

Commodity Futures-Linked Securities

Sales Practice Obligations for Commodity Futures-Linked Securities

Executive Summary

Securities that offer exposure to commodities have become increasingly popular and accessible to retail investors in recent years. Given the practical difficulties that can be associated with investing directly in many commodities, commodity-linked securities often use futures contracts to track an underlying commodity or commodity index. Commodity futures-linked securities can be an effective tool for gaining exposure to an asset class that in some cases can be difficult for retail investors to access. However, firms should be aware that, in some cases, the performance of the commodity futures-linked security can deviate significantly from the performance of the referenced commodity, especially over longer periods. The deviation could be either positive or negative, depending on market conditions and the product's investment strategy. This deviation can produce unexpected results for investors who are not familiar with futures markets, or who mistakenly believe that commodity futures-linked securities are designed to track commodity spot prices.

FINRA is issuing this *Notice* to remind firms that offer commodity futures-linked securities that they must ensure that communications with the public about these securities are fair and balanced, that recommendations to customers are suitable, and that their registered representatives adequately understand and are able to inform their customers about these securities before they recommend them. To meet these obligations, firms must train registered personnel about the characteristics, risks, and rewards of each product before they allow registered persons to sell that product to investors. Firms must also have adequate written supervisory procedures and supervisory controls that are reasonably designed to ensure that sales of commodity futures-linked securities comply with the federal securities laws and applicable FINRA rules.

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Notice Type

- Guidance

Suggested Routing

- Advertising
- Compliance
- Legal
- Senior Management

Key Topics

- Commodity Futures-Linked Securities
- Communications with the Public
- Exchange-Traded Products
- Futures Contracts
- Suitability
- Supervision and Training

Referenced Rules & Notices

- Incorporated NYSE Rule 342
- NASD Rule 2210
- NASD Rule 2310
- NASD IM-2310-2(e)
- NASD Rule 3010
- NASD Rule 3012
- Regulatory Notice 09-31



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Background and Discussion

Commodity prices can be volatile. For example, the price of crude oil declined nearly 80 percent between July and December 2008; in the first six months of 2009, it rose nearly 50 percent. Nonetheless, some research suggests that investments in commodities can be a valuable part of an overall diversification strategy. Some investors may also be attracted to commodities as a hedge against inflation, or as a strategy for taking advantage of growth in emerging markets.

Over the past several years, the number of products designed to provide retail investors exposure to either a particular commodity or a diversified basket of multiple commodities has grown.¹ Given the practical difficulties associated with investing in some commodities, many products that offer exposure to commodities use futures contracts as their investment strategy. Standardized futures contracts are exchange-traded derivatives that guarantee delivery of a commodity on an agreed-upon date for an agreed-upon price. To avoid taking physical delivery of the commodity, commodity futures-linked securities that seek to provide investors with continuous exposure to commodities typically sell their next-to-expire contracts (those with the nearest delivery date) prior to expiration and replace them with contracts with more distant delivery dates—for example, those expiring in the next month. This is called rolling the position.

A futures contract reflects the expected value of the commodity upon delivery in the future, whereas the spot price reflects the immediate delivery value of the commodity.² The price movements of a futures contract are typically correlated with the movements of the spot price of the referenced commodity, but the correlation is generally imperfect and price moves in the spot market may not be reflected in the futures market (and vice versa). Prices for futures contracts with more distant delivery dates can differ from each other as well as the spot price.³ Futures and spot prices generally converge as the futures contract expiration approaches, and they should be equal upon expiration of the futures contract, which then becomes a contract for immediate delivery.

A commodity futures-linked security will typically roll its position before a contract's expiration and can face differing prices between the contract it sells and the new contract—for more distant delivery—that it buys. This difference is called the roll yield.

In some cases a commodity futures-linked security will have to roll its position into a more expensive contract (that is, the contract that is sold has a lower price than the one with which it is replaced), resulting in a loss, or negative roll yield. This is typical of a futures market in contango, in which futures contracts with more distant delivery dates are more expensive.⁴ In other cases, it may roll its position into a less expensive contract (that is, the contract that is sold has a higher price than the one with which it is replaced), resulting in a gain, or positive roll yield. This is typical of a futures market in backwardation, in which futures contracts with more distant delivery dates are less expensive.⁵ Due to these and other market forces, commodity futures-linked securities can perform differently—either better or worse—than the spot price for the commodity itself.⁶ Moreover, over time, any performance differential can be magnified if a specific condition persists in the market for a given commodity, such as contango or backwardation. This deviation is not tracking error, because the futures-linked products are designed to track futures. However, it can lead to unexpected results for investors or registered representatives who do not understand the product, or who mistakenly believe that the product will replicate the performance of the commodity's spot price.

Commodity futures-linked securities can have different methodologies for achieving their investment objectives, and they may or may not employ strategies that address roll yield. Some invest in a single futures contract, often the one with the closest delivery date. Others invest in multiple contracts along the futures curve (*e.g.*, holding contracts for each of the next 12 months), which can allow them to diversify across different futures contracts. Others pursue more complicated investment strategies, such as tracking indices that attempt to optimize roll yield by minimizing the impact of contango or maximizing the impact of backwardation. Each strategy has different benefits, risks and costs, and the appropriateness of a particular methodology depends, in part, on an investor's needs and preferences.

Sales Practice Obligations

Firms have an obligation to understand the products they sell in order to ensure that their communications with the public about the products are fair, balanced, and not misleading, that their recommendations to customers are suitable, that customers are adequately informed about the product and that their sales force is adequately trained and supervised.

Under NASD Rule 2210, firms must ensure that all communications with the public are fair and balanced, and provide a sound basis for evaluating the facts about any particular security or type of security, industry or service. No firm may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading. In particular, firms

should not suggest that a commodity-futures linked security offers direct exposure to the commodity's spot price, overstate the degree of correlation between the two or understate the risks inherent in investing in commodity futures. Firms should also not overstate the hedging value of commodity futures-linked products, or commodities generally, for, by example, implying that their performance is always negatively correlated with equities or other asset classes. The fact that a prospectus makes it clear that the goal of the product is to use futures to track the price of the commodity or index, or discloses that there is a potential for a performance gap between the futures and spot prices does not alleviate a firm's duty to ensure that its communications regarding the product are fair, balanced and not misleading.

In addition, NASD Rule 2310 requires that, before recommending the purchase, sale or exchange of a security, a firm must have a reasonable basis for believing that the transaction is suitable for the customer to whom the recommendation is made. NASD IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products) emphasizes the obligation of firms to deal fairly with customers when making recommendations or accepting orders for new financial products. The IM states that "[a]s new products are introduced from time to time, it is important that members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding the products." For commodity futures-linked securities, the registered representative and retail customer should discuss, among other things:

- the commodity, basket of commodities or commodities index that a given product tracks;
- the product's goals, strategy and structure;
- that commodities prices, and the performance of commodity futures-linked securities, can be volatile;
- that the use of futures contracts can affect the performance of the product as compared to the performance of the underlying commodity or index;
- the product's methodology, including its strategy, if any, for managing roll yield and other factors that may affect performance; and
- the product's tax implications. (Commodity pools have different tax implications than mutual funds or exchange-traded notes.)

The fact that commodity futures-linked securities can perform differently from the spot price of a given commodity does not mean that they are not suitable for any investor or that they cannot be effective investment vehicles. However, firms that sell commodity

futures-linked securities must ensure that their registered representatives understand each product's goals, strategy and structure, and how those factors may affect the product's suitability for specific customers, given, among other things, the customers' investment objectives, investment horizons and tax status.

Training and Supervision

Firms that sell commodity futures-linked securities must provide adequate training to ensure that their registered persons understand the products they recommend, and that they describe them in a manner that is fair, balanced and not misleading. Firms must also train registered personnel about the characteristics, risks, and rewards of each product before they allow registered persons to sell that product to investors. In connection with such training, firms should train registered persons about how to make customers aware of the pertinent information regarding the products and train them about the factors that would make the products either suitable or unsuitable for certain investors. Training should not be limited to representatives selling such products. Firms should also provide appropriate training to supervisors of registered persons selling commodity futures-linked securities. Firms must also have adequate written supervisory procedures and supervisory controls that are reasonably designed to ensure that sales of commodity futures-linked securities comply with the federal securities laws and FINRA rules.⁷

Endnotes

- 1 One such example is the commodity-linked exchange-traded product (ETP). ETPs can be organized as, among other things, 1940 Act investment companies (*e.g.*, exchange-traded funds), commodity pools, grantor trusts, or exchange-traded notes. At the end of July 2010 there was over \$80 billion in commodity ETPs, or about 10 percent of total ETP assets, up from around \$60 billion at the same point in 2009. Other investment products offering retail investors exposure to commodities can include mutual funds and closed-end funds, structured notes linked to commodities, and hedge and managed futures funds. Some commodity-linked products offer leveraged or inverse exposure to the commodity or index they track. Leveraged and inverse commodity-linked products could present similar issues to those highlighted by FINRA in *Regulatory Notice 09-31* regarding non-traditional exchange-traded funds (ETFs).
- 2 A variety of factors can lead to a disparity between the expected future price of a commodity and the spot price at a given point in time, such as the cost of storing the commodity for the term of the futures contract, interest charges incurred to finance the purchase of the commodity, and expectations concerning supply and demand for the commodity.
- 3 The difference between the price of a futures contract and the spot price of a commodity is often referred to as the basis. The difference between prices for futures contracts with different expiration dates is often called the spread.
- 4 Contango does not necessarily lead to negative returns, but can be a drag on performance relative to the spot commodity. A futures market can experience contango because the price of the underlying commodity is expected to rise.
- 5 Backwardation does not necessarily lead to positive returns, but can boost performance relative to the spot commodity. A futures market can experience backwardation because the price of the underlying commodity is expected to decline.
- 6 The roll yield is only one factor that can cause the performance of a commodity futures-linked security to deviate from the performance of the spot price of a commodity. The previously noted imperfect correlation between futures and spot prices is another. Like any product that tracks an asset or index, other factors that can affect the performance of a futures-linked security include transaction costs, management fees and taxes.
- 7 See NASD Rules 3010 and 3012, and Incorporated NYSE Rule 342 and its related supplementary material and interpretations.

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