring that their sales of these products are consistent with the requirements under the suitability, communications and supervision rules, and beginning on June 30, 2020, their obligations under Reg BI, as well as other applicable rules and requirements. Firms are reminded of their obligation to put reasonably designed supervisory controls in place, and to train their registered representatives and supervisors to ensure that suitability and other obligations under FINRA and SEC rules are met.

Endnotes

1. An ETP is a security listed on an exchange that seeks to provide exposure to the performance of an index, benchmark, or actively-managed strategy. The most common type of ETP is the exchange- traded fund (ETF). ETFs are registered under the Investment Company Act of 1940 (1940 Act), and are organized under the laws used for the issuance and governance of mutual funds. Other ETPs, which are not registered under the 1940 Act, include commodity pools, which invest in futures, grantor trusts, which hold physical commodities or currencies, and exchange-traded notes (ETNs), which track an index or benchmark but are debt obligations of an issuer and hold no underlying portfolio. While ETPs are often referred to as exchange-traded "funds" or "ETFs," there are important differences among the various legal or tax-related structures that are used across the product range—and such differences have implications for investors and product issuers. All ETPs are registered under the Securities Act of 1933 and Securities Exchange Act of 1934, but different ETPs may be subject to different regulatory requirements and oversight by different Securities and Exchange Commission (SEC) divisions or the Commodity Futures Trading Commission depending on their particular structures. Moreover, there is no universally-accepted comprehensive naming framework for the products. Differences among the various ETP structures include the asset classes in which portfolios may invest, how portfolios are constructed, use of derivatives and securities lending, when and if distributions are reinvested, and how taxes are assessed.

2. For the purposes of this *Notice*, "oil-linked ETPs" include ETPs that seek to provide exposure to oil as an asset as represented by investments in exchange-traded crude oil futures contracts and ETNs that are designed to provide exposure to an oil-linked futures price index.

3. *See, e.g.*, *Regulatory Notice 10-51* (October 2010) (Sales Practice Obligations for Commodity Futures-Linked Securities) and *Regulatory Notice 17-32* (October 2017) (FINRA Reminds Firms of Sales Practice Obligations for Volatility-Linked Exchange-Traded Products).

4. *See* Cadaret, Grant & Co., Inc., Securities Act Release No. 10542, 2018 SEC LEXIS 2239 (Sept. 11, 2018).

5. For a discussion of the risks of investing in ETNs, including the risk of early termination, *see* FINRA Investor Alert, "Exchange-Traded Notes – Avoid Unpleasant Surprises" (July 10, 2012).

6. *See* "Collapse in Oil Prices Deepens, Dragging Down Markets Globally," *The Wall Street Journal*, April 22, 2020, p. A1.

7. *See* "Oil Wagers Burn Some Individual Investors," The Wall Street Journal, April 22, 2020, p. B1.

8. *See* "Oil Wagers Burn Some Individual Investors," *The Wall Street Journal*, April 22, 2020, p. B13; *see also* Barclays press release, "Barclays announces the redemption of the iPath® Series B S&P GSCI® Crude Oil Total Return Index ETNs (the "ETNs") and the suspension of further sales and issuance of the ETNs," (April 20, 2020).

9. *See* Kate Rooney, "Young investors rush into struggling oil ETF that isn't even tracking the price of oil anymore" (April 23, 2020), available at www.cnbc.com.

10. *See* *Regulatory Notice 10-51* (October 2010) (Sales Practice Obligations for Commodity Futures-Linked Securities). Notice 10-51 addressed firms' obligations with regard to suitability, communications with the public, supervision and training.

11. *See* *Regulatory Notice 12-03* (January 2012) (Heightened Supervision of Complex Products).

12. *See id*.

13. A customer's investment profile also includes the customer's age, other investments, tax status, investment time horizon, and any other information the customer may disclose to the member or associated person in connection with such recommendation. *See* FINRA Rule 2111(a).

14. FINRA notes, as well, the importance of vetting of new products, particularly new products that are complex or have potentially high levels of risk associated with them. *See, e.g.,* *Regulatory Notice 05-26* (April 2005) (NASD Recommends Best Practices for Reviewing New Products) (highlighting best practices for vetting new products), and *Regulatory Notice 09-31* (June 2009) (FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds) (concerning the obligation to vet new complex and non-traditional ETFs).

15. 17 CFR 240.15l-1; *see also* Securities Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019).

16. Under Reg BI, a "retail customer" is a natural person or the legal representative of the natural person, who (i) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer, and (ii) uses the recommendation primarily for personal, family, or household purposes. 17 CFR 240.15l-1(b)(1). A retail customer may include a natural person who falls within the definition of "institutional account" under FINRA Rule 4512(c) (*e.g.,* a natural person with total assets of at least $50 million), and thus previously was excluded from the customer-specific suitability requirements of FINRA Rule 2111 under specified conditions.

17. *See* *Notice to Members 05-26* (April 2005) (NASD Recommends Best Practices for Reviewing New Products).