

LPL beefing up its compliance in wake of Massachusetts suit; B-D cracking down on sale of leveraged ETFs; suitability at issue

By Bruce Kelly January 27, 2013 InvestmentNews

In today's tough regulatory climate for broker-dealers, with watchdogs routinely whacking firms with large fines, broker-dealer executives may be imagining a securities regulator or two under their beds when they nod off at night.



Recent decisions by LPL Financial LLC would hint that compliance pros at the biggest independent broker-dealers are seeing a gaggle of state and federal securities cops chase them in their dreams.

And the nomination by President Barack Obama last week of Mary Jo White, a former federal prosecutor, to head the Securities and Exchange Commission is probably not helping.

The Massachusetts Securities Division in December sued LPL, alleging the firm failed to supervise registered representatives who sold nontraded real estate investment trusts in violation of both state limitations and the company's rules. Nontraded REITs are by far the most popular alternative investment product sold by independent broker-dealers such as LPL.

Massachusetts regulators also charged the company with dishonest and unethical business practices. The state's charges stemmed from the sale of \$28 million in nontraded REITs to almost 600 clients between 2006 and 2009.

Charges included sales made in violation of Massachusetts' 10% concentration limits, prospectus requirements and LPL compliance practices.

The firm received gross commission of \$1.8 million for those sales, according to the complaint.

LPL now has told its 13,000 registered reps and investment advisers that it is cracking down on sales of leveraged, inverse and monthly reset mutual funds.

As of April 1, LPL reps no longer can source those kinds of mutual funds directly from a fund sponsor such as ProFund Advisors LLC or Rydex Funds. Instead, those orders must be directed through LPL's broker-dealer, undoubtedly giving the company more control over the flow of such orders.

Leveraged and inverse mutual funds are nontraditional investments and can either move in the opposite direction of a market or index, boost the way the market moves, or both. The North American Securities Administrators Association in 2009 included leveraged exchange-traded funds among its top 10 investor traps, while the Securities and Exchange Commission and the Financial Industry Regulatory Authority Inc. at the same time issued alerts to investors warning about the risks of such funds.

“I tell my clients that misery loves company,” said Alan Wolper, a partner at Ulmer & Berne LLP. “The regulators are not picking on you; they're picking on everybody.”

LPL already prohibits the sale of ETFs, exchange-traded notes and mutual funds that are more than two times leveraged, meaning investors see double the daily gains or losses created by the investments. Over the past few years, securities regulators have been closely watching broker-dealers' sales of such leveraged products, particularly ETFs.

One problem has been that some reps and investors do not understand that leveraged ETFs reset daily and are not securities that benefit from a “buy and hold” strategy.

Indeed, securities regulators recently have taken action against firms for sales of leveraged and inverse-action ETFs. Last May, Finra ordered broker-dealers of four major banks, Wells Fargo & Co., Citigroup Global Markets Inc., Morgan Stanley and UBS Financial Services Inc., to pay \$9.1 million in fines and restitution for selling such funds “without reasonable supervision and for not having a reasonable basis for recommending the securities.”

Is LPL's move to stop sales of such leveraged funds directly from a fund sponsor an indicator that broker-dealers could face more scrutiny of sales of such products?

“Last year, the regulators became concerned with self-directed individual retirement accounts and third-party custodians,” Mr. Wolper said. LPL's move may be a reaction to that, with a broker-dealer's looking to have more control, he said.

KEY CHANGES

As a consequence of Massachusetts' investigation into its sale of nontraded REITs, LPL said it has made key changes. “In July of 2012, LPL changed its policies and procedures, creating a separate complex-products team to review all alternative investments,” according to the lawsuit.

So why did LPL make this decision to prohibit the direct sale of such funds by their reps?

“We often review our policies relating to investment products and suitability, and make enhancements we believe are in the best interests of both our advisers and the clients they serve,” LPL spokeswoman Betsy Weinberger said.

So if regulatory bogeymen are lurking under the beds of executives at broker-dealers, they may be finding fewer to scare at LPL. Time will tell.

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