**FINANCIAL INDUSTRY REGULATORY AUTHORITY**
**LETTER OF ACCEPTANCE, WAIVER AND CONSENT**
**NO. 2010024620303**

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: FSC Securities Corporation (BD No. 7461)
Respondent

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent FSC Securities Corporation ("FSC" or the "Firm") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against FSC alleging violations based on the same factual findings described herein.

## I.

## ACCEPTANCE AND CONSENT

A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

### BACKGROUND

FSC has been a member of FINRA since August 1977, and is an introducing broker-dealer headquartered in Atlanta, Georgia. FSC conducts a general securities business employing an independent contractor model. FSC has over 1,300 registered individuals and over 650 branch offices located nationwide.

FSC has no relevant disciplinary history with the Securities and Exchange Commission, any state securities agency, FINRA or any other self-regulatory organization.

### OVERVIEW

From January 2009 through September 2014 (the "Relevant Period"), FSC executed approximately 6,500 purchases of leveraged, or inverse, or both inverse and leveraged Exchange-Traded Funds (collectively, "Non-Traditional ETFs") in approximately 1,400 retail customer accounts. Those purchases were worth approximately $92 million and generated approximately $603,000 in commissions.

However, FSC failed to establish and maintain a supervisory system, including written procedures, reasonably designed to ensure that the Firm's offering of Non-Traditional ETFs complied with NASD and FINRA rules. Non-Traditional ETFs have certain risks that are not associated with traditional ETFs or equities. The Firm's general supervisory system was not sufficiently tailored to address the unique features and risks involved with these products.

From January 2009 through November 2009, FSC allowed registered representatives to recommend Non-Traditional ETFs without establishing a reasonable supervisory system or written supervisory procedures specifically addressing these products. While the Firm prohibited the offering of certain kinds of Non-Traditional ETFs in December 2009, it allowed the offering of other kinds of Non-Traditional ETFs to continue after that date without implementing a reasonable system and written procedures to supervise those offerings. Based on the foregoing, FSC violated NASD Rule 3010(a) and (b) and FINRA Rule 2010.

Also, during the Relevant Period, FSC, by and through its registered representatives, recommended Non-Traditional ETFs to customers without fully understanding the features and risks associated with those products. FSC allowed its registered representatives to make unsuitable recommendations of Non-Traditional ETFs to many customers with conservative and moderate investment objectives and risk tolerances, some of whom were elderly. Moreover, many of those customers held the investments over extended periods of time and sustained losses of $492,485. Based on the foregoing, FSC violated NASD Rule 2310 and FINRA Rules 2111 and 2010.[1]

## FACTS AND VIOLATIVE CONDUCT

### A. Background

#### 1. Non-Traditional ETFs

ETFs are typically registered unit investment trusts (UITs) or open-end investment companies whose shares represent an interest in a portfolio of securities that track an underlying benchmark or index.[2] Shares of ETFs typically are listed on national securities exchanges and trade throughout the day at prices established by the market.

Leveraged ETFs are different from other ETFs in that they seek to deliver multiples of the performance of the index or benchmark they track. Some Non-Traditional ETFs are "inverse" or "short" funds, meaning that they seek to deliver the opposite of the performance of the index or benchmark they track. Some funds are both inverse and leveraged, meaning that they seek to achieve a return that is a multiple of the inverse performance of the underlying index or benchmark. To accomplish their objectives, Non-Traditional ETFs use swaps, futures contracts and other derivative instruments. The

[1] On July 9, 2012, FINRA Rule 2111 superseded NASD Rule 2310.
[2] *See* FINRA Regulatory Notice 09-31, *Non-Traditional ETFs* (June 2009).

Firm was not involved in the creation or initial structuring of the Non-Traditional ETFs that its registered representatives eventually sold.

Most Non-Traditional ETFs "reset" daily, meaning that they are designed to achieve their stated objectives on only a daily basis. On a particular day, a Non-Traditional ETF may come close to achieving its intended return. But the correlation between a Non-Traditional ETF and its linked index or benchmark is inexact, and there is typically at least a small difference or "tracking error," between a fund and its benchmark, which may compound over longer periods of time. This effect becomes more pronounced during periods of volatility in the underlying index or benchmark.

By January 2009, Non-Traditional ETFs had grown in popularity and their unique features and risks were prominently discussed in Non-Traditional ETF prospectuses and industry articles. FINRA noted in its June 2009 Regulatory Notice 09-31 about Non-Traditional ETFs that "[d]ue to the effect of compounding, their performance over longer periods of time can differ significantly from the performance . . . of their underlying index or benchmark during the same period of time."[3] Because of the risks and the inherent complexity of the products, FINRA advised broker-dealers and their representatives that Non-Traditional ETFs "are typically not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets."[4]

### 2. FSC's Non-Traditional ETF Business

During the Relevant Period, FSC's registered representatives recommended to retail customers the purchase of approximately $92 million worth of Non-Traditional ETFs that generated approximately $603,000 in commissions. FSC executed approximately 6,500 Non-Traditional ETF purchases in approximately 1,400 retail customer accounts. Many of the customers to whom the Firm recommended these products had primary investment objectives of income or growth and conservative/moderate risk tolerances. Many customers also held their Non-Traditional ETF positions for extended periods of time, often months and sometime years, and suffered net losses in those positions.

## B. FSC Failed to Establish and Maintain a Reasonable Supervisory System, including Written Procedures, Regarding Non-Traditional ETFs

NASD Rule 3010(a) states in part that

> each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.

[3] *Id.* at 2.
[4] *Id.* at 1.

> Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following: (1) the establishment and maintenance of written procedures...

NASD Rule 3010(b)(1) states in part that

> each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD.

**1. FSC Failed to Establish a Reasonable Supervisory System Regarding Transactions Involving Non-Traditional ETFs**

From January 2009 through November 2009, despite the publicity surrounding the risks of these products, the Firm did not employ a reasonable supervisory system or written procedures to monitor the recommendation of Non-Traditional ETFs. In December 2009, FSC prohibited the offering of Non-Traditional ETFs that were *greater than two times* leveraged and/or inverse of the daily performance of an underlying index, six months after the issuance of FINRA's June 2009 Regulatory Notice. The Firm's written procedures were revised in February 2010 incorporating this prohibition. However, the Firm did not at that time establish a reasonable system, including written procedures, to address the risks posed by Non-Traditional ETFs that sought to deliver, *two times or less*, leveraged and/or inverse of the daily performance of an underlying index. Hence, throughout the Relevant Period, the Firm allowed its registered representatives, without any monitoring, to recommend Non-Traditional ETFs that sought to deliver, *two times or less*, leveraged and/or inverse the daily performance of an underlying index. During most of the Relevant Period, the Firm did not have exception reports or any alerts in the Firm's electronic trade review system that addressed the risks posed by Non-Traditional ETFs. Further, the Firm did not reasonably implement a supervisory system to review the recommendations of Non-Traditional ETFs based on a customer's age, investment objective, risk tolerance or financial profile such as net worth or net income.

As a result, during the Relevant Period, FSC's representatives recommended Non-Traditional ETFs to retail customers for whom they were not suitable investments, as detailed below.

**2. FSC Failed to Monitor Non-Traditional ETF Holding Periods**

During the Relevant Period, FSC relied on its general supervisory procedures to supervise transactions in Non-Traditional ETFs. However, these general supervisory procedures were insufficient to address the unique features and risks involved with these products, including that their performance over longer periods of time can differ significantly from the performance of their underlying index or benchmark. From January 2009 to May 2012, the Firm failed to develop any system or procedure to monitor, review or evaluate the length of holding periods in Non-Traditional ETFs.

While in May 2012 FSC implemented a monthly report reflecting the holdings of Non-Traditional ETFs in retail customer accounts (the "holdings report"), the supervisors were given no guidance on how to evaluate holding periods or address the risks related to long-term holding periods. As such, even after May 2012, there were many customer accounts where Non-Traditional ETFs were held for long periods, and in some cases more than 1,000 days. The Firm suspended the issuance of the holdings report from June 2013 through August 2014 due to technical issues relating to the methodology used to calculate the holding periods. In September 2014, the Firm redeployed the holdings report. During the 15-month period that the Firm ceased the production of the holdings report, the Firm did not implement another procedure to monitor the length of the holding periods in Non-Traditional ETFs. Therefore, during the Relevant Period, despite being aware of the risks, the Firm had no system or procedures to monitor the length of the holding periods of Non-Traditional ETFs. This contributed to retail customers holding open positions of Non-Traditional ETFs for extended periods and incurring losses.

In October 2014, more than five years after the issuance of FINRA's June 2009 Regulatory Notice, the Firm imposed restrictions on the purchase of *all* Non-Traditional ETFs that sought to magnify or provide the inverse performance of an underlying index or benchmark. The Non-Traditional ETF purchases were allowed only in (i) fee-based accounts where the advisor had discretion over the account; or (ii) third party money manager wealth management platform accounts. The Firm's written procedures were revised in January 2015 reflecting the restrictions imposed on offering of all Non-Traditional ETFs.

Based on the foregoing, FSC violated NASD Rule 3010 (a) and (b) and FINRA Rule 2010 in that during the Relevant Period the Firm failed to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with NASD and FINRA Rules in connection with the offering of Non-Traditional ETFs in retail customer accounts.

### C. FSC Made Unsuitable Recommendations of Non-Traditional ETFs

The reasonable-basis suitability obligations under NASD Rule 2310 and FINRA Rule 2111 (that superseded NASD Rule 2310 on July 9, 2012), require a broker-dealer and its registered representatives to, inter alia, perform reasonable diligence to understand the nature of a recommended security, as well as the potential risks and rewards. FINRA has explained that with respect Non-Traditional ETFs, that means that firms "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."[5]

FSC failed to perform any reasonable basis suitability analysis of Non-Traditional ETFs to understand the unique features and specific risks associated with these products before offering the products to its retail customers.

As a result, FSC through its registered representatives, recommended Non-Traditional ETFs that were unsuitable for many retail customers based on their investment objectives, financial situation and age. FSC representatives recommended these complex and risky products to many customers with primary investment objectives of income or growth and conservative/moderate risk tolerances, some of whom were elderly. Moreover, many of these customers held Non-Traditional ETF positions for extended periods of time and sustained losses of $492,485. For example:

- An 82-year old customer with investment objectives of growth and income, a conservative risk tolerance, and a net worth of $500,000 held a Non-Traditional ETF for 521 days in her IRA account and sustained a loss of $14,251; and

- A 67-year old customer with investment objectives of income and growth, a moderate conservative risk tolerance and a net worth of $350,000 held a Non-Traditional ETF for 1,319 days in his IRA account and sustained a loss of $13,420.

Based on the foregoing, FSC violated NASD Rule 2310 and FINRA Rules 2111 and 2010.

B. FSC also consents to the imposition of the following sanctions:

- Censure;
- A fine in the amount of $100,000; and
- Restitution to be paid by FSC to certain of its customers in the amount of $492,485.33.

FSC agrees to pay the monetary sanctions upon notice that this AWC has been accepted and that such payments are due and payable. FSC has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

FSC specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanctions imposed in this matter.

Restitution is ordered to be paid to the customers listed on Attachment A hereto in the total amount of $492,485.33.

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[5] *See* FINRA Regulatory Notice 09-31; see also FINRA Regulatory Notice 12-03, *Complex Products-Heightened Supervision of Complex Product* (January 2012), at 5-6.

A registered principal of on behalf of Respondent firm shall submit satisfactory proof of payment of restitution or of reasonable and documented efforts undertaken to effect restitution. Such proof shall be submitted to Radhika Bhargava, Senior Counsel, FINRA Department of Enforcement, One Brookfield Place, 200 Liberty Street, New York, New York 10281, either by letter that identifies the Respondent and the case number or by email from a work-related account of the registered principal of FSC to EnforcementNotice@FINRA.org. This proof shall be provided to the FINRA staff member listed above no later than 120 days after acceptance of the AWC.

If for any reason FSC cannot locate any customers identified in Attachment A after reasonable and documented efforts within 120 days from the date of the AWC is accepted, or such additional period agreed to by a FINRA staff member in writing, FSC shall forward any undistributed restitution to the appropriate escheat, unclaimed property or abandoned property fund in the state in which the customer is last known to have resided. Respondent shall provide satisfactory proof of such action to the FINRA staff member identified above and in the manner described above, within 14 days of forwarding the undistributed restitution to the appropriate state authority.

The imposition of a restitution order or any other monetary sanction herein, and the timing of such ordered payments, does not preclude customers from pursuing their own actions to obtain restitution or other remedies.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

## II.

## WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

A. To have a Complaint issued specifying the allegations against it;

B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and

D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

## III.

## OTHER MATTERS

Respondent understands that:

A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and

C. If accepted:

1. this AWC will become part of the Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;

2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;

3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and

4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's: (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal

proceedings in which FINRA is not a party.

D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that they may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that the Firm has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

FSC Securities Corporation

07/13/2017
Date (mm/dd/yyyy)

By: Jerome Murphy
Jerome Murphy
President and CEO

Accepted by FINRA:

8/10/17
Date

Signed on behalf of the
Director of ODA, by delegated authority

Susan Light
Susan Light
Senior Vice President and Chief Counsel
FINRA Department of Enforcement
One Brookfield Place
200 Liberty Street
New York, New York 10281-1003
Tel: (646) 315-7333

## Attachment A

| Customer Initials | Amount of Restitution |
|---|---|
| W.H. | $284.25 |
| M.W. | $381.00 |
| W.M. | $1,151.82 |
| W.D. | $1,669.75 |
| M.W. | $2,207.35 |
| B.C. | $3,458.51 |
| E.M. | $7,631.64 |
| J.R. | $13,850.65 |
| D.B. | $6,325.50 |
| H.B. | $251.45 |
| J.S. | $306.66 |
| M.M. | $323.68 |
| B.M. | $349.18 |
| J.J. | $367.41 |
| V.W. | $377.62 |
| J.S. | $397.62 |
| M.K. | $430.65 |
| P.A. | $447.81 |
| G.L. | $464.80 |
| H.W. | $471.80 |
| S.C. | $473.79 |
| L.G. | $478.61 |
| J.G. | $481.32 |
| L.M. | $481.61 |
| W.S. | $485.30 |
| K.S. | $493.43 |
| W.M. | $498.80 |
| E.M. | $554.54 |
| J.G. | $557.37 |
| A.M. | $574.23 |
| J.W. | $603.62 |
| K.W. | $605.00 |
| M.T. | $666.10 |
| R.K. | $690.99 |
| J.W. | $693.99 |
| C.B.C. | $708.35 |
| M.B. | $728.85 |
| J.M. | $741.62 |
| R.M. | $871.06 |

| Customer Initials | Amount of Restitution |
|---|---|
| F.R. | $891.08 |
| B.G. | $907.24 |
| V.B. | $937.58 |
| K.D. | $942.03 |
| D.S. | $1,028.55 |
| S.A. | $1,032.61 |
| D.G. | $1,056.62 |
| C.C. | $1,086.30 |
| C.S. | $1,086.30 |
| F.R. | $1,086.30 |
| K.C. | $1,133.24 |
| K.B. | $1,241.80 |
| J.R. | $1,312.60 |
| M.R. | $1,362.44 |
| D.M. | $1,452.81 |
| K.S. | $1,453.99 |
| P.M. | $1,526.89 |
| D.T. | $1,573.42 |
| S.M. | $1,780.92 |
| R.B. | $2,174.40 |
| J.M. | $2,192.92 |
| R.R. | $2,384.12 |
| G.P. | $2,592.28 |
| J.C. | $2,608.34 |
| R.K. | $2,680.35 |
| C.L. | $2,757.00 |
| F.Z. | $3,178.80 |
| L.A. | $3,316.04 |
| J.M. | $3,323.88 |
| E.M. | $3,421.86 |
| A.M. | $3,461.86 |
| J.C. | $3,575.02 |
| L.F. | $3,595.66 |
| K.M. | $3,649.74 |
| P.W. | $3,708.91 |
| P.M. | $3,957.95 |
| K.K. | $4,023.13 |
| T.K. | $4,155.96 |
| G.R. | $4,716.45 |
| F.B. | $4,765.07 |
| C.W. | $4,904.32 |

| Customer Initials | Amount of Restitution |
|---|---|
| J.M. | $5,147.81 |
| J.P. | $5,159.22 |
| L.P. | $5,361.22 |
| K.M. | $5,497.76 |
| S.R. | $6,026.22 |
| M.C. | $6,148.42 |
| D.P. | $6,953.13 |
| J.L. | $7,233.24 |
| C.J. | $7,321.28 |
| R.M. | $8,716.56 |
| S.R. | $8,922.33 |
| F.A. | $9,165.31 |
| P.M. | $9,216.84 |
| G.H. | $9,387.96 |
| R.C. | $9,818.10 |
| R.G. | $9,834.00 |
| B.R. | $10,090.60 |
| G.M. | $10,466.46 |
| J.M. | $10,661.20 |
| J.B. | $11,185.62 |
| G.S. | $11,594.70 |
| S.C. | $12,436.50 |
| E.P. | $13,283.88 |
| R.M. | $13,420.40 |
| E.M. | $14,251.09 |
| F.F. | $14,771.75 |
| M.S. | $15,353.39 |
| C.R. | $15,710.07 |
| J.S. | $30,047.16 |
| M.T. | $38,728.60 |
| **Total** | **$492,485.33** |