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Insights

FINRA STRESSES THE NEED FOR HEIGHTENED SUPERVISION OF NON-TRADITIONAL EXCHANGE-TRADED FUNDS

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FINRA recently provided additional guidance on firms' obligations to actively supervise the trading and performance of non-traditional exchange-traded funds ("NTETFs") within their customers' accounts. Specifically, in a settlement order dated May 18, 2020 (the "Order"), FINRA found a bank-affiliated introducing broker-dealer (the "Firm") violated FINRA Rules 3110(a), 3110(b), and 2010 by failing to "establish, maintain and enforce a supervisory system, including written supervisory procedures that were reasonably designed to ensure compliance with Rule 2111" in relation to solicited sales of NTETFs by its registered representatives. As a result, the Panel censured the Firm, imposed a $50,000 fine, and ordered a restitution payment of $584,466.13 in addition to the $445,836.27 the Firm had already voluntarily returned to impacted customers.

As is standard in FINRA settlement Orders, the Firm neither admitted nor denied FINRA's findings, but merely consented to the entry of the Order.

The matter arose out of the Firm's alleged failure to maintain and enforce a system of supervisory procedures reasonably designed to achieve compliance with FINRA's suitability rules. According to the Order, the Firm executed approximately 252 solicited NTETF transactions in 95 retail customer accounts totaling over $2.8 million in principal funds. In 2016, the Firm released a compliance bulletin prohibiting the solicitation of both buy and sell NTETF transactions, but continued to allow its representatives to accept unsolicited sell orders for NTETFs if they liquidated an existing position. While this action eliminated the risk of customers purchasing additional NTETFs and holding them for extended periods, the Firm still had over 300 existing NTETF positions in its customer accounts as of January 1, 2018. Many of these positions had, according to FINRA, sustained significant unrealized losses which the Firm failed to address.

Approximately 60 of the open NTETF positions were solicited, and more than half of the solicited positions had lost value. Prior to the conclusion of FINRA's investigation, the Firm voluntarily offered the customers who held solicited positions the opportunity to sell their existing NTETF positions and any resulting loss would be compensated by the Firm. As a result, the Firm paid $445,836.27 to thirty customers who, on average, held their NTETF positions for 1,136 days. The

Firm then made the same offer to customers who had previously purchased NTETFs on a solicited basis and sold them at loss. Consequently the Firm paid an additional $138,629.86 to fifty-seven customers who, on average, held their NT-ETF positions for 90 days.

According to the Order, the Firm's supervision of NTETFs was insufficient to protect its customers from avoidable losses. The Firm's written supervisory procedures recognized NTETFs could be inefficient and problematic long-term investments and required the positions to be monitored by the representative, supervising principal, and the Firm's Central Supervision group. Yet, the Firm allegedly did not provide representatives and supervisors with reasonable guidance on how to determine whether an NTETF was suitable given the unique features and risks associated with these products. The Order also noted the Firm's supervisory procedures did not require a customer-specific suitability analysis for NTETF positions held for periods longer than one day, and the Firm was unable to produce evidence that such an analysis was actually conducted. Further, FINRA found that the Firm did not have an automated alert/exception report system in place to assist in monitoring NTETF holding periods. Consequently, the Firm was found to have violated FINRA Rules 3110(a), 3110(b), and 2010 and ordered to pay a $50,000 fine and additional restitution.

In determining appropriate sanctions, FINRA explicitly gave credit to significant remedial steps taken by the Firm. These remedial measures included the Firm's 2016 decision to voluntarily cease selling NTETFs and its voluntary payment of $445,836.27 in restitution to impacted customers identified through its own investigation prior to the opening of a FINRA enforcement action.

This Order reinforces FINRA's ongoing guidance that firms must implement sufficient supervisory safeguards to counter the heightened risks and complexities of NTETF securities. FINRA has previously advised broker-dealers that NTETFs "are typically not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets" and cautioned member firms to establish reasonable NTETF supervisory systems and procedures and ensure their registered brokers are trained on the terms, features and risks of all NTETF products they sell. (See FINRA Regulatory Notice 09-31).

Undoubtedly, this Order should serve as a reminder to firms that FINRA has, and will continue to, put significant focus on the suitability of NTETF trades and holding periods. Accordingly, firms engaged in trading NTETFs should carefully review and revise their supervisory systems and procedures to ensure that NTETFs are being traded in accordance with FINRA's guidance.

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