Updates
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FINRA and CFTC Staff Issue COVID-19 Advisories on Commodity-Linked ETPs and Funds

In the wake of severe market volatility resulting from the COVID-19 pandemic, self-regulatory organizations and government agencies continue to provide guidance analyzing and interpreting the effects of the pandemic on market participant activities. The U.S. Financial Industry Regulatory Authority (FINRA) and the U.S. Commodity Futures Trading Commission (CFTC) staff each recently issued advisories addressing the potential risks posed by exchange-traded product (ETP) commodity pools and explaining that the nature of commodity-linked ETPs present unique issues for both investment professionals and investors. FINRA's Regulatory Notice 20-14 highlights concerns relating to oil-linked ETPs and reminds broker-dealers and their associated persons of their compliance obligations when recommending or otherwise communicating with retail consumers about complex investment products. The CFTC Customer Advisory informs retail investors of the risks related to investing in commodity ETPs or funds.

This update summarizes both regulatory alerts and provides key considerations.

Background: ETPs and Commodity Pools

Given their jurisdictional mandates over the securities and commodities and futures markets, respectively, both the U.S. Securities and Exchange Commission (SEC) (and, accordingly, FINRA) and the CFTC have a regulatory interest in addressing market risks and compliance concerns related to oil-linked ETPs. ETPs encompass a variety of investment products that are traded on national securities exchanges.[1] For example, a popular type of ETP is an exchange-traded fund (ETF) that is registered with the SEC as an open-end investment company and primarily invests in other securities. ETPs also may be commodity pools, or pooled investment vehicles that hold futures, currencies, or physical commodities (e.g., precious metals) rather than securities, or take a different form such as exchange-traded notes (ETNs), which are debt obligations and do not hold an underlying portfolio (collectively, Commodity ETPs).[2]

Investments in Commodity ETPs may bear different risks for investors than investments in the equities securities markets. A traditional equity security represents an investment interest in a company's stock. Such purchases are assets and, accordingly, investors may retain shares indefinitely. Commodity ETPs differ both in the underlying investment and structure. Unlike an investment vehicle that purchases equity securities, Commodity ETPs purchase time-limited commodity contracts that cannot be retained at the discretion of the purchaser.[3] Commodity ETPs also have a number of technical features that may generate additional and unique risks for investors.[4] For example, unlike the ETFs described above that can issue unlimited shares, a Commodity ETP has share limits under each securities registration statement and must file a new securities registration statement to issue additional shares if the existing share limit is reached. A Commodity ETP also may be subject to position limits on the number of futures contracts that it may hold. These technical features, among others, may cause the Commodity ETP's market price to deviate from its underlying value or cause the ETP to change its investment holdings (e.g., selecting different futures or swaps contracts for its portfolio). These deviations posed particular concerns for the CFTC, as the agency tasked with monitoring and ensuring that trading in these contracts "remains orderly and reflects the forces of supply and demand."[5]

FINRA Regulatory Notice 20-14: Oil-Linked ETPs

Issued on May 15, 2020, Regulatory Notice 20-14 reiterated FINRA's concerns regarding broker-dealers and their personnel meeting their compliance obligations when recommending oil-linked ETPs (e.g., FINRA Notice 12-03).

COVID-19 Generated Concern

The COVID-19 pandemic, and subsequent global lockdowns, placed stress on the oil markets and caused frequent fluctuations in the prices of oil futures contracts. The May 2020 WTI contract price settled at minus $37.63 per barrel and the June 2020 WTI crude oil futures contract fell 43% to $11.57 per barrel.[6] As FINRA noted, market volatility has generated negative effects on the normal operations of both oil-linked commodity pool ETPs and oil-linked ETNs.[7]

For instance, an increasing number of investors purchased all of the available shares of an oil-linked ETP as prices of oil decreased during the COVID-19 pandemic, which ultimately forced the close-end fund to file a Form S-3 registration statement with the SEC.[8] With the inventory of available shares depleted and without an operating share-creation mechanism until its registration statement became effective, the oil-linked ETP experienced large variations between market price and its shares' net asset value. Another issuer of an oil-related ETN had to announce an early liquidation.

FINRA Guidance on Sales Practice Obligations Related to Oil-Linked ETPs

Consistent with FINRA's investor protection and market integrity core mission, Regulatory Notice 20-14 addresses concerns regarding retail investors' and investment professionals' increased demand for oil-linked ETPs. Specifically, FINRA highlights the potential for mistaken beliefs that these ETPs are a proxy for the spot price of oil, when in fact their investment objectives are to track oil futures contracts. As a result, many retail investors and investment professionals may not fully understand the risks related to holding oil-linked ETPs for extended periods of time.[9] FINRA previously explained in Regulatory Notice 12-03 that certain types of investments tied to indices and commodities, including oil-linked ETPs are "complex" products, meaning they may not be appropriate for certain investors.[10] Broker-dealers and their personnel are required to comply and adhere to their sales practice obligations when recommending "complex" products to retail customers.

In Regulatory Notice 20-14, FINRA raised the following concerns regarding broker-dealers and their personnel recommending oil-linked ETPs to retail investors:

- **Suitability and Regulation Best Interest:** As of June 30, 2020, broker-dealers' recommendations of securities, including oil-linked ETPs, to retail customers will be governed by Regulation Best Interest (Reg BI). Reg BI requires broker-dealers to act in the retail customer's best interest at the time the recommendation is made, without placing the interests of the broker-dealer ahead of the customer's interests.[11] In addition, FINRA Rule 2111 (Suitability) requires a broker-dealer or its associated person to have a reasonable basis to believe that a recommendation is suitable for the targeted customer based on diligence of the customer. According to FINRA, customer-specific and reasonable-basis suitability are particularly relevant to oil-linked ETPs.
- **Communications With the Public:** FINRA Rule 2210 (Communications with the Public) requires, among other things, that communications with the public are fair, balanced, and provide sufficient information concerning their subject. Communications that present the benefits of a particular type of

investment, such as an oil-linked ETP, must also include key risks.

- **Supervision:** FINRA Rule 3110 (Supervision) requires that broker-dealers have a system to monitor the activities of their associated persons. A broker-dealer's supervision system must be tailored to its business and the products that it offers, such as oil-linked ETPs, and be designed to achieve compliance with any applicable laws, regulations, and FINRA rules.
- **Training:** Broker-dealers must train their associated persons about the terms, features, and risks of oil-linked ETPs, as well as any factors that would make such products either suitable or unsuitable for retail investors.[12]

CFTC Customer Advisory on Commodity ETPs and Funds

On May 22, 2020, the CFTC Office of Customer Education and Outreach (OCEO) and the Division of Swap Dealer and Intermediary Oversight (DSIO) jointly published a Customer Advisory cautioning individual investors about the risks posed by commodity ETPs or funds. In a related press release, DSIO Director Joshua Sterling stated, "[n]ow more than ever, it is important for Main Street investors to understand how our futures markets work when they go to evaluate their investment choices." The Customer Advisory provides information to this end, by detailing some of the risks related to commodity ETPs or funds, which stem primarily from the core differences between commodity ETPs or funds and traditional securities.

The Customer Advisory urges individual investors to ensure that they are fully aware of risks related to Commodity ETPs or funds, which often differ based on the structure of the product as well as the investment strategy of the Commodity ETP or fund. The Customer Advisory notes, for example, that the underlying commodity (i.e., energy, agricultural, metal) will lead to certain types of risks that may affect such commodity (e.g., storage, transportation, weather), and ultimately the associated futures contracts. Such changes may prompt the commodity pool to change its investment strategy. While the pool may make changes to address market shifts, fluctuations in commodity prices create a risk of reducing the pool's annual returns, as commodity pools must continue to roll over future contracts in order to maintain their positions.

The Customer Advisory is the third Customer Advisory that CFTC staff has issued in response to the COVID-19 pandemic. On March 18, 2020, OCEO published an advisory regarding COVID-19 related fraudulent schemes generally and on April 6, 2020, OCEO published an advisory identifying key characteristics of fee scams that may target persons affected by the pandemic. The Customer Advisory also follows a CFTC Staff Advisory on Risk Management and Market Integrity Under Current Market Conditions that was published by the CFTC Divisions of Clearing and Risk, Market Oversight, and Swap Dealer and Intermediary Oversight. The Staff Advisory was not specifically limited to Commodity ETPs; however, it also responded to "substantially increased market volatility in key agricultural, energy, and financial sectors" generated by the COVID-19 pandemic.[13] The Staff Advisory urged designated contract markets, futures commission merchants, and derivatives clearing organizations to understand their obligations to assess risks related to the changing market conditions and make appropriate changes to their operations, where needed.

Considerations in Connection With Oil-Linked and Commodity ETPs

FINRA and the CFTC staff provided the following consideration and recommendations for market participants and individual investors:

FINRA Regulatory Notice 20-14	CFTC's Customer Advisory

"Complex" Products: Broker-dealers should consider reviewing Regulatory Notice 12-03 and consider whether to use heightened scrutiny and supervision for oil-linked ETPs.

Suitability and Reg BI: If offering oil-linked ETPs to retail customers, broker-dealers and their associated persons should consider whether they are able to sufficiently explain the features and risks of oil-linked ETPs. Broker-dealers and their associated persons should also consider whether they understand the differences between the various types of oil-linked ETPs.

Communications with the Public: When communicating with the public, broker-dealers should consider whether their description of any benefits of investing in oil-linked ETPs is balanced by a description of the risks. These risks may include fluctuations in oil prices, that the ETP's price does not necessarily track the spot price of oil, the impact of contango and backwardation, and the potential effects when holding an oil-linked ETP for an extended period of time.[15]

Supervision: Broker-dealers should consider whether to use additional scrutiny of oil-linked ETPs and then in turn, incorporate any additional supervision of personnel to ensure compliance with applicable laws, regulations, and FINRA rules.

Training: Broker-dealers should consider reviewing their training materials to ensure that the materials address the unique risks and complexities of oil-linked ETPs. The materials may cover understanding a customer's investment horizon and the impact of time and volatility on an oil-linked ETP's performance as well as the consideration of alternative investment products with similar objectives.

Assess carefully any representations that, by trading commodity interests, a pool should outperform stock and bond funds during recessions or in other financial downturns. A pool's actual performance may indicate otherwise. As you review the prospectus or disclosure document for a commodity ETP fund, consider:

- What financial instruments will the commodity pool be allowed to trade? How do those instruments behave when markets go up or down?
- What could happen to those financial instruments in extreme market conditions?
- What changes to the announced trading strategy is the commodity pool operator permitted to make, and under what circumstances? Can changes be made without notifying participants?[14]

Conclusion

The COVID-19 pandemic has caused myriad effects on the financial system and physical commodities markets, including strain, volatility, and the shutdown of physical trading floors and transition to all electronic platforms. The related effects on oil markets and the ensuing market reaction raised the regulatory and investor protections concerns that prompted the FINRA and CFTC responses.[16] It appears that financial regulators are coordinating and paying close attention to the overall financial markets to ensure investor protection and overall market integrity. These notices provide a reminder of the regulatory obligations of market participants as well as educate market participants and investors about risks associated with complex investment products such as oil-linked and other commodity ETPs.

Please contact experienced securities or commodity regulatory counsel with any questions about this development and how it might apply to you or your business.

Endnotes

[1] Exchange-Traded Funds, 84 Fed. Reg. 57,162, 57,164 n.16 (Oct. 24, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-10-24/pdf/2019-21250.pdf.

[2] FINRA, Regulatory Notice 20-14 (May 15, 2020), at 2; U.S. Commodity Futures Trading Commission, *Customer Advisory: Learn About Risks Before Investing in Commodity ETPs or Funds*, https://www.cftc.gov/LearnAndProtect/FraudAwarenessPrevention/CFTCFraudAdvisories/CustomerAdvisory_Isolation (last visited May 28, 2020) [hereafter "Customer Advisory"].

[3] *Id.*

[4] FINRA, Regulatory Notice 20-14, at 2.

[5] CFTC, Statement of Commissioner Dan M. Berkovitz on Recent Trading in the WTI Futures Contract before the Energy and Environmental Markets Advisory Committee Meeting, https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement050720#_ftn10 (last visited June 2, 2020).

[6] *Id.* at 2-3 (citing Joe Wallace, David Hodari, & Amrith Ramkumar, "Oil-Price Crash Deepens, Weighs on Global Markets," *Wall St. J*. (Apr. 21, 2020), available at https://www.wsj.com/articles/oil-crash-accelerates-rippling-to-currencies-and-stocks-11587463189).

[7] *See, e.g.*, Wallace, Hodari & Ramkumar, *supra* note 6.

[8] Form S-3 is a short form registration statement that can be filed by eligible existing issuers to issue additional shares. *See* Sec. & Exch. Comm'n, Form S-3 (last visited June 2, 2020), https://www.sec.gov/about/forms/forms-3.pdf.

[9] FINRA, Regulatory Notice 20-14, at 3.

[10] FINRA explicitly elected to not define a "complex product" in Regulatory Notice 12-03. It also chose not to provide an exhaustive list of features of a "complex product, stating "some relatively simple products may also present significant risks to investors that warrant heightened scrutiny or supervision. Each firm is responsible for determining which products require enhanced compliance and supervisory procedures." FINRA, Regulatory Notice 12-03, at 3.

[11] 15 C.F.R. § 240.15*l*-1; *see also* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318 (July 12, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf.

[12] FINRA, Regulatory Notice 20-14, at 6 (citing National Association of Securities Dealers, Notice to Members 05-26, available at https://www.finra.org/sites/default/files/NoticeDocument/p013755.pdf).

[13] CFTC Staff Letter No. 20-17 (May 13, 2020), available at: https://www.cftc.gov/csl/20-17/download.

[14] *See* Customer Advisory.

[15] As described in Regulatory Notice 20-14, "contango" occurs when "the prices of futures contracts with more distant expiration dates are higher than those with shorter dates." "Backwardation" occurs when the oil market is operating in an opposite manner from contango and the prices of futures contracts with more distant expiration dates are lower than those with shorter dates. FINRA, Regulatory Notice 20-14, at 3.

[16] On May 29, 2020, there was a report citing anonymous sources that the SEC and CFTC have both opened investigations into the risk disclosures of an oil-linked ETP that experienced extreme volatility during the COVID-19 pandemic. Matt Robinson, Benjamin Bain & Catherine Ngai, "USO Oil ETF Faces U.S. Probes Over Investor Risk Disclosures," *Bloomberg* (May 29, 2020, updated 6:08 P.M.), https://www.bloomberg.com/news/articles/2020-05-29/uso-oil-etf-faces-u-s-probes-into-risk-disclosures-to-investors.

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