

Avoiding that Subpoena: Large Trends; Mini-Trends

Tracking the key areas of concern to SEC enforcement can be beneficial for issuers, investment advisers and others that may be subject to scrutiny by the Commission. For example, identifying key areas of focus by determining the areas in which cases were filed is beneficial but often not sufficient to avoiding a subpoena.

Tracking what might be called mini-trends can effectively aid compliance, although it may be more difficult. Two recent mini-trends illustrate the point. One involved “pulling in” revenue; the other improperly utilizing exchange traded products.

Pulling in revenue

First, actions involving Under Armour and HP illustrate “pulling in” revenue. *Under Armour* traces to the second quarter of 2010. The company reported year-over-year revenue growth exceeding 20%. Over the next several years Under Armour’s financial results replicated this type of growth, a pattern highlighted by the firm.

By the second half of September 2015, however, the company saw signs that its long running streak of exceeding analyst expectations was ending. To stem the downward tide the firm began “pulling forward” orders it had for customers that were not to be delivered until a point in the future. In some instances, the practice was discussed with customers. For six consecutive quarters the practice continued.

On January 31, 2017 the company missed analyst expectations for the fourth quarter and full-year 2016 periods. The stock price dropped about 23%. The Order alleges violations of Securities Act Sections 17(a)(2) and (3) and Exchange Act Section 13(a) and the related Rules. To resolve the matter the company consented to the entry of a cease-and-desist order based on the Sections cited in the Order. Under Armour will pay a penalty of \$9 million. *In the Matter of Under Armour, Inc.*, Adm. Proc. File No. 3-20278 (May 3, 2021).

HP, a former Hewlett-Packard segment, is similar. It was charged with engaging in a two-

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fold scheme. One part began in the second quarter of 2015 when regional managers used a variety of incentives to accelerate or “pull in” sales that they may have otherwise expected to appear in later periods. The practice, typically employed at period end, can alter financial trends.

This case also involved management in one region selling printing supplies to distributors known to be outside their territory, so-called “gray marketing.” Despite the risk that those sales practices could negatively impact operating profit in future quarters, there was no disclosure.

In June 2016 the firm announced that it was changing its go-to-market model. The change was intended in part to address these two practices. The company took a net revenue reduction of about \$450 million in the third and fourth quarters of that year. The Order alleges violations of Securities Act Sections 17(a)(2) and (3) and Exchange Act Section 13(a). To resolve the matter Respondent consented to the entry of a cease-and-desist order based on the sections cited in the Order. In addition, the firm will pay a penalty of \$6 million that will be transferred to the U.S. Treasury. Disclosure controls: *In the Matter of HP Inc.*, Adm. Proc. File No. 3-20112 (Sept. 30, 2020).

Misuse of ETP

Second, cases involving American Financial Services and UBS each center on the same key issue: misuse of exchange traded products. The action involving American Financial Services and American Portfolios Advisors, respectively, a registered broker-dealer and an investment adviser centered on iPath S&P 500 VIX Short-Term Futures ETN or VXX.

VXX is traded on the NYSE Arca, Inc. It is a volatility-linked, complex exchange traded note which “offers exposure to futures contracts” of specific maturities on the VIX — the CBOE. The VIX tries to track the expected volatility of the S&P 500 but not its price level. The performance of VXX is not directly linked to the VIX. It is linked to a separate Index that tracks the price of futures contracts on the exchange. That Index is based on a “rolling portfolio of one-month and two-month futures contracts to target a constant weighted average of one-month maturity.” To do this, each day the Index sells futures contracts that are the closest to the expiration and buys the next month out.

The VXX prospectus made it clear that that historically the exchange has been in contango – the farther out contracts priced higher than those of the near-term contracts. When the market is in backwardation the reverse is true. Since the exchange is typically in contango, a significant cost is incurred over time from the daily roll of the futures contracts.

At times the VIX performance may vary from that of the Index and may have a positive performance during periods when the Index experiences poor performance. On the other hand, the VXX may experience a significant decline over time. In those instances, the risk increases the longer the VXX is held. In the end, however, the VXX has a limited upside potential, according to the prospectus, because over the longer term it usually reverts to a historical mean and its absolute level has been constrained within a band.

Registered representatives began early in 2016 to recommend investors buy and hold the VXX as a part of their overall portfolio. At the time there was a fear that political and other events would cause the market to drop. Many of the clients followed the advice, purchased the VXX and held it for over a year.

The VXX was viewed as a kind of hedge that would guard against the feared price drop. In making those recommendations the registered representatives failed to understand that the investments were not suitable for use as a short-term hedge. Yet customers were told the opposite — buy and hold for the long term to protect against downward market risk. No mention was made of what is effectively a monthly reset and the resulting costs incurred in each instance.

The firms did have policies and procedures regarding complex products. Those policies and procedures mandated that representatives understand the products prior to making a recommendation. The policies and procedures were ineffective in preventing the losses incurred by customers here because they were not properly implemented. Supervisory failure also facilitated the client losses. The Order alleges violations of Exchange Act Section 15(b)(4)(E) and Advisers Act Section 206(4) and Rule 206(4)-7.

To resolve the matter Respondents implemented certain remedial efforts. Respondent APA consented to the entry of a cease-and-desist order based on the Advisers Act Section and Rule cited in the Order. APFS consented to the entry of a cease-and-desist order based on the Exchange Act Section cited in the Order. The two firms were censured and will also pay, jointly and severally, a civil monetary penalty of \$650,000. A fair fund will be created for the portion of the losses tied to the product. *In the Matter of American Financial Services, Inc.*, Adm. Proc. File No. 3-20151 (Nov. 13, 2020).

The recent action involving UBS, a dual registered broker-dealer investment adviser, is similar. It centers on the failure of the firm to properly implement policies and procedures with respect to the VXX product as used in its discretionary Portfolio Management Program or PMP.

Beginning in 2016 firm financial advisers put clients involved in the PMP program into the VXX product. VXX is typically built on short term futures products. Here the firm had policies and procedures in place to effectively prevent holding the VXX for long periods. Those policies and procedures did not, however, apply to the PMP program. When financial advisers put PMP clients into the VXX they failed to ensure that it was only held for the short term. Indeed, about 1,882 clients were involved with the product that was in hundreds of accounts. Those accounts held the product beyond the short term — many held VXX for over a year. Accordingly, clients suffered losses.

In resolving this matter, the firm took remedial steps. The Order alleges violations of Advisers Act Section 206(4) and Rule 206(4)-7. Respondent resolved the proceedings, consenting to the entry of a cease-and-desist order based on the Section and Rule cited in the Order and to a censure. The firm will also pay disgorgement of \$96,344, prejudgment interest of \$15,15,930 and a penalty of \$8 million. A fair fund will be established. *In the Matter of UBS Financial Services Inc.*, Adm. Proc. File No. 3-20401

(July 19, 2021).

Comment

The key to identifying the issues in *Under Armour* and *BP* and American Financial and UBS was data and trend analysis. In each of these actions, the practices at issue – inappropriate use of exchange traded products and maintaining long term revenue trends through end of the quarter sales accelerations – could have been uncovered by the firms involved through effective data, risk and trend analysis. Analysis of how professionals were utilizing the complex exchange traded products in *American Financial* and *UBS* should have uncovered the abuse; analysis of long term sales trends in *Under Armour* and *HP* should have uncovered the quarter end rush to a number to support the conclusion. In each action, consideration of the issues uncovered in view of the firm's compliance and disclosure policies and procedures should have completed the process – and avoided a subpoena from SEC Enforcement.