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SEC Imposes First Fines In Exchange-Traded Product Probe

By **Al Barbarino**

Law360 (November 13, 2020, 10:13 PM EST) -- The U.S. Securities and Exchange Commission levied $3 million in fines against five firms for what it called unsuitable sales of complex, volatility-linked exchange-traded products on Friday, the first actions announced as part of its so-called exchange-traded products initiative.

The firms' offering documents made clear that the short-term nature of the products made them susceptible to declines in value "when held over a longer period," yet "contrary to these warnings, and without understanding the products," the representatives recommended that clients hold them for months and even years.

The orders also find that the firms failed to adopt policies and procedures to ensure that their representatives understood the products enough to recommend them.

"It is important for firms to put the appropriate protections in place to ensure complex products are properly evaluated and understood by their representatives. Failing to do so puts investors at risk," said Stephanie Avakian, director of the SEC's enforcement division, in a statement. "We take these failures seriously, and we will continue to look for sales that expose customers to unsuitable investments."

The firms are American Portfolios Financial Services/American Portfolios Advisors Inc., Benjamin F. Edwards & Co. Inc., Royal Alliance Associates Inc., Securities America Advisors Inc., and Summit Financial Group Inc.

The civil penalties include $650,000 each against American Portfolios and Benjamin Edwards; $500,000 for Royal Alliance; and $600,000 each for Securities America and Summit Financial Group.

The products in question, which attempt to track short-term market volatility, fall into a bucket of complex investments that SEC Chairman Jay Clayton and three agency division directors flagged in an Oct. 28 joint statement as presenting potential "investor protection issues ... for retail investors who may not fully appreciate the particular characteristics or risks of such investments."

"The SEC seems to think firms are getting it wrong across the market," said Kurt Wolfe, a Troutman Pepper attorney focused on securities enforcement and regulation. "This shows they're prepared to bring cases, and I think we'll continue to see developments in this space."

While enforcement cases relating to exchange-traded products have been few and far between and the SEC did not formally announce the new initiative outside of Friday's order, industry attorneys had been waiting for "the shoe to drop," Wolfe said.

"People who provide either regulatory counsel or who represent registered advisers and broker-dealers have heard rumblings about this," he said. "But it has come somewhat swiftly."

SEC actions targeting exchange-traded products in recent years have targeted perceived knowledge gaps regarding the investments, both on the part of the firms and their representatives as well as the investing public.

Those included a **$35 million SEC settlement** with Wells Fargo on Feb. 27. Similar to Friday's orders, the SEC said Wells Fargo's brokers and advisers recommended unsuitable investments because they "did not fully understand the risk of losses these complex products posed when held long term."

In an **$8 million settlement** with Morgan Stanley in February 2017, the SEC said its policies and procedures were not adequate enough to "ensure that clients understood the risks" involved with potentially volatile exchange-traded products.

And in a **$15 million settlement** in September 2016 with UBS Financial Services, the SEC again took aim at alleged failures to educate sales staff regarding the complexities of another type of complex financial product: stock-linked reverse convertible notes.

The exchange-traded products initiative is headed up by the Division of Enforcement's complex financial instruments unit and was developed by Armita Cohen, a former senior counsel in the unit who now serves as counsel to SEC Commissioner Caroline A. Crenshaw, along with two agency data analytics specialists, the SEC said.

The SEC did not respond to requests seeking comment.

American Portfolios, Benjamin F. Edwards and Summit Financial did not immediately respond to requests for comment. Securities America Advisors and Royal Alliance Associates could not be immediately reached.

The agency is represented in-house by Nicholas A. Brady, Matthew B. Homberger, Kristopher Heston, Elisabeth Goot, Brendan McGlynn, Osman Nawaz, Kelly Rock, Margaret Y. Rubin, Trevor Schumacher, Jeffrey Shank, Thomas Silverstein, Andrew Sporkin, Danielle R. Srour and Jeffrey Weiss.

American Portfolios is represented by Rob Moses of Lax & Neville LLP.

Benjamin F. Edwards is represented by Steven Malina of Greenberg Traurig LLP.

Summit Financial Group is represented by Ellen Wheeler of Foley & Lardner LLP.

Securities America and Royal Alliance are represented by Steve Wastek of Advisor Group Inc.

The settlement orders against are filed as Securities and Exchange Commission administrative proceedings under case numbers 3-20149, 3-20150, 3-20151, 3-20152 and 3-20153.

--Editing by Adam LoBelia.
