MEMO# 23545

June 15, 2009

FINRA Reminds Firms of Suitability Obligations Relating to Leveraged and Inverse ETFs

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TO: INTERNAL SALES MANAGERS ROUNDTABLE No. 3-09
SALES FORCE MARKETING COMMITTEE No. 2-09   RE: FINRA REMINDS FIRMS OF SUITABILITY OBLIGATIONS RELATING TO LEVERAGED AND INVERSE ETFS

The Financial Industry Regulatory Authority ("FINRA") has issued a regulatory notice to member firms reminding them of their sales practice obligations relating to leveraged and inverse exchange-traded funds ("ETFs"). [1] Specifically, the Notice reminds members that recommendations to customers regarding these instruments must be suitable and based on a full understanding of the terms and features of the product; sales materials related to leveraged and inverse ETFs must be fair and accurate; and members must have adequate supervisory procedures in place to ensure that these obligations are met.

Suitability

The Notice reminds members of FINRA's suitability requirement that, before recommending the purchase, sale or exchange of a security, a firm must have a reasonable basis for believing that the transaction is suitable for the customer to whom the recommendation is made. This analysis requires determining (1) whether the product is suitable for any customer and (2) whether it is suitable for the specific customer to whom it is recommended. Due to the complexity of leveraged and inverse ETFs, including the compounding mechanism, the Notice states that leveraged and inverse 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.

Communications with the Public

The Notice reminds members that all sales materials and oral presentations used by firms regarding leveraged and inverse ETFs must present a fair and balanced picture of both the risks and benefits of the funds. Further, the materials and presentations may not omit any material fact or qualification that would cause such a communication to be misleading. For example, the Notice states that an advertisement for a leveraged or inverse ETF must specifically disclose that the fund is not designed to, and will not necessarily, track the underlying index or benchmark over a period of time greater than on a daily basis. The Notice also reminds members that providing risk disclosure in a prospectus or product description does not cure otherwise deficient disclosure in sales material, even if the sales material is accompanied or preceded by the prospectus or product description.

Supervision and Training

The Notice emphasizes that firms should establish appropriate supervisory procedures to ensure that their associated persons comply with all applicable FINRA and Securities and Exchange Commission rules when recommending any product, including leveraged and inverse ETFs. It also states that firms must train registered persons about the terms, features and risks of all ETFs that they sell, as well as the factors that would make such products either suitable or unsuitable for certain investors. In particular, training should emphasize the need to understand and consider the risks associated with leveraged and inverse ETFs, including investor's time horizons, and the impact of time and volatility on the ETF's performance. For example, training should emphasize that these types of ETFs may not perform over time in direct or inverse correlation to their underlying index.

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endnotes

[1] FINRA Regulatory Notice 09-31, *Non-Traditional ETFs,* June 2009 ("Notice"). The Notice may be found on FINRA's website at http://www.finra.org/Industry/Regulation/Notices/2009/P118953. Of note, it was issued concurrently with an Investment Industry Regulatory Organization of Canada Notice on the same topic.