Leveraged and Inverse ETFs: Trojan Horses for Long-Term Investors
Executive Summary

Leveraged and inverse Exchange Traded Funds ("ETFs") are designed by their issuers as tactical trading instruments. They require constant vigilance and rebalancing and thus are not appropriate as strategic positions for buy-and-hold investors.

By prospectus, leveraged and inverse ETFs are required to maintain a constant leverage ratio. This creates what is known as the “constant leverage trap”, whereby an ETF can change into a Trojan Horse if held for even short time periods. In this scenario, a leveraged or inverse ETF can destroy portfolio performance from within, even if the investor is correct about the direction of movement of the underlying investment.

While leveraged and inverse ETFs can be suitable investments for active traders looking to speculate or hedge existing positions, they are designed for daily or intraday holding periods.

Supervisors and compliance personnel overseeing retail investment accounts need to be aware of the dangers of holding these investments for longer than one day and must implement procedures that protect investors from their misuse. They should also document recommendations to hold leveraged and inverse ETFs for periods of longer than one day.

ETF Background

ETFs can be broadly understood as mutual funds that trade like a stock on an exchange. More technically, an ETF is an open-ended investment fund, which means that as more people invest in it, more units are created, and, conversely, as investors sell the ETF, more units are redeemed. In short, this process means that the price of an ETF is primarily determined by the change in the value of its underlying investments and not the supply and demand of its shares.

The primary advantages of ETFs are:

> **Transparency.** ETFs list their holdings daily;

> **Liquidity.** ETFs can be traded intra-day and thus are generally considered more liquid than mutual funds, which trade at the end of each business day;

> **Tax efficiency.** Because of the way ETF shares are continually created and redeemed by what are known as authorized participants in the primary market, investors establish a unique cost basis at purchase. This is vastly superior to investing in mutual funds, where the investor buys into a pool of investments that can have a very low cost basis (resulting in higher embedded capital gains);

> **Lower fees.** According to Morningstar, in 2010, the average ETF expense ratio was 0.6%, compared to 0.73% for index mutual funds and 1.45% for actively managed mutual funds.³ ²

The first ETF was introduced in Canada in 1990.³ ETFs have experienced exponential growth in popularity since then, with global assets under management of roughly $1 billion in 1995 growing to $66 billion in 2000, $608 billion in 2007, and $1,048 billion in 2011.⁴ Furthermore, on September 30, 2012, there were 3,297 different ETFs listed globally.⁵

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⁴ Abner, A Visual Guide to ETFs, 262.
⁵ Id. at 534.
The phenomenal asset growth of ETFs has been partially driven by their broad adoption by registered representatives and investment advisors (hereafter referred to collectively as “advisors”). However, this growth can be attributed to many factors, not least of which was the simplicity of the first generation of ETFs as an investment vehicle. The original ETFs were relatively easy for industry professionals to understand.

This is not true of leveraged and inverse ETFs, which are complex, designed for one-day holding periods, and which are required, by prospectus, to maintain a constant leverage ratio that then requires daily internal rebalancing.

Furthermore, because of their risky nature, leveraged and inverse ETF strategies have remained exotic plays within the ETF universe. In an April, 2011 report by Merrill Lynch, leveraged and inverse ETFs made up only 3.11 percent of the ETF total market. This has held true as a 2012 report from Blackrock showed that leveraged and inverse ETFs made up only a few percent of the entire ETF marketplace.

The Misuse of ETFs

When leveraged and inverse ETFs were introduced in 2006, the new products were generally misunderstood by advisors and subsequently misused in investor portfolios, resulting in many unnecessary losses and eventual litigation. As will be discussed below, this misunderstanding led to these ETFs being held longer than one day which frequently changed them into portfolio Trojan Horses.

In response to the widespread misuse of leveraged and inverse ETFs, the Financial Industry Regulatory Authority, Inc. (“FINRA”) issued Regulatory Notice (“RN”) 09-31 in June 2009. This RN stated:

… (these products) 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. (Emphasis added)

Many advisors who were familiar with unleveraged, long-only, ETFs had bought and held leveraged and inverse ETFs, under the mistaken belief they were the same as their traditional brethren. As FINRA 09-31 makes plain, this assumption was wrong. Whereas traditional ETFs were appropriate for a long-term buy and hold strategy, leveraged and inverse ETFs were not meant to be held for longer than one day.

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6 ETFs: Beyond the basics, Bank of America Merrill Lynch, April 20, 2011, 4.
Advisors that bought and held inverse and leveraged ETFs for their clients had not understood what they were selling, and thousands of customers were damaged because of it. This is particularly remarkable considering there were many warnings sounded in the mainstream and financial press as well as by academics and regulators, about leveraged and inverse ETFs, some of which I have included in the literature review below.

Prospectus Review

From their inception, leveraged and inverse ETFs have self-described their investment objectives as the daily positive or negative multiple of the underlying investment performance. I have provided prospectus extracts describing the investment objectives of a number of different leveraged and inverse ETFs from different times, below:

> **August 30, 2006. ProShares S&P SmallCap 600.** “Seeks daily investment results, before fees and expenses, that correspond to the inverse (opposite) of the daily performance of the S&P SmallCap 600 Index.”\(^\text{10}\) (Emphasis added)

> **August 30, 2006. ProShares Ultra Russell 2000.** “Seeks daily investment results, before fees and expenses, that correspond to twice (200%) the daily performance of the Russell 2000 Index.”\(^\text{11}\) (Emphasis added)

> **September 28, 2007. ProShares Short S&P 500.** “Seeks daily investment results, before fees and expenses, that correspond to the inverse (opposite) of the daily performance of the S&P SmallCap 600 Index.”\(^\text{12}\)

> **September 28, 2007. ProShares Ultra Dow30.** “Seeks daily investment results, before fees and expenses, that correspond to twice (200%) the daily performance of the Dow Jones Industrial Average (DJIA).”\(^\text{13}\)

After the financial crisis of 2008 the ETF disclosures became even more explicit regarding the daily return investment objective:

> **ProShares Short S&P500.** “The Fund seeks daily investment results, before fees and expenses, that correspond to the inverse (opposite) of the daily performance of the Index. **The Fund does not seek to achieve its stated investment objective over a period of time greater than one day.**”\(^\text{14}\) (Emphasis in the original);

> **ProShares Ultra Dow30.** “The Fund seeks daily investment results, before fees and expenses, that correspond to twice (200%) the daily performance of the Index. **The Fund does not seek to achieve its stated investment objective over a period of time greater than one day.**”\(^\text{15}\) (Emphasis in the original).

What is remarkable is that despite these clear self-descriptions, many advisors did not understand the negative implications of ETFs seeking daily leveraged or inverse investment results.

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\(^\text{10}\) ProShares Prospectus; available at [http://www.sec.gov/Archives/edgar/data/1174610/000119312506182367/d485apos.htm#tx22507_2](http://www.sec.gov/Archives/edgar/data/1174610/000119312506182367/d485apos.htm#tx22507_2); accessed June 27, 2013. 106.

\(^\text{11}\) Id. at 300.

\(^\text{12}\) Id. at 22.

\(^\text{13}\) Id. at 12.

\(^\text{14}\) Id. at 134.

\(^\text{15}\) Id. at 12.
Furthermore, all inverse and leveraged ETF strategies engage in the use of leverage, which is described by prospectus as a speculative technique. The PowerShares prospectus states the following:

Each Fund intends to use, on a regular basis, leveraged investment techniques in pursuing its investment objectives. Utilization of leverage involves special risks and should be considered to be speculative.16

Lastly, the impact of internal ETF rebalancing to maintain a constant leverage ratio is discussed at length in the post-2008 prospectuses. In discussing these risks (which they refer to as “compounding”), ProShares writes:

(The deviation of ETF returns from underlying index returns) is caused by compounding, which exists in all investments, but has a more significant impact in a leveraged fund. In general, during periods of higher index volatility, compounding will cause longer term results to be less than three times (or minus three times) the return of the index. This effect becomes more pronounced as volatility increases… Similar effects exist for Short ProShares.

Daily objective leveraged funds if used properly and in conjunction with the investor’s view on the future direction and volatility of the markets can be useful tools for investors who want to manage their exposure to various markets and market segments and who are willing to monitor and/or periodically rebalance their portfolios. But investors considering these funds should understand that they are designed to provide a positive or negative multiple of an index on a daily basis and not for greater periods of time. As a result, fund returns will not likely be a simple multiple (e.g., 3x, -3x) of an index’s return for time periods longer than one day.

Additionally, investors should recognize that the degree of volatility of the underlying index can have a dramatic effect on a fund’s longer-term performance. The greater the volatility, given a particular index return, the greater the downside deviation will be of a fund’s longer-term performance from a simple multiple (e.g., 3x, -3x) of its index’s longer-term return. As shown in the first example, it is even possible that a fund may move in opposite direction as the index.17 (Emphasis added)

Despite these clear explanations regarding the intended daily use of leveraged and inverse ETF, advisors did not understand them.

16 Id. at 18. Also, for more on speculation, see the ETF Specific Suitability section, below.
17 Id. at 327.
Sidebar: “Mirrored” Volatility in the S&P 500 Index

It is important to understand that in almost any market scenario, there are usually up and down market movements of approximately equal magnitude from day to day. As an example, in a sharply declining bear market, there will typically be dramatic up days, and in sharply rising bull markets, dramatic down days.

In markets that are trending more gradually, this mirrored volatility is also true, but with smaller moves.

In Chart 1, below, the mirrored nature of market volatility can be easily seen. The colored lines show daily percentage moves in the market and the black line shows the daily value of the S&P 500 Index.

CHART 1. 18

What is remarkable is that the mirrored volatility phenomenon stays true through bear, bull and trending markets, including: the bursting of the technology bubble from 2000 through 2002; the up trend recovery from 2002 through 2007; the financial crisis of 2008 and 2009; and the recovery after that.

For leveraged and inverse ETFs, this can spell disaster. If these instruments are held longer than a day (especially in volatile markets) they are likely to take large losses as the fund’s internal rebalancing mechanism works against them. This phenomenon explains how a leveraged or inverse ETF can lose money even if the market moves in the direction favorable to the holder.

18 Data obtained from Yahoo! Finance. Dotted Reference lines show range of one standard deviation of daily S&P 500 returns: -1.38% to 1.38%. Data from May 1, 2000 through May 31, 2010.
How ETFs Maintain Constant Leverage Through Internal Rebalancing

In order to understand how ETFs maintain constant leverage, as well as the negative implications of constant leverage, it is important to first understand how a simple margin account uses leverage without having to maintain constant leverage.

In the following three examples we will examine how inverse ETFs work by comparing them to a simple margin account short position.¹⁹

Scenario 1: Margin Account Short Position

<table>
<thead>
<tr>
<th>DAY</th>
<th>UNDERLYING RETURN</th>
<th>ACCOUNT RETURN</th>
<th>CASH</th>
<th>INVESTMENT</th>
<th>EQUITY</th>
<th>LEVERAGE RATIO</th>
<th>ACTION REQUIRED TO KEEP LEVERAGE RATIO CONSTANT</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>—</td>
<td>—</td>
<td>200</td>
<td>(100.0)</td>
<td>100</td>
<td>-1.00</td>
<td>—</td>
</tr>
<tr>
<td>1</td>
<td>10%</td>
<td>-10%</td>
<td>200</td>
<td>(110.0)</td>
<td>90</td>
<td>-1.22</td>
<td>N/A</td>
</tr>
<tr>
<td>2</td>
<td>-10%</td>
<td>10%</td>
<td>200</td>
<td>(99.0)</td>
<td>101</td>
<td>-0.98</td>
<td>N/A</td>
</tr>
<tr>
<td>3</td>
<td>10%</td>
<td>-10%</td>
<td>200</td>
<td>(108.9)</td>
<td>91</td>
<td>-1.20</td>
<td>N/A</td>
</tr>
<tr>
<td>4</td>
<td>-10%</td>
<td>10%</td>
<td>200</td>
<td>(98.1)</td>
<td>102</td>
<td>-0.96</td>
<td>N/A</td>
</tr>
</tbody>
</table>

In Scenario 1, we assume that an investor has opened a margin account at a brokerage, deposited $100 in cash, and immediately sold short a security for another $100. This starting position can be observed in the first row, where: Cash (Column D) is $200; Investment (Column E) is -$100; Equity (Column F) is the sum of Cash and Investment (D and E); the Leverage Ratio (Column G) is the quotient of Investment and Equity (E and F); the Day is reflected in Column A; the Underlying Return is given in Column B; and the Account Return is in Column C.

At the outset, the Leverage Ratio is negative one. However, in the first day, the Underlying Return is positive 10 percent. This is a bad start for our imaginary account owner, because she is short and thus wants the investment to go down. The positive Underlying Return causes the Account Return to move in the exact opposite direction, down 10 percent.

Inside the account, the Cash position stays the same ($200), but the short position gets bigger ($110), thus the Equity in the account declines to $90 ($200-$110), and the Leverage Ratio increases to -1.22 ($110/$90).

Importantly, because this is a margin account, there is no requirement to keep the Leverage Ratio constant.²⁰ Thus, the Leverage Ratio is allowed to fluctuate.

After four days in Scenario 1, the time weighted return is zero (the sum of the Underlying Returns), but the account Equity grows by two percent because of the timing of the returns (the leverage ratio is higher when the Underlying investment moves in the account holders favor).

¹⁹ Numbers may not be exact due to rounding.

²⁰ If the Underlying investment kept increasing (and thus the Equity decreasing) there would eventually be a maintenance call or Regulation T margin call requiring the client to deposit additional funds or securities, or to close out the short position. However, these potential call scenarios serve only as a potential upper bound to the Leverage Ratio and do not come into play in our example.
In Scenario 2, we can clearly see how the requirement to keep the Leverage Ratio at 1 turns into the “Constant Leverage Trap”. The daily returns are identical to those in Scenario 1, but we have added an additional row showing the results of the ETF’s management rebalancing at the end of each day.

For example, in Day 1, the Underlying Return is 10 percent and the ETF Return is negative 10 percent. This takes the Leverage Ratio to -1.22. As the markets near the close, the ETF manager is required to buy back $20 of the short position (Column G) to bring the Leverage Ratio back to one. This requirement forces the ETF manager to buy high and lock in losses. The ETF manager does this by using $20 of Cash to buy back $20 of the Investment. The result is that Cash is reduced to $180 ($200-$20), the Investment is reduced to -$90 (-$110+$20) and the Leverage Ratio comes back to -1 (-$90/$90). (Equity remains unchanged by the intraday rebalancing by the manager.)

In Day 2, the gears reverse. The Underlying Return is negative 10 percent, and the ETF Return is positive 10 percent. This takes the Leverage Ratio to -0.82. As the markets near the close, the ETF manager is required to sell $18 more of the short position to bring the Leverage Ratio back to one. This forces the ETF manager to sell low. The ETF manager effectuates this by selling $18 of the Investment. The result is that Cash is increased to $198 ($180 + $18), the Investment is increased to -$99 (-$81 – $18), and the Leverage Ratio comes back to -1 (-$99/$99). As before, Equity remains unchanged by the intraday rebalancing by the manager.

Scenario 1 and Scenario 2 can now be compared over the four days evaluated. Both scenarios involved the same return assumptions. The only difference was the requirement of the ETF to maintain a constant leverage ratio of -1. The result is four full percentage points of underperformance.

The margin scenario resulted in a two percent gain and the Inverse ETF scenario resulted in a two percent loss. The cause of this underperformance is purely the constant leverage trap.
In Scenario 3, the effect of maintaining constant leverage in a 2X leveraged inverse ETF is similar in direction to that of the inverse ETF (Scenario 2), but much more extreme in its result.

Under the same market conditions, the equity in the 2X leveraged inverse ETF declines by 30 percent, whereas the margin scenario saw a gain of two percent and the unleveraged inverse ETF saw a decline of two percent. This dramatic decline is due to the addition of more leverage and the maintenance of constant leverage.

If the returns in Scenario 3 seem extreme, they are not. The performance of two and three times leveraged ETFs can be even more destructive of owner equity. Indeed, in RN 09-31, FINRA cites a number of examples of leveraged and inverse ETFs where investor capital was severely impaired in a matter of months:

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.21

Note that some of the ETFs cited had precipitous declines even though the underlying investment moved in a favorable direction for the ETF.

The rebalancing mechanism examined in the tables above show the Trojan Horse potential of leveraged and inverse ETFs that are required to maintain constant leverage. For intraday or one-day holders, the rebalancing is benign. However, the longer they are held, and the more leverage utilized, the more the rebalancing works against the holder.

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Literature Review

Financial Press

Leading up to the financial crisis which climaxed in the fall of 2008 and spring of 2009, there were many articles in the mainstream and financial press about the problems with leveraged and inverse ETFs. I have included some extracts from a number of them below:

April 2, 2007. “Leveraged ETFs: A Value Destruction Trap?” – Seeking Alpha. Co-authors Yates and Kok write that: “The Constant Leverage Trap is a well-known problem in financial modeling. Attempting to maintain a constant leverage ratio in a portfolio over a long period of time will eventually lead to the portfolio selling off almost all of its assets in the worst of market conditions. This problem was largely academic until recently, when two companies, ProShares and Rydex launched a set of leveraged ETFs that seek to track double the return of the S&P 500 Index.”22 (Emphasis added)

May 17, 2007. “The Case Against Leveraged ETFs” – Seeking Alpha. Co-authors Yates and Kok summarize that: “(1) many investors are misled by these leveraged ETFs and believe that they’ll get twice the daily return of the underlying index over the long term; (2) even just looking at X2 funds as a theoretical concept, the idea has some problems; (3) the current ETFs do not even deliver twice the daily performance of the underlying index; (4) investors should compare these new ETFs to the leveraged funds that were offered by these same companies seven years ago, because the long-term performance will most likely be similar.”23

August 20, 2007. “Living with Leverage” – Forbes. Tristan Yates writes: “What if the investor simply tried to maintain a low, but constant, level of leverage over time? This simple strategy is actually used by many leveraged funds and exchange traded funds (ETFs), but has hidden dangers. These funds are marketed based on their predictability—for example, in a two-times leveraged fund or ETF, a 1% rise in the daily value of the S&P creates a 2% rise in the value of the fund. Unfortunately, that ratio doesn’t hold over time, and given periods of several years, these funds often lag the underlying index upon which they are based.

The problem is that when the market declines significantly, the fund has less equity compared to assets and the leverage ratio goes up. The fund then has to sell some of its assets and pay down its debt. Given the cyclical nature of markets, the strategy leads to funds buying lots of shares during market highs and then selling them during market lows.”24 (Emphasis added)

May 21, 2008. “Triple Your Returns? Don’t Bet on It” – The Motley Fool. Author Dan Caplinger writes that: “Because of the tracking error that tends to build up over time, leveraged ETFs aren’t really suited for buy-and-hold investors. As with many get-rich-quick ideas, the reality can fall well short of your hopes.”25 (Emphasis added)

Academic and Industry Publications

Most of the academic and industry literature on leveraged and inverse ETFs was written after the financial crises of 2008. I have included extracts from a number of academic and industry sources below:

October 7, 2009. Rebalancing Act: A Primer on Leveraged and Inverse ETFs – NERA Economic Consulting. “In fact, prior to the market crash in late 2008, the average month-long deviation (from the underlying index performance) for one particular leveraged ETF, the ProShares Ultra S&P 500 ETF, was 0.27% (3.24% annualized)...”

November 2009. Rebalancing Leveraged and Inverse Funds – ProFund Advisors LLC and ProShare Advisors LLC. “(Writing that in order to neutralize the inherent destructive nature of maintaining constant leverage inside leveraged and inverse ETFs, investors need to actively manage those positions by frequently rebalancing them in the market.) “We found that: rebalancing was an effective way to get close to the stated multiple times the index return over time. The benefits of rebalancing were most significant during high-volatility periods... Inverse strategies and high-volatility indexes generally called for more frequent rebalancing... For inverse strategies, the (rebalancing frequency needed) was from about every two weeks for lower-volatility indexes to as often as once a week for more volatile indexes.”

2010. Leveraged ETFs, Holding Periods and Investment Shortfalls – Securities Litigation & Consulting Group. “It is possible for an investor in a leveraged ETF to experience negative returns even when the underlying index has positive returns... We find that investors in leveraged and inverse ETFs can lose 3% of their investment in less than 3 weeks, an annualized cost of 50%.”

2010. Three Essays in Investments: Financial Risk Tolerance and Leveraged and Inverse Exchange Traded Funds – Hunter Holzhauer. “Leveraged and inverse ETFs are specifically designed to return a multiple of their underlying benchmark index. Consequently, these funds must rebalance their holdings on a daily basis to prevent leverage from becoming too excessive. However, this daily rebalancing has significant consequences. First, these ETFs will always be chasing their own position, which implies that they will buy high and sell low. This phenomenon is known as the constant leverage trap.” (Emphasis added)

April 20, 2011. ETFs: Beyond the basics – Bank of America Merrill Lynch. “In our view, leveraged ETFs generally should be used only by sophisticated investors for short-term (one day), tactical trades and investors should understand how positions held for more than one day can deviate from expectations.”

27 Hill and Teller, Rebalancing Leveraged and Inverse Funds, ProFund Advisors LLC and ProShare Advisors LLC; November 2009; 2.
28 Guedj, Li, and McCann, Leveraged ETFs, Holding Periods and Investment Shortfalls, 2010, 1.
30 See supra note 6 at 6.
Regulatory Publications

Regulators have observed the negative effects of ETFs maintaining constant leverage and have issued educational articles with warnings. Some of these are included below:

- **August 18, 2009. Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors – Securities and Exchange Commission, The Office of Investor Education and Advocacy.** “Most leveraged and inverse ETFs ‘reset’ daily, meaning that they are designed to achieve their stated objectives on a daily basis. Their performance over longer periods of time – over weeks or months or years – can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time. This effect can be magnified in volatile markets. As the examples below demonstrate, an ETF that is set up to deliver twice the performance of a benchmark from the close of trading on Day 1 to the close of trading on Day 2 will not necessarily achieve that goal over weeks, months, or years.”

- **2009. What You Should Know About Exchange Traded Funds – NYSE Informed Investor.** “At the time of this publication, all leveraged and inverse ETFs are designed to generate daily returns that are a positive or negative multiple of the daily return of a specified index. They are not designed to match the return for a holding period that is longer than the objective stated in the prospectus. Therefore, the daily compounded return of a leveraged ETF over one year, one month, one week, or even a two-day period may be significantly different from the returns produced by simply applying the stated multiple to the index’s total holding period return. Daily monitoring and adjustment (buying and selling) by the investor could modify the return to match its stated objective over time.

  Daily leveraged ETFs may be unsuitable for investors who seek an intermediate-term or long-term holding period. Instead, this type of leveraged ETF may be better suited to traders who wish to increase or hedge their market exposure over a short period of time.”

**Suitability**

The concept of suitability can be succinctly stated as appropriately matching investments to the investor. In order to accomplish a suitability determination, a broker must know and understand both the investments and the investor. Given that the FINRA suitability rule has recently been updated to explicitly include both elements, both will be examined.

**FINRA Rule 2010 (Standards of Commercial Honor and Principals of Trade)**

Before addressing suitability it is worth noting that FINRA Rule 2010 sets forth the standard for member conduct. This Rule states simply:

A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.

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While not a fiduciary standard, FINRA is clearly setting the bar beyond mere arms length transactions and *caveat emptor*. This standard should be kept in mind by member firms and their associated persons in all their dealings with customers and other member firms.

**FINRA Rule 2310 (Recommendations to Customers)**

During the initial popularity of leveraged and inverse ETFs in 2006-2007, Registered Representatives (hereafter “brokers”) working for FINRA member firms, were required under Rule 2310 to insure each recommendation made to a client was “suitable”. FINRA Suitability Rule 2310 stated (in part):

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

1. the customer’s financial status;
2. the customer’s tax status;
3. the customer’s investment objectives; and
4. such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.  

In order to comply with FINRA Rule 2310, the broker must know her client. In order to know her client, a broker must conduct the necessary due diligence by gathering all the pertinent facts, goals, objectives, and circumstances of the client. In the industry, this process is known as “profiling”.

Similarly, in order to know an investment, a broker must conduct the necessary due diligence by reading the prospectus, prospectus supplements, statements of additional information, and other documents, depending on the type of investment being recommended.

Once the broker knows her client and many different investments, she can go about selecting investments that are within the client’s risk tolerance and investment objectives and will help achieve her client’s goals and objectives.

Importantly, if either side of the suitability due diligence equation is not completed, the recommendation cannot be said to be suitable. More specifically, if the broker does not know the client or the investment, or both, then she cannot have “reasonable grounds” for believing the recommendation is suitable.

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FINRA Rule 2111 (Suitability)

On July 9th, 2012, FINRA updated Rule 2310 with a new suitability rule, 2111. FINRA Rule 2111 states, in part:

(a) A member or an associated person must have a reasonable basis to believe that a 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. A customer’s investment profile includes, but is not limited to, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.  

Although a full analysis of the changes in the suitability rule is beyond the scope of this paper, there are a few aspects worth highlighting: the explicit inclusion of investment strategies; the explicit description of the three components of the suitability obligation; and the treatment of a recommendation to hold as a recommendation.

As will be discussed, all three of these aspects existed before the new suitability rule, with Rule 2111, FINRA has merely brought them together in one place. This has greatly simplified the rule for brokers and broker-dealer firms and should lead to better supervisory practices and customer outcomes.

Investment Strategies

The new suitability rule explicitly includes “investment strategies” as a possible recommendation. This language is important because many transactions, if viewed in isolation, might be deemed suitable but if viewed in the context of other transactions are unsuitable.

An example of this would be where a number of leveraged or inverse ETFs are purchased for a client and comprise a large portion of her investment assets. Any one of the transactions might represent only a small portion of the client’s assets, but taken together could represent a large portion or even a majority of the client’s assets. Viewing all the purchases together might make them all unsuitable.

36 See, for instance, FINRA RN 12-25, “FINRA reiterates, however, that many of the obligations under the new rule are the same as those under the predecessor rule and related case law. Existing guidance and interpretations regarding suitability obligations continue to apply to the extent that they are not inconsistent with the new rule.” (Emphasis added) May 2012, 2.
37 This is a classic investment example of the Fallacy of Composition, which simply posits that the traits and characteristics of an action or object often change when considered in aggregate. Take for example savings. Savings is good for the individual, but if everyone in a society saved and did not spend, the economy would collapse. This is also known as the “paradox of thrift.”
Importantly, the “investment strategies” language also applies to non-securities related recommendations. Examples include: the use of margin; borrowing against a house to fund investments;\(^{38}\) equity indexed annuities;\(^{39}\) and other insurance products such as whole life or universal life policies.\(^{40}\)

**Components of Suitability Obligations**

Under FINRA Suitability Rule 2111, there are three components to the suitability obligation: reasonable-basis suitability; customer-specific suitability; and quantitative suitability. Each will be discussed in turn.

As discussed above, the concept of suitability can be succinctly stated as appropriately matching investments to the investor. With Rule 2111, FINRA has now made both ends of this task explicit.

**Customer-Specific Suitability**

FINRA Rule 2310 clearly dealt with the customer and required that for each recommendation to a customer, “a member have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.”\(^{41}\)

The “basis of the facts, if any” language was essentially voided for retail clients under NTM 90-52, which imposed an affirmative duty upon the broker to profile the client.\(^{42}\) This modification was addressed originally in Article III, Sections 2 and 21 (c) of the Rules of Fair Practice\(^{43}\), and later in Rule 2310(b), which added the explicit requirements for the broker to gather basic information about non-institutional clients.

FINRA Rule 2111 continues the client profiling requirement (and incorporates the phrase “customer’s investment profile”) of Rule 2310(b) and adds more specific areas of inquiry. Most important among the new profiling questions are: the customer’s needs; the customer’s investment time horizon; the customer’s liquidity needs; and the customer’s risk tolerance.\(^{44}\)

While explicitly listing the new profiling questions in the Rule is helpful, they have been part of industry profiling practices for decades, if not longer. Indeed, most member firm New Account Forms have required the broker to inquire about the customer’s time horizon and risk tolerance as well as other aspects of their financial life.

Lastly, it is worth noting that FINRA has also incorporated the New York Stock Exchange (“NYSE”) Rule 405 into FINRA Rule 2090 (Know Your Customer). As with NYSE Rule 405, FINRA Rule 2090 is a due diligence based rule. Rule 2090 states:

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\(^{38}\) Using home equity to fund investments has been addressed by FINRA as an “investment strategy” at least as far back as December 2004 with NTM 04-89 “Liquifed Home Equity,” stating: “The Notice reminds members that recommending liquefying home equity to purchase securities may not be suitable for all investors...” 1.

\(^{39}\) See FINRA NTM 05-50, “Some EIAs are not registered under the Securities Act of 1933 (the Securities Act) based on a determination that they are insurance products that fall within that statute’s Section 3(a)(8) exemption and therefore are not considered to be securities.” August 2005, 1.

\(^{40}\) See FINRA RN 12-55, “The new suitability rule would continue to cover a broker-dealer’s or registered representative’s recommendation of an “investment strategy” involving both a security and a non-security investment. Suitability obligations apply, for example, to a broker-dealer’s or registered representative’s recommendation... to purchase an investment-related product that is not a security.” (Emphasis added) December 2012, 4. (See also FINRA RN 12-25 at 8, referencing previous Regulatory Notices and disciplinary actions.

\(^{41}\) See supra Note 33.


\(^{43}\) The Rules of Fair Practice was what the original NASD Manual was called. The numbering system was changed in May 1996.

\(^{44}\) See supra Note 34 and accompanying text.
Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.\textsuperscript{45}

Instead of approaching suitability by focusing on what is required for broker recommendations (as does Rule 2111), Rule 2090 approaches suitability by concentrating on the due diligence required for every customer relationship. Under Rule 2090, suitability is ensured by knowing and understanding the customer prior to account opening, and maintaining the account in accord with what is known.

Importantly, the “maintenance” language in Rule 2090 creates an ongoing requirement to know the customer. That is to say, the broker must continue to conduct her due diligence on the customer’s particular facts and circumstances during the lifetime of the relationship.

This is an important element of profiling as a customer’s life situation can change and thus require changes in her investments or strategies. As with the new profiling questions of Rule 2111, these have been an industry practice for decades, if not longer.

**Reasonable-Basis Suitability**

The reasonable-basis suitability component addresses how broker-dealers and their associated persons must perform due diligence on investments before they recommend them. The first level of due diligence is performed at the firm level and requires the member firm to first determine that the investment is at least suitable for some of its investors.\textsuperscript{46}

Methods employed by firms to determine this first level of suitability will “vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member’s or associated person’s familiarity with the security or investment strategy.”\textsuperscript{47}

The second reasonable basis suitability determination is carried out by the broker when she educates herself about the investment. This is how the broker comes to “know the investment”.

One of the primary goals of the reasonable basis suitability obligation is that:

\begin{quote}
A member’s or associated person’s reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy.\textsuperscript{48}
\end{quote}

As mentioned above, a failure to “know the investment” makes the recommendation unsuitable. FINRA clearly states this in the Supplementary Material to Rule 2111:

\begin{quote}
The lack of such an understanding (about the potential risks and rewards of the recommending security or strategy) when recommending a security or strategy violates the suitability rule.\textsuperscript{49}
\end{quote}

\textsuperscript{45} FINRA Rule 2090 (Know Your Customer); available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13389&element_id=9858&highlight=2090#r13389; accessed August 1, 2013.

\textsuperscript{46} See supra Note 34. FINRA Rule 2111 Supplementary Material .05 Components of Suitability Obligations.

\textsuperscript{47} Id. See also FINRA NTM 05-26 for suggested best practices for vetting new products.

\textsuperscript{48} Id.

\textsuperscript{49} Id.
Quantitative Suitability

The explicit quantitative suitability component highlights the potential for abuse in instances where accounts are “churned” by frequent purchases and sales of securities in order to generate excess commissions. As mentioned above, there can be instances where one trade, viewed in isolation could be suitable, but if made repeatedly, would change all the trades to unsuitable transactions. FINRA Rule 2111 addresses this potential head on, stating:

Quantitative suitability requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer’s investment profile, as delineated in Rule 2111(a).  

(Emphasis added)

The Rule also addresses common metrics used to evaluate churning:

No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer’s account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

Hold as a Recommendation

Advice to hold a security is now clearly considered a recommendation, and is captured in the “investment strategy” language of Rule 2111. FINRA RN 11-25 makes it clear that even recommendations which do not result in transactions come under the aegis of the Rule:

The rule explicitly states that the term “strategy” should be interpreted broadly. The rule would cover a recommended investment strategy regardless of whether the recommendation results in a securities transaction or even references a specific security or securities. For instance, the rule would cover a recommendation to purchase securities using margin or liquefied home equity or engage in day trading, irrespective of whether the recommendation results in a transaction or references particular securities. (Emphasis added)

50 Id.
51 Id.
52 Under NYSE Rule 472 (Communication with the Public) a hold was included in the definition of a recommendation. Under Rule 472.10/09: “For purposes of these standards, the term ‘recommendation’ includes any advice, suggestion or other statement, written or oral, that is intended, or can reasonably be expected to influence a customer to purchase, sell or hold a security.” (Emphasis added); available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=15076&element_id=11054&highlight=472#r15076; accessed August 1, 2013.
And then even more specifically:

The term also would capture an explicit recommendation to hold a security or securities. While a decision to hold might be considered a passive strategy, an explicit recommendation to hold does constitute the type of advice upon which a customer can be expected to rely. An explicit recommendation to hold is tantamount to a “call to action” in the sense of a suggestion that the customer stay the course with the investment. The rule would apply, for example, when an associated person meets with a customer during a quarterly or annual investment review and explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio. (Emphasis added).

Importantly, FINRA RN 12-25 addresses the documentation of hold recommendations, and highlights those involving leveraged and inverse ETFs:

For “hold” recommendations, FINRA has stated that a firm may want to focus on securities that by their nature or due to particular circumstances could be viewed as having a shorter-term investment component; that have a periodic reset or similar mechanism that could alter a product’s character over time; that are particularly susceptible to changes in market conditions; or that are otherwise potentially risky or problematic to hold at the time the recommendations are made.

Some possible examples could include leveraged ETFs (because they reset daily and their performance over long periods can differ significantly from the performance of the underlying index or benchmark during the same period)... (Emphasis added)

These requirements are in addition to the general obligation of member firms to evidence compliance with applicable FINRA rules.

Leveraged and inverse ETF hold recommendations need documentation because they are not meant to be held, and thus a hold recommendation would be a recommendation to use them in a manner for which they were not designed. In effect, the client needs to be put on notice as to the potential Trojan Horse in their portfolio.

ETF Specific Suitability

Leveraged and inverse ETFs are not suitable for most investors because they are (respectively) speculative and aggressive investments. In order to understand why these investments are speculative and aggressive it is helpful to define those terms.

Speculation is a term of art within the investment world and it has a very specific meaning, in particular, it indicates the high probability of the complete, or near complete, loss of the entire investment. A classic example of a speculative investment is purchasing an out-of-the-money (“OTM”) call option on a stock.

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54 The “call to action” standard is addressed in NASD NTM 01-23, which was issued in response to the proliferation of online trading firms putting out generic “tip sheets”, “top 10 lists” and other communications regarding stocks. The primary question this NTM addresses is whether or not these types of generic communication constitute a recommendation and thus would be subject to Rule 2310. In short, they do not. The guidance principles enumerated in NTM 01-23 were that: (1) the communication had to be a call to action on the part of the investor; and (2) the more tailored the communication was to an individual’s particular facts and circumstances, the more likely it was to be a recommendation. While generic tip sheets may constitute a call to action (buy these five stocks now!), they fail in the second criteria, and thus are not recommendations.

55 Id.

56 See supra Note 35 at A13.

57 See supra Note 52 at A10.
When you purchase an OTM call option, it has a fixed amount of time before it expires worthless. If the underlying stock does not rise above the strike price before the expiration date, the call option will become worthless and the investor will have lost the entire premium she paid for it.

Aggressive investments are also a term of art within the investment world. An aggressive investment is one in which there can be expected large and violent price movements, but which do not have a high likelihood of a total loss. A good example of an aggressive investment is an investment in a stock market index such as the S&P 500 or the NASDAQ index.

As recent investors in the above indices can attest, both have experienced extreme volatility over the past 14 years. Indeed, the S&P 500 declined approximately 45 percent twice and the NASDAQ declined approximately 70 percent and 50 percent over the same time period. While these investments are extremely volatile, they carry a much smaller risk of complete loss than a stock option, and thus are in a different category.

Additionally, the more speculative or aggressive an investment is, the more closely it must be watched and the more active management it requires. This is due to what is commonly referred to as “investment math”. If an investor holds an investment that declines by 50 percent and then rises by 50 percent, they are still down 25 percent on a dollar basis. The reason for this is that the positive 50 percent return came after the investment had already declined by 50 percent, so it was a 50 percent return on a “50 percent investment”. Thus that return was only 25 percent of the original investment.

A simple example is instructive. If an investor invests $100,000 and it declines to $50,000, a 50 percent return on the $50,000 only gets her back to $75,000. She is still down $25,000 on her original investment. What is needed is a 100 percent return after the original decline (because a 100 percent return on $50,000 is $50,000 and this would get her back to her original investment value).

This investment math is why investors who have been invested in the broad stock market since 2000 have the same portfolio value 13 years later. They suffered through two declines of around 50 percent and subsequent recoveries of around 100 percent but their portfolios are at the same approximate value as when they started.

Using broad asset allocation rebalancing on a quarterly or annual basis is a way to more actively manage aggressive positions. However, more frequent management may be warranted given an investment’s specific traits. In particular, leveraged and inverse ETFs require constant vigilance and frequent (even daily) rebalancing by the advisor if they are held longer than one day.

As addressed above, leveraged ETFs are speculative because the use of leverage magnifies the deleterious effects of internal rebalancing to maintain constant leverage. Chart 2, below, illustrates the negative effects of maintaining constant leverage in an ETF. Simply put, the more leverage used, the faster the ETF declines towards zero.
Prospectus Delivery and Suitability

A final word is required on suitability. FINRA has been, and remains, crystal clear in its position that the delivery of a prospectus to a client does not cure an otherwise unsuitable recommendation nor any material misstatements or omissions that were made during the recommendation.

This position goes back in the FINRA literature at least to 1994. For instance, in NASD NTM 94-16, the (then) NASD advised:

Members are also advised that, although the prospectus and sales material of a fund include disclosures on many matters, oral representations by sales personnel that contradict the disclosures in the prospectus or sale literature may nullify the effect of the written disclosures and may make the member liable for rule violations and civil damages to the customers that result from such oral representations.\(^{59}\)

(Emphasis added)

Furthermore, a number of FINRA Enforcement decisions reiterate this position, including the following:

- **Department of Enforcement v. Hornblower & Weeks, 2004.** “Respondent could not cure defects in disclosure by providing more detail and further disclosure in the same package or by answering questions.”\(^{60}\)

- **Department of Enforcement v. Ryan Mark Reynolds, 2001.** “The SEC has held that, in the enforcement context, a registered representative may be found in violation of the NASD’s rules and the federal securities laws for failure to fully disclose risks to customers even through such risks may have been discussed in a prospectus delivered to customers.”\(^{61}\) (Emphasis added)

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\(^{58}\) Closing price data obtained from Yahoo!Finance. Date range is from June 19, 2009 to June 19, 2013. SPXS price is adjusted for one-for-five stock split on February 24, 2011


\(^{61}\) Id.

Lastly, under Rule 2111, Supplementary Material 2111.02 states explicitly: “Disclaimers. A member or associated person cannot disclaim any responsibilities under the suitability rule.” This is consistent with all of FINRAs previous guidance.

Registered Investment Advisors Fiduciary Duty

A fiduciary is, very simply, one in whom confidence and trust has been reposed by another to look after their interests. The standard of care due to an investor who has engaged a fiduciary to look after their financial affairs is the highest under the law.

Unlike broker-dealers, Registered Investment Advisors (“RIAs”) are considered fiduciaries under the Investment Advisors Act of 1940, which contemplated the “delicate fiduciary nature of an investment advisory relationship.” Furthermore, the language of the ‘40 Act was reaffirmed in a 1963 Supreme Court decision, SEC v. Capital Gains Research Bureau. In this decision, the justices noted a number of obligations that arose with a fiduciary duty:

Courts have imposed on a fiduciary an affirmative duty of “utmost good faith, and full and fair disclosure of all material facts”, as well as an affirmative obligation “to employ reasonable care to avoid misleading” his clients.

More recently, RIA experts Lemke and Lens have written on the obligations that arise under the fiduciary duty:

As a fiduciary, an adviser owes its clients more than honesty and good faith alone. Rather, an adviser has an affirmative duty of utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser’s interests may conflict with the client’s. Pursuant to this duty, an investment adviser must at all times act in its clients’ best interest, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions. In particular, an adviser must be sensitive to the possibility of rendering less than disinterested advice, whether consciously or unconsciously, and an adviser may be faulted even where it did not intend to injure a client or even if a client does not suffer a monetary loss.

The fiduciary standard of care due from an RIA is continuous. It applies equally at the inception of a position, the entire time it is held, and the closing of the position. There is an ongoing duty to monitor all investments and to make sure they remain appropriate and in the client’s best interests.

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62 Id.
63 See supra Note 34.
67 Id. at 927.
68 Id. at 167.
The continuous nature of the fiduciary duty has particular relevance to leveraged and inverse ETFs which are held longer than one day. This is simply because leveraged and inverse ETFs were not designed to be held longer than one day. Thus merely holding these investments puts the client in peril of seeing their investment steadily eroded by the rebalancing required to maintain a constant leverage ratio within the ETF.

Needless to say, using an investment in a manner that is contrary to how it is designed (and virtually locking the client into small, but frequent, internal losses) would be a breach of fiduciary duty.

In order for an advisor to carry out such a strategy and hold true to their duties as a fiduciary, the advisor would need to make extensive written disclosures to the client, including disclosure of the contrary nature of the intended usage of the ETF(s), and show a clear line of sight to how the contrary usage would result in a net benefit to the client. Furthermore, they would need to show how there were no alternative strategies that could achieve the same result with less risk.

**Supervision**

Supervision of advisors must be effectuated to insure that their respective duties are being carried out. Neither FINRA, or the ‘40 Act specify exactly how supervision is to be implemented. However, common sense applies across both types of firms in a simple dictum: a supervisory system must be tailored to the business in which the broker-dealer or RIA engages and it must be reasonably designed to achieve compliance with the relevant securities rules, regulations, and laws.

**Broker-Dealer Supervision**

FINRA broker-dealer compliance is built on a three-legged stool comprising of the following Rules: 3010 (Supervision), 3012 (Supervisory Control System), and 3130 (Annual Certification of Compliance and Supervisory Processes). In summary, these rules require:

>(3010) each member to “establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules”\(^6\)

> (3012) “Each member shall designate and specifically identify to NASD one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that (A) test and verify that the member’s supervisory procedures are reasonably designed”\(^7\)

> (3130) annual attestation by the CEO and COO that “…the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures…”\(^8\)

Thus each member firm must establish a supervisory system, populate it with registered principals, and attest to its implementation each year. How it is implemented is left up to individual firms and is largely dictated by the type of business the firm operates.

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Lastly, under RN 11-25, the implementation of supervisory and compliance procedures must be evidenced and retained, particularly involving situations where leveraged and inverse ETFs are held for longer than one day:

Each firm has a general obligation to evidence compliance with applicable FINRA rules. A firm may use a risk-based approach to evidencing compliance with the suitability rule. In that context, a firm may want to focus on hold recommendations involving securities *that by their nature or due to particular circumstances could be viewed as having a shorter-term investment component, that have a periodic reset or similar mechanism that could alter the product’s character over time, that are particularly susceptible to changes in certain market conditions, or that are otherwise potentially risky to hold at the time when the recommendations are made.*\(^{72}\) (Emphasis added)

As with FINRA Rules 2310 and 2111, evidencing of supervisory and compliance procedures has been an industry practice for decades, if not longer, and explicitly exists in many rules, including Rule 2510 (Discretionary Accounts) and 3012 (Supervisory Control System).

**Registered Investment Advisory Firm Supervision**

RIA firms are regulated by the states or the SEC, depending on the amount of their assets under management. The duty to supervise is required under Section 203(e)(6) of the Investment Advisers Act of 1940, which states (in part):

> The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds… that such investment adviser, or any person associated with such investment adviser… has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.\(^{73}\)

As with FINRA, neither the ‘40 Act, the SEC, nor the states, specify exactly how the supervisory system should be implemented. The ‘40 Act contemplates compliance requirements in Section 206(4)-7 but does not delineate any specific elements.

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\(^{72}\) See *supra* Note 52, at A10.

Authors Lemke and Lens look to the SEC for guidance on specific compliance elements for RIAs. They highlight the following minimum areas for compliance oversight:

- Portfolio management processes;
- Trading practices;
- Proprietary trading of the adviser;
- Personal trading by supervised persons;
- The accuracy of disclosures (e.g. account statements, advertising and other communications) to investors, clients, and regulators;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- Accurate creation and secure maintenance of required records;
- Marketing advisory services, including using solicitors;
- Valuation of client assets;
- Safeguarding the privacy of client records and information; and
- Business continuity plans

As discussed above, if leveraged and inverse ETFs are being used in a buy and hold manner (against the way they were designed to be used), and without the appropriate disclosures, then there are two immediate supervisory violations. Those would involve the supervision of portfolio management processes and the accuracy of disclosures.

The first violation of failing to supervise the portfolio management process should be obvious. The portfolio management process supervisory procedure should insure that investment vehicles selected for clients are being used as they are designed to be used.

The second violation of accuracy of disclosures should also be obvious. If an advisor chooses to use an investment in a way that it is not designed to be used, then it must be clearly disclosed to the client. Furthermore, as in the case of leveraged and inverse ETFs, if the against-design use involves the extremely high likelihood of systematic embedded losses within the product, then there would need to be a clear explanation of how this would result in a net benefit to the client. Furthermore, a thorough review of alternative methods of achieving the desired result would need to be undertaken to justify such a strategy.

74 Lemke and Lens, Regulation of Investment Advisors, at 272.
Conclusion

The defining characteristic of leveraged and inverse ETFs is the prospectus requirement to maintain a constant leverage ratio. This requirement is how these instruments stay true to their names. However, if held longer than one day, the maintenance of constant leverage can turn leveraged and inverse ETFs into Trojan Horses.

As described above, holding a leveraged or inverse ETF for longer than one day triggers a mathematical sequence that can turn the instrument against the holder, even if the holder is correct about the direction of the underlying investment. This trait makes these investments suitable for only the most active and speculative accounts, and unsuitable for traditional buy-and-hold investors.

Leveraged and inverse ETF issuers, regulators such as the SEC and FINRA, as well as the financial and popular press all agree that these instruments are designed for daily holding periods. If they are held for longer than one day, extensive written disclosures should be made to the client and documented internally.

Advisors and their supervisors should be especially diligent about understanding these investments and the limited spectrum of investors for which they are suitable, and subsequently monitor and document recommendations to hold leveraged and inverse ETFs for periods longer than one day.
About Accelerant

Accelerant (www.accelerant.biz) is a securities litigation consulting and support firm specializing in large and complex cases. We bring broad and deep securities and regulatory knowledge as well as analytic rigor to our work. Our experts have industry, academic, and regulatory experience which they bring to bear on all client matters.

Accelerant’s clients value our ability to communicate complex ideas simply, our reputation for unbiased, independent and high quality analysis, and our commitment to a highly responsive work ethic.

Headquartered in New York City, Accelerant also serves clients from our Hong Kong and London offices.

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