

Complex Products: In Need of A Solution

Complex financial products continue to present difficult issues for the Commission. In many instances the products involved are so complex that it may be questionable if any amount of policies, procedures and disclosure will be sufficient to support a suitable recommendation.

Background

The Commission has addressed the question of complex products in enforcement actions and public remarks. For example, *In the Matter of American Financial Services, Inc.*, Adm. Proc. File No. 3-20151 (Nov. 13, 2020) focused on the use of a product known as the iPath S&P 500 VIX Short-Term Futures ETN or VXX. The product is a volatility-linked, complex exchange traded note that offers exposure to futures contracts of specific maturities on the VIX – the CBOE. While it is not suitable for use as a short-term hedge, in fact firm representatives recommended it to clients for that purpose. The clients had losses; the firm settled the matter based on a consent decree tied to a failure to properly implement policies and procedures that mandated representatives understand the products.

The next year following the approval by the agency of two new complex products, three Commissioners addressed the question of recommending investments in complex products. Chair Gensler cautioned investors about products such as leveraged ETFs and inverse ETFs. Commissioners Lee and Crenshaw concurred but went further. The Commissioners recommended a three-part approach to the issue. First, consistent regulatory oversight of these products is critical. Second, the Commission must adopt a consistent, holistic approach to reviewing these products. Finally, the approach should be based on heightened protections for investors.

Recent cases

Despite the comments of the Commissions and the actions initiated by Enforcement, market professionals continue to recommend highly complex products which are at best

Related Capabilities

- Securities & Financial Services Litigation & Enforcement
- Investment Management

difficult to understand to those for whom they are not suitable. Three cases filed last week illustrate the point. In *SEC v. Applebaum*, Civil Action No. 9:22-cv-81115 (S.D. Fla. Filed July 28, 2022) a product called VRSP was repeatedly recommended by a market professional at Aegis Capital Corp. to investors who were not properly informed about the product.

Defendant Alan Applebaum was a Managing Director at Aegis. Over a three year period, beginning in July 2017, Mr. Applebaum made over 140 recommendations and purchases of VRSPs for clients. The product has a complex structure under which recovery of principal at maturity is contingent upon the operation of derivative features linked to equity indexes such as the Russell 2000 stock market indexes. Customers faced the risk of losing all of their investment even if the VRSP did not default.

Defendant Applebaum recommended this product to investors despite the fact that they had expressed a preference for investments that had “moderate” risk. In making the recommendations, Defendant Applebaum omitted material facts about the suitability of the product as an investment and at times made misstatements. Defendant executed hundreds of trades in the instruments for seven customers who suffered six and seven figure losses. The complaint alleges violations of Securities Act Section 17(a) and Exchange Act Section 10(b). The case is pending. See Lit. Rel. No. 25459 (July 29, 2022).

The Commission also brought actions against the firm and another broker based on similar facts. In *the Matter of Aegis Capital Corp.*, Adm. Proc. File No. 3-20940 (July 28, 2022)(Eleven firm employees made hundreds of recommendations that clients purchase VRSPs despite the fact that the product was not suitable for the clients and that the firm failed to develop reasonable systems to implement its policies and procedures; settled with a cease-and-desist order based on Securities Act Sections 17(a)(2) & (3) and Exchange Act Section 17(a)(1) and the pertinent rules. The firm will also pay disgorgement of \$165,828, prejudgment interest of \$55,037 and a penalty of \$2.3 million); In *the Matter of Paul F. Gallivan*, Adm. Proc. File No. 3-20939 (July 28, 2022) (action based on similar facts against firm representative Gallivan; resolved with a cease-and-desist order based on Securities Act Sections 17(a)(2) & (3), the payment of disgorgement in the amount of \$26,807, prejudgment interest of \$3,166 and a penalty of \$25,000 and certain suspensions from various activities).

Comment

Commissioner Hester M. Peirce stated at the time the settlements in the two cases above were approved by the agency that she could not support the Order. Her primary reason was that Aegis adopted a policy during the Commission’s investigation that precluded associated persons from purchasing VRSPs. That could be read, according to the Commissioner, as meaning that “certain investment products, categorically, should be unavailable to certain types of investors.”

Ms. Peirce’s concern is understandable. What is not understandable is the continued failure of the Commission to specifically address the question of complex products being

sold to investors under circumstances like those discussed above. While Chair Gensler's comments above are clearly correct, and the proposal of Commissioners Lee and Crenshaw appear to have merit, nothing has been done. It is time for the Commission to step-up and protect the numerous Main Street investors who are losing their hard earned money to unsuitable recommendations -- unless the only solution is the one Ms. Peirce fears.