

IIROC NOTICE

Rules Notice

Guidance Note

Dealer Member Rules

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09-0172

June 11, 2009

Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds

Executive Summary

Exchange-traded funds (ETFs) that offer leverage or that are designed to perform inversely to the index or benchmark they track, or both, are growing in number and popularity. While such products may be useful in some sophisticated trading strategies, they are highly complex financial instruments that are typically designed to achieve their stated objectives on a daily basis. Due to the effects of compounding, their performance over longer periods of time can differ significantly from their stated daily objective. Therefore, leveraged and inverse ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets.

This Notice reminds Dealer Members of their sales practice obligations in connection with leveraged and inverse ETFs. In particular, recommendations to customers must be suitable and based on a full understanding of the terms and features of the product recommended; sales materials related to leveraged and inverse ETFs must be fair and accurate; and Dealer Members must have adequate supervisory procedures in place to ensure that these obligations are met.



Further Information

This Notice is being issued concurrently with a Financial Industry Regulatory Authority (FINRA) Regulatory Notice on the same topic. The Notice content is similar, with the exception of the inclusion and discussion of IIROC rule references and the inclusion of Canadian ETF performance examples. A copy of the equivalent FINRA Regulatory Notice is available at:

www.finra.org/notices/09-31

Background and Discussion

ETFs are securities that trade on an exchange that track the performance of an underlying benchmark or index. The underlying assets to the benchmark or index may be stocks, bonds or other assets such as commodities.

Leveraged ETFs seek to deliver multiples of the performance of the index or benchmark they track. Some leveraged ETFs are “inverse” or “short” funds, meaning that they seek to deliver the opposite of the performance of the index or benchmark they track. Like traditional ETFs, some inverse ETFs track broad indices, some are sector-specific, and still others are linked to commodities or currencies. Inverse ETFs are often marketed as a way for investors to profit from, or at least hedge their exposure to, downward-moving markets. Some funds are both short and leveraged, meaning that they seek to achieve a return that is a multiple of the inverse performance of the underlying index. An inverse ETF that tracks the S&P/TSX 60 Index, for example, seeks to deliver the inverse of the performance of the S&P/TSX 60 Index, while a 2x leveraged inverse S&P/TSX 60 Index ETF seeks to deliver twice the opposite of that index’s performance. To accomplish their objectives, leveraged and inverse ETFs pursue a range of investment strategies through the use of swaps, futures contracts and other derivative instruments.

Most leveraged and inverse ETFs “reset” daily, meaning that they are designed to achieve their stated objectives on a daily basis. Due to the effect of compounding, their performance over longer periods of time can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark over longer periods of time. For example, a Canadian ETF that seeks to deliver twice the daily return of the COMEX Gold Bullion Index fell 5 per cent between January 22, 2008 and May 29, 2009. However, its inverse fund (twice the inverse daily return of the index) fell 38 per cent in the same time period. The underlying COMEX Gold Bullion Index increased by 6 per cent during this period.

This effect can be magnified in volatile markets. Using a two-day example, if the index goes from 100 to close at 101 on the first day and back down to close at 100 on the next day, the two-day return of an inverse will be different than if the index had moved up to close at 110 the first day but then back down to close at 100 on the next day. In the first case with low



volatility, the inverse ETF loses 0.02 per cent; but in the more volatile scenario the inverse ETF loses 1.82 per cent. The effects of mathematical compounding can grow significantly over time, leading to scenarios such as those noted above.

Suitability

IIROC Dealer Member Rules 1300.1(p) and (q) require that, before recommending or accepting a customer order to purchase or sell a security, a firm must determine that the transaction is suitable for the customer. This analysis has two components. The first in determining whether the product is suitable for any customer, an analysis that requires Dealer Members and its registered persons to fully understand the products and transactions they recommend. With respect to leveraged or inverse ETFs, this means that a firm must understand the terms and features of the funds, including how they are designed to perform, how they achieve that objective, and the impact that market volatility, the ETF's use of leverage and the customer's intended holding period will have on their performance. Dealer Members may find it helpful to refer to IIROC Guidance Note 09-0087, which provides further guidance on best practices for product due diligence.

Once a determination is made that a product is generally suitable for at least some investors, a firm must also determine that the product is suitable for specific customers. This analysis includes making reasonable efforts to obtain information concerning the customer's financial situation, investment knowledge, investment objectives, risk tolerance and any other relevant customer specific information. While the customer-specific suitability analysis depends on the investor's particular circumstances, leveraged and inverse ETFs typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets.

Communications with the Public

In accordance with IIROC Dealer Member Rule 29.7, all sales materials and oral presentations used by Dealer Members regarding leveraged and inverse ETFs must present a fair and balanced picture of both the risks and benefits of the funds, and may not omit any material fact or qualification that would cause such a communication to be misleading. For example, statements about a leveraged or inverse ETF that are designed to achieve its investment objective on a daily basis may not omit that fact or imply that the fund is designed to track the underlying index or benchmark over a longer period of time. Dealer Members are further reminded that providing risk disclosure in a prospectus or product description does not cure otherwise deficient disclosure in sales material, even if the sales material is accompanied or preceded by the prospectus or product description.



Supervision

In accordance with IIROC Dealer Member Rule 2500, firms should establish an appropriate supervisory system to ensure that their registered persons comply with all applicable IIROC rules and applicable securities laws when recommending any product, including leveraged and inverse ETFs. Among other things, if a firm promotes or allows its registered representatives to recommend or accept orders for such funds, the firm must ensure that its written supervisory procedures require that:

- the appropriate product suitability analysis is completed;
- a customer-specific suitability analysis is performed;
- all sales materials are accurate and balanced; and
- all IIROC rules and applicable securities laws are followed.

In addition to establishing written procedures, Dealer Members must document the steps they have taken to ensure adherence to these procedures.

Training

Dealer Members must train registered persons about the terms, features and risks of all ETFs that they sell, as well as the factors that would make such products either suitable or unsuitable for certain investors. In the case of leveraged and inverse ETFs, that training should emphasize the need to understand and consider the risks associated with such products, including the customer's investment objectives, and the impact of time and volatility on the fund's performance. Training for all persons should emphasize that, due to the complexity and structure of these funds, they may not perform over time in direct or direct inverse correlation to their underlying index. This is particularly important as many investors may be turning to these funds as part of a long-term strategy to weather current market conditions.