Regulatory Notice 17-32

Volatility-Linked Exchange-Traded Products

FINRA Reminds Firms of Sales Practice Obligations for Volatility-Linked Exchange-Traded Products

Summary

Volatility-linked exchange-traded products (ETPs)[1] are designed to track Chicago Board Options Exchange Volatility Index (VIX) futures, rather than the VIX itself. For the reasons explained further below, many volatility-linked ETPs are highly likely to lose value over time. Accordingly, volatility-linked ETPs may be unsuitable for certain retail investors, particularly those who plan to use them as traditional buy-and-hold investments.

This *Notice* reminds firms of their sales practice obligations in connection with volatility-linked ETPs as discussed more generally in *Regulatory Notice 12-03*, including, without limitation, that recommendations to customers must be based on a full understanding of the terms, features and risks of the product recommended, sales materials must be fair and accurate, and firms must have reasonable supervisory procedures in place to ensure that these obligations are met.

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Financial Industry Regulatory Authority

October 2017

Notice Type
- Guidance

Suggested Routing
- Advertising
- Compliance
- Legal
- Senior Management

Key Topics
- Communications with the Public
- Exchange-Traded Products
- Suitability
- Supervision
- Training
- Volatility-Linked Exchange-Traded Products

Reference Rules and Notices
- FINRA Rule 2111
- FINRA Rule 2210
- FINRA Rule 3110
- Regulatory Notice 10-51
- Regulatory Notice 12-03

Background and Discussion

The VIX is frequently cited as a measure of investor fear, which historically tends to be elevated in periods of market distress and lower under normal market conditions.[2] The VIX often moves sharply higher when stock indices decline significantly. As such, the VIX has the desirable attribute that it is negatively correlated with the broader stock market.

Volatility-linked ETPs generally provide exposure to volatility by tracking short- and mid-term VIX futures indices.[3] Volatility-linked ETPs that seek to maintain a continuous, targeted maturity exposure to VIX futures will either track or hold VIX futures contracts on a rolling basis, meaning that they will sell shorter-term contracts or contracts about to expire with contracts that have more distant or deferred maturity dates in order to maintain the desired exposure. Historically, the prices for VIX futures have tended to increase as the futures contract dates go out farther into the future, so the strategy of maintaining a targeted maturity exposure to VIX futures can often involve selling a contract with a lower price than the one bought to replace it. This rolling of contracts can result in a loss on the trade or a negative roll yield.[4]

Because of the negative roll yield, many volatility-linked ETPs that seek to maintain a continuous, targeted maturity exposure to VIX futures, particularly to shorter maturities, have lost a significant amount of value over time; some have lost more than 90 percent of their value since they launched. And, such products will likely continue to lose value over longer periods of time. Moreover, the performance of VIX futures can diverge from that of the VIX, and in general, movements in the futures are smaller in magnitude than those of the VIX. For these reasons, the performance of volatility-linked ETPs that seek to maintain a continuous, targeted maturity exposure to VIX futures may also be less correlated to that of the VIX than investors might expect.[5]

The risks of volatility-linked ETPs have been highlighted by both academic and financial publications[6] and firms, registered representatives, their supervisors and investors should understand the risks of these products. Without understanding the key features of these volatility-linked ETPs, some investors and registered representatives could mistakenly believe that these products are likely to exhibit behavior similar to that of the VIX over short as well as long time horizons and thus provide protection against market losses over a variety of time periods. In fact, these products have not exhibited, and likely will not exhibit, behavior similar to the VIX over longer periods and exhibit imperfect correlation even over shorter periods.[7]

Sales Practice Obligations Relating to Volatility-Linked ETPs

As detailed in *Regulatory Notice 12-03*, products that offer retail investors exposure to stock market volatility, such as volatility-linked ETPs, are "complex" products. Firms should review that *Notice* and consider whether to use the type of heightened scrutiny and supervision suggested therein for these complex products.[8] Firms are similarly reminded that they must comply with the obligations discussed below when offering volatility-linked ETPs.

Suitability

FINRA Rule 2111 requires member firms and associated persons to have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. Two of the main suitability obligations delineated in Rule 2111 that are particularly relevant to volatility-linked ETPs are customer-specific and reasonable-basis suitability. The former requires a reasonable basis to believe that a recommendation is suitable for a particular customer based on the customer's investment profile, including the customer's investment experience, risk tolerance, liquidity needs, investment objectives, and financial situation and needs.[9] The latter requires that the member or associated person perform reasonable diligence to understand the nature of a recommended security or strategy, as well as potential risks, and then determine whether there is a reasonable basis to believe, based on the reasonable diligence, that the recommendation is suitable for at least *some* investors. The level of reasonable diligence that is required will rise with the complexity and risks associated with the security or strategy. With regard to a complex product such as a volatility-linked ETP, an associated person should be capable of explaining, at a minimum, the product's main features and associated risks.[10]

Communications with the Public

FINRA Rule 2210 requires, among other things, that all communications with the public be based on principles of fair dealing and good faith, be fair and balanced, and provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service.

Supervision

FINRA Rule 3110 requires that member firms establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. A reasonably designed system must be specifically tailored to a member's business, taking into account, among other things, the nature and complexity of the products offered and the customer base. Firms also must train registered representatives and supervisors about the terms, features and risks of the products they recommend, as well as the factors that would make such products either suitable or unsuitable for certain investors.

Volatility-linked ETPs are complex products that could be easily misunderstood and improperly sold by registered representatives. As discussed in *Regulatory Notice 12-03* and noted above, firms should consider whether to use heightened scrutiny and supervision of ETPs.[11] Firms must act reasonably to ensure that their registered representatives and supervisors understand the risks presented by such products and that their systems and training are reasonably designed to avoid unsuitable sales or improper communications.[12]

Conclusion

Volatility-linked ETPs are complex products that are not suitable for all investors. Firms are reminded of their obligation to vet complex products, to put reasonable supervisory controls in place, and to train their registered representatives and supervisors to ensure that suitability and other obligations under FINRA rules are met.

Endnotes

1. An exchange-traded product (ETP) is a security listed on an exchange that seeks to provide exposure to the performance of an index, benchmark, or actively-managed strategy. The most common type of ETP is the exchange-traded fund (ETF). Other ETPs include commodity pools, which invest in futures, and exchange-traded notes (ETNs), which track an index or benchmark but are debt obligations of an issuer and hold no underlying portfolio. Volatility-linked ETPs include ETPs that provide exposure to volatility as an asset, as represented by the VIX or other analogous index. These products typically track derivatives such as futures to achieve volatility exposure and have been structured as commodity pools, ETFs or ETNs.

2. The VIX is calculated using one month put and call options on the S&P 500 Index and is designed to measure the market's expectations of volatility in large cap U.S. stocks over the next 30-day period. While the VIX is perhaps the best known and most widely cited, there are numerous other indices that are similar to the VIX but measure volatility in other markets, such as the markets for non-U.S. stocks, as well as for interest rates, currencies and commodities.

3. Current U.S.-listed volatility ETPs include VIX futures trackers, inverse versions of the VIX futures trackers and two-times leveraged VIX futures trackers, as well as more sophisticated strategies providing exposure to different combinations of long and short positions in VIX futures of varying maturities.

4. "Roll yield" is measured by the percentage difference between the price of the futures contract sold and the new one purchased. A futures market in which the roll yield is negative—because the prices of futures contracts increase as the contract expiration dates go further out into the future—is said to be in "contango." Conversely, for a market in "backwardation," the prices of futures contracts decrease as the contract expiration dates go farther out into the future. Rolling a position in a market in backwardation results in a positive roll yield, as the contract that is sold has a higher price than the one with which it is replaced. *See* *FINRA Regulatory Notice 10-51* (discussing sales practice obligations for commodity futures-linked securities).

5. For example, over a recent 12-month period, while the VIX was down around six percent, one volatility ETP tracking the short-term VIX futures index lost more than 70 percent of its value.

6. For example, according to the academic researcher who developed the VIX:

   "Unlike other securities traded on stock exchanges, however, [volatility-linked ETPs] are not suitable buy-and-hold investments and are virtually guaranteed to lose money through time.... The nature and performance of [volatility-linked ETPs] suggest that a significant proportion of holders are either irrational and/or unaware of how these products are structured and perform through time. Among the finding is that [volatility-linked ETPs] benchmarked to the VIX Short-Term Futures indices are virtually certain to lose money through time.... Over their three-year history, the holders of ETPs bench-marked to the VIX Short-Term Futures indices have lost nearly $4 billion."

See Robert E. Whaley, "Trading Volatility: At What Cost?" *Journal of Portfolio Management*, Fall 2013, pp. 95-108. *See also* Brendan Conway, "No, Your ETF Doesn't Track the VIX Volatility Index – and Here are the Numbers," Barron's (June 17, 2014); Chris Dieterich, "The Fear Gauge: Investors Should Avoid VIX ETFs," Barron's, (March 26, 2016).

7. In a FINRA enforcement action being issued contemporaneously with this *Notice*, for example, FINRA found that certain brokers were making unsuitable recommendations of volatility-linked ETPs to customers with the mistaken belief that such products could be used as a long-term hedge on their customers' equity positions in the event of a market downturn. *See Wells Fargo Clearing Services, LLC* (AWC No. 2014042465601) (October 16, 2017).

8. *See FINRA Regulatory Notice 12-03* (discussing heightened scrutiny and supervision of complex products).

9. A customer's investment profile also includes the customer's age, other investments, tax status, investment time horizon, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

10. FINRA notes, as well, the importance of a firm's vetting of new products, particularly new products that are complex or have potentially high levels of risk associated with them. *See, e.g.,* FINRA *Regulatory Notices 05-26* (April 2005) (highlighting best practices for vetting new products); and *09-31* (June 2009) (reminding firms of their obligation to vet new complex and non-traditional exchange-traded funds).

11. *See FINRA Regulatory Notice 12-03* (discussing heightened scrutiny and supervision of complex products).

12. In this regard, firms are also encouraged to consider adopting effective conflict-review practices for the introduction of complex new products, such as those highlighted in FINRA's October 2013 Report on Conflicts of Interest.