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Are complex ETFs suitable investments?

Executives want more regulation of complicated leveraged and inverse funds

By Jessica Toonkel | *February 10, 2011 - 4:02 pm EST*

Executives at BlackRock Inc. and Invesco PowerShares Capital Management LLC are calling on regulators to address suitability requirements for the sale of sophisticated ETFs, such as commodities-based and leveraged funds.

Although BlackRock would like to see increased suitability requirements for the sale of these kinds of exchange-traded funds, Invesco PowerShares hopes that regulators create a separate class of investors who could invest in more-sophisticated products, executives at the firms said.

The firms have good reason to be championing greater control over investments in the funds.

ETFs have been growing rapidly, surpassing $1 trillion in assets at the end of last year. And a chunk of that growth is from retail investors.

At The Charles Schwab Corp., retail investor ownership of ETFs jumped 61% last year.

A horror story in the ETF industry, however, could spoil things for other providers, turning ETFs into “the new CDO,” said Christian Magoon, an ETF consultant and chief executive of Magoon Capital LLC, referring to collateralized-debt obligations, the instruments that fueled the mortgage crisis. “And with products that are traded on the exchange, you can't control how people are using them.”

That lack of control has already caused problems and given ETFs something of a black eye.

Commodity ETFs — dubbed the “Worst Investment in America” in a recent Bloomberg BusinessWeek article — were linked to the May 6 flash crash during which smaller investors got smacked.

And today, a report in the Financial Times said that the Securities and Exchange Commission is investigating whether ETFs are being used to hide large bets based on inside information.

Although that probe may have nothing to do with ETFs themselves, more negative headlines for the offerings can't help.

Future problems are most likely to arise from complicated ETFs, particularly leveraged and inverse funds, observers said. Leveraged ETFs use derivatives and debt instruments to outperform their market indexes, while inverse ETFs use derivatives to achieve high returns when their benchmark indexes decline.

Regulators have already expressed concerns about these products.

In 2009, the SEC and Financial Industry Regulatory Authority Inc. published notices warning investors about leveraged and inverse ETFs.

In March, the SEC stopped approving new ETFs that use derivatives. At the time, the SEC indicated that it wanted to see if additional investor protections were warranted, particularly for leveraged and inverse ETFs.

In October, Finra came out with another notice specifically about disclosures for commodity futures-linked securities. Finra said that the returns on these products, which include ETFs, can deviate substantially from the performance of their referenced commodities, particularly over longer periods of time.

BlackRock, however, is worried that just asking firms to disclose the risks associated with these kinds of funds isn't enough, said Noel Archard, head of U.S. product at the firm's iShares unit.

“I am not sure a pop-up disclosure is enough,” he said during a panel discussion at a conference last week. “Leveraged and inverse ETFs are very hard to explain.”

Mr. Archard has talked to the SEC about creating some type of suitability requirement that would address these issues, he said. Although some broker-dealers do have approved lists for ETFs, not all do, he said.

“This is something that everyone — the sponsors and the distributors — need to get involved in,” Mr. Archard said in comments following the panel discussion.

But Florence Harmon, an SEC spokeswoman, said “there is nothing currently on the Commission’s rulemaking calendar.”

Nancy Condon, a Finra spokeswoman, said that the regulator already has suitability requirements in place that apply to both simple and sophisticated ETF products.

If BlackRock ever launches leveraged or inverse ETFs, it probably would only make them available to institutional investors, given their complexity.

“These products are difficult to explain. So for now we make them available only through institutions,” Mr. Archard said.

For its part, Invesco PowerShares would like regulators to allow firms to offer complicated ETFs such as leveraged or inverse funds. But Benjamin Fulton, head of the firm's global ETF business, suggested that regulators allow the sale of these kinds of ETFs to sophisticated investors, such as high-net-worth investors.

“You could qualify investors by assets under management or by whether they are an institutional investor or not,” said Mr. Fulton, who said that he has discussed this idea with the Investment Company Institute, the mutual fund trade association.

In turn, the ICI has asked the SEC “not to hold up consideration of new and pending ETF applications during its review” of the use of derivatives by mutual funds and ETFs, said Ianthe Zabel, a spokeswoman at the ICI.

“The staff seeks to review applications as efficiently as possible in the best interest of investors," Ms. Harmon said.

Not everyone, however, thinks that there should be formal rules about who should be allowed to buy complex ETFs or how advisers should sell them.

“I am not sure you need to put a structure around it,” said Andrew O'Rourke, chief marketing officer at Direxionfunds, which offers leveraged ETFs. “There is a responsibility of the adviser and the investor to know what they are buying.”

Direxion offers online modules explaining its ETFs, but the firm thinks that broker-dealers could do more in terms of education.

“I would like to see more guidance for broker-dealers on how to explain and sell these products, rather than have regulators create guidelines about who should invest in them,” Mr. O'Rourke said.

Whether either approach sits well with brokers remains to be seen.

The broker-dealer industry will have to weigh the costs and benefits of increasing suitability requirements for complex-ETF buyers, said Jim Ross, senior managing director at State Street Global Advisors Inc.

“I see both sides of the argument,” he said. “The challenge is that the broker-dealers would need to build the infrastructure to support this.”