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ETF Exams May Pave Way For SEC Enforcement Actions

By **Ed Beeson**

Law360, New York (January 11, 2016, 9:09 PM ET) -- The U.S. Securities and Exchange Commission on Monday announced plans to take a broad look at the operations of exchange-traded funds, leading some experts to anticipate that the agency will find fodder for enforcement actions and possibly new rules covering the fast-growing class of investment products.

Among other things, SEC examiners will look at whether exchange-traded funds are complying with the terms of the so-called exemptive relief granted by agency staff. (Credit: Law360)

In a letter detailing its priorities for 2016, the SEC's Office of Compliance Inspections and Examinations placed its new probe of ETFs near the top of its laundry list of things to do. And while the five-page note is brief in describing the staff's various areas of focus, the breadth of what the SEC plans to inspect when it comes to exchange-traded products leaves little doubt that sponsors like BlackRock Inc. and ProShares will find themselves busy explaining their business to the government this year.

Among other things, SEC examiners will be looking at whether ETFs are complying with the terms of the so-called exemptive relief granted by agency staff, without which they can't legally operate. They also will inspect the process that ETFs have in place for creating and redeeming shares.

Also, having categorized the initiative as one to protect retirement savers, the SEC will look at how ETF providers treat their customers by examining sales and trading practices, disclosures of risks and the suitability of sales, particularly when it comes to complex varieties known as leveraged and inverse ETFs.

While it is anyone's guess what SEC examiners will uncover and whether it will generate an enforcement referral, some violations will likely be found and punished given the wide scope of the agency's planned review, said Todd Cipperman, principal at Cipperman Compliance Services LLC.

“You can sure bet when they have this focus, you are going to see some enforcement actions,” said Cipperman, a former general counsel of mutual fund complex SEI Investments Co.

“Dollars to doughnuts, I think there are maybe some enforcement actions in the hopper already,” he added.

ETFs, which are essentially baskets of securities that continually trade on exchanges, have become hugely popular alternatives to mutual funds in recent years. At the end of 2015, ETFs had more than $2.13 trillion in assets under management, or about double the $1.06 trillion under management at the end of 2011, according to Morningstar data.

Yet despite this growth, regulators and some financial market leaders have raised serious questions about the safety and soundness of the products as they have become more and more mainstream.

These concerns were particularly elevated after the market meltdown on Aug. 24, when dozens of ETFs saw their prices plunge below the indices they were tracking and hundreds of subsequent trading halts hit ETFs shares in the minutes that followed. Some of these problems appeared to be exacerbated by rules set up in the wake of the 2010 flash crash to limit how much a single stock can rise or fall within a given period, experts say.

To some attorneys who frequently work with ETF sponsors, the issues seen during the flash crash and on Aug. 24 were but a blip on the long and generally problem-free history of ETFs.

"They have had 45 minutes of problems over the past 20 years," said W. John McGuire of Morgan Lewis & Bockius LLP.

But for the SEC, "it’s enough to spook them," he added.

Current SEC member Kara Stein has raised concerns about ETFs in speeches over the past year. And before he left the agency at the end of last year, former Commissioner Luis Aguilar said the whole ETF sector may be ripe for a review and possibly new rule-making.

But it is unknown whether any action will be taken. The SEC in 2008 proposed new rules to shed the current process of obtaining exemptive orders to offer ETFs, yet no action has been taken on the proposal in the nearly eight years that have passed.

For the past few years, the SEC has been outlining its priorities for examinations going forward, much as the Financial Industry Regulatory Authority has done. While some of its interests are perennial, the focus on ETFs is new for this year’s letter.

Other new priorities added to this year's letter include a focus on the controls that firms have in place when dealing with potentially illiquid investments, an issue that became highlighted by the December blowup of a $790 million junk-bond fund run by Third Avenue Management.

The SEC also will be zeroing in on investment advisers to public pension funds, in order to check their compliance with pay-to-play regulations.

Attorneys said they had yet to hear from the SEC's examinations unit on ETFs, so it remains to be seen where they will focus their energies. But experts don't expect firms will walk away with a clean bill no matter how much they focus on compliance.

"No one ever gets perfect marks. Everyone knows they are going to get comments [from the exam staff]," said Kathleen Moriarty, a partner at Kaye Scholer LLP. "The only question is: Are they going to be serious comments?"

One area that appears ripe for inspection and potential yellow flags by the SEC is the compliance with the conditions of ETF exemptive orders, attorneys said.

While the orders lay out a number of conditions that need to be satisfied in order for the necessary exemptive relief to be granted, firms also make a number of representations about how their ETF will operate. It is an open question of how examiners will treat funds that have seen their procedures evolve over the years in a way that doesn't exactly match their representations.

The SEC's interest in ETFs' unit creation and redemption process also may be reviewed in light of what was disclosed in the exemptive order and the problems that were experienced on Aug. 24, Cipperman said.

The head of the SEC's examinations unit, Marc Wyatt, wasn't available for an interview on Monday. But in a statement, he said, "We hope that registrants will use this information to inform the evaluation of their own compliance programs in these key areas."

Similarly, attorneys said they were hopeful the ETF probe will be used more to further the SEC's own grasp of the fast-growing sector, rather than as a steppingstone for future enforcement.

"In the most positive sense, I like to think this is the SEC's way of getting a better understanding of how ETFs operate in the marketplace," McGuire said.

--Editing by Jeremy Barker and Patricia K. Cole. Photo by Jimmy Hoover.