

MEMO# 35328

May 31, 2023

SEC Charges Investment Adviser for Breach of Fiduciary Duty in Connection with Use of Leveraged ETFs

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TO: Chief Compliance Officer Committee
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee
Investment Adviser and Broker-Dealer Standards of Conduct Working Group
Investment Advisers Committee
SEC Rules Committee SUBJECTS: Compliance
Disclosure
Exchange-Traded Funds (ETFs)
Investment Advisers
Litigation & Enforcement RE: SEC Charges Investment Adviser for Breach of Fiduciary Duty in Connection with Use of Leveraged ETFs

On May 4, 2023, the SEC brought a settled enforcement action against a registered investment adviser and its part-owner and investment adviser representative (together, "Respondents") for alleged breach of the fiduciary duty of care and compliance violations under the Investment Advisers Act of 1940 (the "Advisers Act") in connection with the use of leveraged exchange-traded funds (LETFs) in discretionary client accounts.[\[1\]](#) Without admitting or denying the charges, the Respondents agreed to a settlement with the SEC that included a cease-and-desist order, a censure, and payment of \$195,228 and \$738,113, by the investment adviser and the part-owner investment adviser representative, respectively, in disgorgement, prejudgment interest, and civil penalties.

The SEC's findings are as follows:

- From at least January 2017 through December 2020 ("Relevant Period"), the Respondents purchased and held LETFs in advisory client accounts. The order describes the LETFs as complex securities that carry significant risks. The LETFs included at least fifteen different funds, all of which seek to deliver multiples of the performance of the index or benchmark they track. Respondents held these LETFs for extended periods of time in discretionary client accounts, often in significant concentrations, despite warnings in the LETFs' prospectuses that the products carried

unique risks, were designed to be held for no more than a single trading day, and required frequent monitoring;

- As a result of the highly concentrated positions in ETFs, held for periods substantially longer than one day, certain clients invested in the ETFs experienced substantial losses during the Relevant Period;
- Respondents misunderstood the fundamental characteristics of ETFs and did not have a reasonable basis to conclude that the ETFs were suitable for their clients. Despite the language in the prospectuses, Respondents did not fully appreciate the ETFs' most consequential attributes, including that the ETFs were designed as short-term trading tools and that there were material risks to holding the ETFs in significant amounts for periods considerably longer than recommended by the issuers;
- Further, despite the prospectuses highlighting the need for frequent monitoring, after purchasing the ETFs for clients, Respondents failed to monitor the investments to assess whether they were in the clients' best interest throughout the holding period; and
- Lastly, during the Relevant Period, the Respondent investment adviser did not adopt or implement written policies and procedures under the Advisers Act that were reasonably designed to ensure its representatives understood the material features and risks of complex products like ETFs before purchasing them for advisory clients. The adviser's policies and procedures did not address due diligence, product specific disclosures to clients, or suitability assessments for these products. Also, there were no policies and procedures addressing training required for ETFs and no procedures for supervisory review of recommendations or purchases of ETFs or monitoring of the products.

As a result of the conduct described above, the SEC found that Respondents willfully violated Section 206(2) of the Advisers Act, which makes it unlawful for any investment adviser, directly or indirectly, to "engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." The investment adviser Respondent was also found to have violated Section 206(4) of the Advisers Act and Rule 206(4)-7 under the Advisers Act, which require a registered investment adviser to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act.

Mitra Surrell
Associate General Counsel, Markets, SMAs, & CITs

Notes

[1] See In the Matter of Classic Asset Management, LLC and Douglas G. Schmitz, Investment Advisers Act Release No. 6300 (May 4, 2023) (the "Order"), which is available at <https://www.sec.gov/litigation/admin/2023/34-97427.pdf> .