

Only Sell What You Know-II: Selling Variable Interest Structure Products Is a Fraud on the Unsuspecting

Article By:

Peter D. Hutcheon

The U.S. Securities and Exchange Commission (“SEC”) has become increasingly concerned about the sale of complex investment products to retail investors, especially as investors seek enhanced returns in a period (from the Great Recession in 2008 until the Spring of 2022) when the recurring commitment of Quantitative Easing policies by the Board of Governors of the Federal Reserve System (“FRB”) and the interest-rate strictures by the FRB’s Open Market Committee (“FOMC”) had driven down yields on debt investments to just above 0%. A persistent feature of the human condition is, apparently, a desire to “beat the market” by achieving above-average returns. These types of products use option strategies, investments tied to unusual indices, and other exotica.

The SEC regularly issues warnings to investors, such as the statements of three of the Commissioners (Chairman Gensler and Messrs. Crenshaw and Lee) in 2021 questioning the appropriateness of market professionals recommending complex products to retail investors. However, those professionals continue to recommend such products, which are difficult to understand at best, and are unsuitable for most retail investors. The SEC regularly pronounces that “[r]egistered representatives [of a broker/dealer] are required to recommend only securities transactions that are suitable for their customers,” as asserted in the Commission’s July 28, 2022, Complaint filed against Alan Z. Appelbaum in the Federal Court for the Southern District of Florida. To date, however, the Commission has elected not to promulgate regulatory guidance expressly limiting the sale of such products to investors. Instead, the SEC has engaged in “Regulation by Enforcement,” with its first “salvo” a Nov. 13, 2020, administrative enforcement action against American Financial Services, Inc., involving the sale of exchange traded notes linked to future contracts on specific maturities on the VIX (the Volatility Index created and administered by the Chicago Board of Options Exchange [CBOE]). That investment caused the investor a considerable loss.

On June 29, 2022, the SEC instituted an Administrative and Cease-and-Desist Proceeding against UBS Group, AG (“UBS”), the Swiss institution that is the largest bank in Europe and the second largest in the world, for selling “Yield Enhancement Strategy” (“YES”) products to hundreds of investors, without a full understanding of the products or the risks inherent in them. See my Blog published Aug. 22, 2022 [“Only Sell What You Know: Swiss Bank Negligence is a Fraud on Investors”](#), for a more detailed discussion of YES investments and the history of UBS. YES, investors were told the use of short-term out-of-the money options tied to their existing stock portfolios would

produce additional income from the yields on the options. When the market turned against them the investors lost over \$60 million. The SEC enforcement action required UBS to disgorge \$5.8 million of profits plus \$1.4 million in prejudgment interest, and imposed a civil penalty of \$17.4 million.

Now the Commission has brought another complex product enforcement action, filing a Complaint against Appelbaum on July 29, 2022, and on that same day initiating two Administrative and Cease-and-Desist Proceedings: one against Paul F. Gallivan, a 49-year-old registered representative and investment adviser resident in Del Ray Beach, Florida, who is associated with Aegis Capital Corp. (“Aegis”); and the other against Aegis itself, a New York corporation headquartered in New York (and with 23 branch offices), acting as a broker/dealer and investment adviser. Aegis employs over 400 registered representatives.

The three enforcement actions seek to discipline the defendant and the two respondents for selling variable interest rate structured products (“VRSPs”). The Complaint states these securities typically had maturities of 15 years or longer, and “[u]nlike conventional debt securities, these ...[VSRPs]... did not pay a fixed amount of principal at maturity...[r]ather ...the recovery of principal at maturity was contingent upon the operation of derivative features tied to equity indexes... [a]s a result, customers could lose part or all of their investment, even if the issuer of the VSRP did not default.” Similarly, “interest payments ... were also contingent... typically tied to equity indexes, as well as the spreads between long-term and short-term United States bond yield curves.”

The SEC Complaint against Appelbaum states the 75-year-old resident-of Boca Raton, Florida, was a registered representative with Aegis from July 2015 to May 2021, and served as a Managing Director of Aegis, heading up its Municipal Bond Desk, from August 2015 to September 2018, and then serving as co-head of the Aegis Fixed Income Desk until he resigned from Aegis in 2021. The Complaint notes that Appelbaum “has a lengthy disciplinary history in the securities industry.” At least 14 of his customers filed arbitration and/or customer complaints against him with regulators, 11 of which resulted in settlement payments, and a twelfth, an arbitration case, resulted in a judgment against him for unsuitable trading. He was censured by the SEC in 1982 for aiding and abetting a former employer’s anti-fraud violations; in July 1991, he was censured by the NASD for selling securities without maintaining required minimum net capital; and in 2006 he was subject to a cease-and-desist order issued by the New Hampshire Bureau of Securities for selling securities to New Hampshire residents without being licensed in that state. He resigned from Aegis in May 2021 for violating the firm’s procedures and for unauthorized trading.

The Complaint alleges that Appelbaum failed to make customer-specific suitability determinations before recommending securities to purchase, and especially when selling complex products like VRSPs, although he was required to do so both by Financial Industry Regulatory Authority (“FINRA”) rules, and by Aegis’ July 2017 written policy (that required VRSP sales to be made only to customers with a “high” or “maximum” risk tolerance). In fact, Appelbaum recommended to (and then purchased VSRP products for) seven customers who had only a “moderate” risk tolerance. He did not provide the Aegis Structured Products Disclosure form, required to be provided to customers under the Aegis 2017 policy, to any of his seven “victims.” Five of the seven were in their 80’s; yet Appelbaum had them purchase multiple VSRPs with maturities of 15 years or more. Appelbaum told his “victims” that he was purchasing “conservative bonds” for them, and repeatedly assured them that any decline in value was temporary, and that the VSRPs would “return to par.” All seven of the accounts were non-discretionary, so Appelbaum was required to obtain customer consent before trading (he claimed he did that by telephone), but the customers told the SEC he did NOT do so, a fact confirmed by an examination of his telephone records. Appelbaum earned at least \$1 million in commissions from the VSRP product sales; the customers lost well over \$1.2 million.

The SEC asserts Appelbaum violated both Section 17(a) of the Securities Act of 1933, as amended (the “33 Act”), and Section 10(b) and Rule 10b-5 thereunder of the Securities Exchange Act of 1934, as amended (the “34 Act”), by selling securities using fraudulent and deceptive practices, including by making material misstatements and or omissions. The SEC does not have to prove scienter to prove violations of the 33 Act. The Commission seeks a permanent injunction against Appelbaum for any future violation of the cited laws, disgorgement of his ill-gotten gains along with prejudgment interest, and payment of a civil penalty, theoretically on the order of \$3 to \$4 million.

The SEC’s July 28, 2022, Administrative and Cease-and-Desist Order (the “Gallivan Order”) against Gallivan asserts that he “made unsuitable recommendations... to four customers,” most of whom “were senior investors with low or moderate risk tolerances, limited investment experience... [and] time horizons of less than fifteen years.” Gallivan allegedly described the VSRPs as “bank bonds.” The Gallivan Order also details material misstatements he made about the VSRP products to the four customers. The SEC asserted that his actions and omissions violated Section 17(a)(2) and 17(a)(3) of the 33 Act. Gallivan consented to the entry of the Gallivan Order, which requires him to cease and desist from future violations of the cited sections; be suspended from working in the securities industry for 12 months; be suspended from any involvement with the issuance or sale of a penny stock for 12 months; be prohibited from serving as an officer or director of a public company for 12 months; disgorge \$26,807 of ill-gotten gains plus payment of prejudgment interest of \$3,166; and finally, to pay a civil penalty of \$25,000 in four installments over nine months.

The Aegis Administrative and Cease-and-Desist Order issued by the SEC on July 28, 2022 (the “Aegis Order”) recites extensive sales of VSRP products in several of its branches, including Melville, New York (out on Long Island,) and Boca Raton, Florida, to a total of 48 retail customers, and asserts those products were not suitable for ANY of those investors. The Order notes the substantial misconduct by Appelbaum involving the unauthorized trades of some 1000 VSRP products to seven investors. The SEC identifies a series of oversight and record-keeping failures involving VSRPs from January 2015 through May 2019, particularly suitability shortcomings. As a result, the Commission asserted that Aegis violated Section 17(a)(2) and (a)(3) of the 33 Act and Section 17(a)(1) of the 34 Act and Rules thereunder. The Commission expressly notes that, during the pendency of its investigation of the VSRP sales, Aegis retained a compliance consultant to review and revise Aegis’ Written Supervisory Procedures (“WSP”) and to conduct three subsequent annual compliance reviews. In the revised WSP adopted by Aegis, the sale of VSRP to retail customers is PROHIBITED. Aegis also implemented a much more rigorous trading review procedure. The Aegis Order also notes that several Aegis employees involved in the case were terminated by the firm.

As a result, the Commission required the Aegis CEO to certify compliance with the remedial steps it proposed, and imposed the following sanctions, to which Aegis consented: Aegis must cease-and-desist from future violations of the cited securities laws; Aegis is censured; Aegis must disgorge \$165,828 and pay prejudgment interest of \$55,037; and Aegis must pay a civil penalty of \$2.3 million. The Commission’s action was approved by a less than unanimous vote. Commissioner Hester Peirce dissented in part to the Aegis Order (as discussed in her July 28, 2022, Statement) because the Aegis Order expressly recognized, as an element of the settlement, the mitigating effect of Aegis’ total ban on trading VSRPs in the accounts of retail investors. She wrote “by citing [the total bar on retail accounts trading in VSRPs] ... -backed up by a CEO certification- as a consideration in accepting Aegis’s settlement offer, the Order inadvertently suggests that certain investment products, categorically, should be unavailable to certain types of investors....The Commission’s orders should not intimate that certain types of investments are never suitable for particular classes of investors.” Commissioner Peirce’s criticism underscores the need for the SEC to adopt rules reasonably designed to protect retail investors from unappreciated risks of complex investment

products, while at the same time permitting such investments even by retail investors, where both the risks are fully disclosed, and the suitability assessment is diligently done by the market professional. There has been enough “regulation by enforcement.”

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