

Follow-Up Response to SEC Questions Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies, File Number S7-24-15

This is a follow-up to our previous comment letter responding to the SEC's questions regarding derivative use by registered investment companies.¹

There was an extensive commentary on funds use of derivatives (187 letters and meetings to date). Below, we discuss concerns with the issues that were raised by the registered fund industry and one of its largest auditors in regard to their current activities regulated under the Investment Company Act of 1940 (the "1940 Act").

Since these are important issues left unresolved and considering there were approximately 1,500 pages of comment letters to the SEC, it seems appropriate that the comment period be extended for a few weeks. The industry may wish to respond to the following matters and reconcile the conflicts raised by auditor Ernst & Young in its' comment letter dated March 30, 2016 (following the comment period closure on March 28). Ernst & Young may want to answer/explain some of the below accounting/auditing questions raised herein.

The most frequent issues/concerns referred to in respondent letters were presented by industry representatives from the Securities Industry and Financial Markets Association ("SIFMA") and the Investment Company Institute ("ICI").² Additional responses of interest are cited below.

Responsibilities of Fund Boards

Some respondents were concerned with the increased work load burden on the fund Board of Directors ("BOD") relating to the proposed derivatives risk management program.

- ICI comments about this program stated:³

"The most critical modification to this part of the proposal is a revision of how the SEC views the role of directors. The proposal would have boards far too burdened with the minutiae of portfolio management rather than exercising their more appropriate oversight function."

¹ Response to SEC Questions Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies File Number S7-24-15, March 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-111.pdf>

² SIFMA letter to the SEC, *Use of Derivatives by Registered Investment Companies and Business Development Companies*, File No. S7-24-15, March 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-174.pdf>
ICI letter to the SEC, *Use of Derivatives by Registered Investment Companies and Business Development Companies* (File No. S7-24-15), March 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-114.pdf>
These two comment letters are referred to in footnotes below as "SIFMA Comment Letter" or "ICI Comment Letter" accompanied by page numbers to the issue referenced.

³ See ICI Comment Letter, page 8.

- The Independent Directors Council stated:⁴

“Although we agree that it is generally appropriate for fund boards to oversee these important areas, we also caution the Commission to be mindful about the effect each new initiative has on the totality of fund board responsibilities.... We urge the Commission to consider taking a step back to evaluate all of a fund board’s responsibilities and whether they all continue to be appropriate, particularly now that funds are required to have compliance programs administered by chief compliance officers.”

However, board oversight is not an additional burden, as BODs already have portfolio risk, valuation and liquidity supervisory duties under the 1940 Act. This proposed rule brings derivatives into a more important status of BOD oversight, but does not change the responsibilities BODs should already be complying with. As former SEC Commissioner, Luis Aguilar stated:⁵

“Fund boards already have extensive regulatory responsibilities in overseeing fund operations and protecting investor interests. Under the **current regulatory regime**, **a fund board needs to oversee the fund’s compliance** with the relevant federal securities laws and other regulatory requirements. Among other things, this includes the responsibility for ensuring that **fund assets are invested in a way that is consistent with the fund’s investment objectives, policies, restrictions, and risk profile**. Although existing board responsibilities **already include a general obligation to oversee a fund’s derivatives use**, today’s proposed rules would add specific responsibilities....”⁶

“**Imposing these responsibilities on fund boards is necessary and appropriate**. As the investors’ representatives, **fund boards play a critical role in overseeing fund operations**. Thus, **if a fund chooses to integrate derivatives into its investment strategies**, it is **only appropriate to require that its board also take on the responsibilities outlined in our proposed rules today**.”

⁴Independent Directors Council letter to the SEC, *Use of Derivatives by Registered Investment Companies and Business Development Companies* (File No. S7-24-15), March 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-123.pdf>

⁵ SEC Commissioner Luis A. Aguilar, *Protecting Investors through Proactive Regulation of Derivatives and Robust Fund Governance*, December 11, 2015 <https://www.sec.gov/news/statement/protecting-investors-through-proactive-regulation-derivatives.html>

⁶ “Under the proposed rules, fund boards would be required to do a number of things:

- First, if applicable, a fund board must approve a fund’s derivatives risk management program, any material changes to the program, and the fund’s designation of the fund’s derivatives risk manager.[29] Under the proposed rules, this formalized program must be reasonably designed to assess the risks of derivatives transactions, manage and monitor risks, segregate functions of fund personnel, and require annual updates and reviews.
- Second, a fund board must review written reports prepared by the derivatives risk manager, at least on a quarterly basis, and review the adequacy and effectiveness of the derivatives risk management program.”

The actual duties of fund BOD members are limited. Most day-to-day responsibilities reside with fund advisors and sub-advisors⁷. Under the 1940 Act, the primary BOD duty is to understand and **oversee** the fund advisors' work and that compliance personnel are appropriately operating the fund in conformity with securities laws, regulations and in specific the 1940 Act.

The proposed rule does not change the spirit of fund BOD oversight that exists, it really just clarifies responsibilities and supports BODs by requiring a derivatives risk manager be appointed to report and help BODs understand the derivative product risks the funds are invested in.

Current Risks of 1940 Act Registered Derivative-Based Securities

As a reminder, SEC, FINRA and others have warned investors about derivative-based leveraged and inverse ETFs. Most are reset each day and should not be invested in for long-term strategies by general market investors, but rather are niche products that should only be invested in by professional market participants.

Regulatory warnings regarding leveraged and inverse ETFs from an August 2009 investor alert issued by the SEC and FINRA advised investors that:⁸

“Most leveraged and inverse ETFs “reset” daily, meaning that they are designed to achieve their stated objectives on a daily basis. Their performance over longer periods of time -- over weeks or months or years -- can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time. This effect can be **magnified in volatile markets**.”

“...**engaging in short sales and using swaps, futures contracts, and other derivatives can expose the ETF—and by extension ETF investors—to a host of risks**.”

SEC investor alerts and warnings appear to be somewhat overwhelmed publicly by the inverse and leveraged ETF promoters via advertising/media coverage, according to the Consumer Federation of America:⁹

“While warnings by regulators may discourage some retail investors from investing in alternative strategy funds, we are not aware of any empirical data that shows investors actually read such warnings or, if investors do read them, that they are effective at informing retail investors' decision-making process. **Even if retail investors do consider regulators' warnings, those warnings may be counteracted by the sophisticated marketing campaigns that product providers engage in, which are designed to**

⁷ For example: The SPDR S&P Retail ETF (Symbol: XRT) is part of the SPDR Series Trust, which includes 40 ETFs. The XRT's prospectus states “the professionals primarily responsible for the day-to-day management of the Fund are Mike Feehily, John Tucker and Karl Schneider”, which are all executives of the advisor, SSGA Funds Management.

⁸ *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors*, <http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm>

⁹ Consumer Federation of America letter to the SEC, *File Number S7-24-15 Use of Derivatives by Registered Investment Companies and Business Development Companies*, March 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-139.pdf>

convey the impression their products are essential for investors' needs."

"There is evidence that suggests investors are incorrectly using certain alternative investments that use derivatives extensively. For example, despite the fact that double and triple leveraged ETFs are short-term trading vehicles that are not meant to be held longer than one day, a significant number of shares are held for several days, if not weeks."

1940 Act Registration

There is a concern in the industry for the actual continued registration of ETFs under the 1940 Act that are employing leverage in their portfolios inconsistent with the proposed rule. It is apparent throughout many comment letters that the industry needs these funds to be registered under the 1940 Act in order for them to be sold to certain investors that may not otherwise be able to purchase the products if they are unregistered. As ICI stated:¹⁰

- "Entire categories of the market that have recently developed (and accordingly might not have accumulated as many assets as other established categories) **may no longer be offered in a 1940 Act structure**, limiting investor choice or potentially increasing investor costs."

"In sum, based on our analysis, at least 369 funds, with \$458 billion in assets under management, either will have to deregister or substantially change their investment strategies to continue their businesses as registered funds."

We question the claim that average non-professional or public fund investors would be disadvantaged without the leveraged/inverse ETFs under the 1940 Act as an investment option. Currently, most leveraged and inverse ETFs and ETNs are illiquid. As of March 31, 2016, 49% of the leveraged and inverse ETPs had an average daily volume under 20,000 shares, with many trading just a few or zero trades per day. Additionally, there were 68% of the ETPs that traded under 100 thousand shares per day.

- ProShares Advisors' response stated ETFs not meeting the requirements of the proposed derivatives rule would not be able to continue registration as an open-end fund under the 1940 Act and would instead have to register under 1933 Act or cease operation:¹¹

"We believe the proposed portfolio limits would likely cause a number of funds to substantially modify their investment objectives and strategies, reorganize outside the 1940 Act, or shut down completely."

"We expect that some types of funds may reorganize as exchange-traded products registered only under the Securities Act of 1933 (and not the 1940 Act)."

¹⁰ See ICI Comment Letter, page 4, footnote 13 and page 38.

¹¹ ProShares Advisors letter to the SEC, *Use of Derivatives by Registered Investment Companies and Business Development Companies* (File No. S7-24-15), March 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-158.pdf>

- Rafferty Asset Management, the sponsor of Direxion ETFs commented:¹²

“Should the 3X ETFs lose the ability to operate as investment companies under the 1940 Act, they would not retreat to the private markets. Rather, they *would likely continue to operate as exchange-traded products (“ETPs”) or exchange-traded notes (“ETNs”) both of which are registered only under the Securities Act of 1933, as amended (“1933 Act”)*. Both of these products trade on an exchange. **Neither, however, has the protection of the 1940 Act.** Thus, the paradoxical impact of the proposed rule would be to migrate 3X ETFs from a more regulated environment (covered by the 1933 and 1940 Acts) to a less-regulated environment (covered only by the 1933 Act).”

The industry through their comment letters cannot see many of these funds in existence without registration under the 1940 Act. Why? Would these derivative products be unsuccessful without this registration? If they have heightened risks for investors and only exist in their current trading status because of the 1940 Act registration, should they be this type of registered fund?

The comments of the industry representatives suggest a simple fact; under the SEC’s proposed rule, some funds employing these derivative strategies should be deregistered from the 1940 Act coverage as they will not be apparently in compliance with its requirements (at least 369 funds according to ICI).

The funds instead could register under the 1933 Act. These products could, in theory, continue with the same strategy, but may have reduced trading activity from certain investors (i.e. pension and mutual funds, retail investors and investment advisors that would be unlikely to promote or recommend products that do not have the implied ‘rigorous’ oversight and rules under the 1940 Act).

These investors with fiduciary duty to their clients’ apparently should not be participating in the more risky financial derivative instruments under the 1933 Act that do not comply with the 1940 Act.

This raises some considerations regarding products registered under the 1933 Act. The implication is that the regulated products under the 1933 Act have inferior SEC protections than those registered under the 1940 Act. Further industry explanation would be beneficial here. Perhaps significant disclosure should be made about the additional risks of products not registered under the 1940 Act. This includes most securities trading in the markets. Does the industry perceive these securities to have less oversight?

¹² Rafferty Asset Management letter to the SEC, *Use of Derivatives by Registered Investment Companies and Business Development Companies*, File No. S7-24-15, March 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-121.pdf>

Portfolio Limits

- SIFMA and ICI suggest the SEC should put **no portfolio limits** on registered investment products, but instead use other assessment portfolio/derivatives methods they suggest.¹³

One of the core points of the 1940 Act passed by Congress was to register funds that would have portfolio limits in place to restrict excessive leverage, limiting illiquid underlying securities and constraining the registered funds' risk levels for investors in the products.

If a portfolio contains an excessive amount of risky derivatives that blow-up, do they not affect the rest of the portfolio and alter, perhaps significantly, the funds ability to sell its other securities under stress conditions without causing disruptions for stakeholders in the market pricing and redemptions? In other words, aren't many portfolios subject to derivative risk also subject to becoming a fire sale risk or a fund where liquidity simply freezes? Think AIG; when derivatives became problematic, trust in the company failed, pricing deteriorated and liquidity froze.

In essence, with ETPs there are 2 portfolios at risk, the ETP fund and the derivatives created through Authorized Participants in the secondary market (the shadow portfolio(s)). These risks could be spread over multiple shadow portfolios operated by a number of Authorized Participants and clearing firms. For the purpose of this discussion, we consider these multiple participants transactional activity together as one shadow ETP portfolio. The shadow portfolios consist of uncovered short sales and other derivatives created by Authorized Participants/clearing firms.

These participants operate somewhat like the ETP issuer by creating *synthetic* positions based on the ETP shares outstanding. Since these shadow portfolios may be subject to similar market stress or compounding to the ETPs stresses, should these be considered together when contemplating the full derivative risk of ETP portfolios and what ETP portfolio limits should actually be?

Value at Risk Models

The most important issue raised by the industry and argued by both SIFMA and ICI, is that any portfolio valuations should be made using industry-proposed models based on 'Value at Risk' ("VAR").¹⁴ Value at Risk models have been touted by the industry as the 'do all and end all' way to value most securities risks by management for decades. As SIFMA notes, the SEC no longer accepts the theory that these models properly function. In fact, the **SEC believes these models are 'subjective' and vulnerable for 'gaming' by industry participants.**¹⁵

SIFMA argues that it understands the SEC's concerns, but suggests there may be other ways to adapt VAR models to help the SEC in their valuation of these portfolios. SIFMA even suggests the SEC can develop its own model portfolio in order to test literally thousands of other

¹³ See ICI Comment Letter, pages 8 and 34, and SIFMA Comment Letter page 2.

¹⁴ See ICI Comment Letter, page 56.

¹⁵ See SIFMA Comment Letter, page 18.

Value at Risk models for portfolios as a means to discover/monitor funds that may be using VAR models subjectively or that are being gamed.¹⁶

VAR models have been around for a long time and many are simply accounting assumptions. In this case, the VAR would be based on assumptions of derivative risks that depend on a number of 'what ifs' that may or may not occur in the markets. Also in the 'what ifs' category, are the structure of the actual derivatives, the counterparties and the hedging or leveraging strategies used by the various counterparties in the transactions (risks for complex derivatives based on equities or other derivatives are significantly more difficult to determine than those for interest rates and other fixed income straightforward derivatives the industry generally addresses in discussions). The VAR models are in fact subjective and very prone to gaming the amount of portfolio risk and projected value by operators who wish to do so.

SIFMA's suggestion may propel the SEC into years of research and an enforcement quagmire of whose 'what ifs' and assumptions are correct, instead of clarifying and enforcing the regulations to cap portfolio risk in funds registered under the 1940 Act.

Many VAR models are flawed mechanisms used to evaluate securities risks that have failed in times of stress. For example, Long-Term Capital Management was a sophisticated firm utilizing large amounts of leverage and derivatives before it collapsed; its VAR models failed. History has provided ample evidence that VAR models used by sophisticated firms may be terribly inaccurate under stressed conditions and in crisis markets. It may be the taxpayers that have to shoulder the burden from these failed risk management systems.

Presumably, there were VAR models in place that had been accurately designed for AIG, Lehman Brothers, Bear Stearns, Wachovia and other firms that collapsed or nearly collapsed in 2008. These were *sophisticated* Wall Street and international firms that used VAR models that failed. Value at Risk models existed during the dot-com bubble, mortgage-backed securities crisis in 2008 and other negative market events where the VAR models did not show warning signs to the marketplace of the coming stresses.

The 1940 Act is not subjective. It is a simple concept of risk that should be easy to understand by ETP operators, investors and regulators as opposed to VAR models that can easily become a quandary of constantly moving valuations, which are subject to the way the fund operators wish their portfolios to appear. The 1940 Act was enacted to supply a certain amount of stability for investors, not risk-free, but an understandable risk level that could be relied upon. The data suggests VAR models should not be considered reliable in these scenarios.

¹⁶ See SIFMA Comment Letter, page 20.

Value at Risk – An Auditors’ Perspective

Ernst & Young commented on this proposal and discussed Value at Risk models from an auditors’ perspective. Ernst & Young is one of the ‘big four’ public accounting firms (‘gatekeepers’ for the public markets) and has been the auditor for hundreds of 1940 Act registered funds for a number of years. Ernst & Young commented:¹⁷

“Generally, the auditor performs audit procedures on the senior securities¹⁸ table in connection with an audit of a closed-end fund’s financial statements. The objective of the audit is to obtain reasonable assurance on whether an entity’s financial statements are free of material misstatement and are presented in conformity with US GAAP. The auditor expresses an opinion on the entity’s financial statements but **does not opine on its compliance with regulatory requirements**. Furthermore, certain conditions with which a closed-end fund would have to comply to rely on proposed Rule 18f-4 before entering into a derivatives transaction or financial commitment transaction during the year **do not include objective criteria**. For example, the risk-based coverage amount represents an *estimate* of an amount the fund would have to pay to exit the derivatives transaction under stressed conditions, **and the value-at-risk (VaR) used to calculate a fund’s full portfolio VaR and securities VaR is an estimate of potential losses on an instrument or portfolio over a specified period and at a given confidence interval**. As a result, we believe that the **extent of procedures performed by auditors with respect to a closed-end fund’s compliance** with the provisions of proposed Rule 18f-4 should be **limited to gaining an understanding of the closed-end fund’s policies and procedures for compliance and verifying that these policies and procedures have been approved by the fund’s board.**”

“If, however, the Commission disagrees and believes that an auditor’s responsibility would extend to evaluating a closed-end fund’s compliance with the provisions of Rule 18f-4 when the auditor is reporting on the senior securities table information, this would require the auditor to be engaged to perform additional procedures to assess the fund’s compliance (or **management’s assertion regarding the fund’s compliance**) with the Rule (e.g., a **compliance attestation engagement**). Accordingly, the Commission should consider **whether the benefits of conducting such an engagement would exceed the associated costs.**”

Ernst & Young’s responses beg the questions: How are accountants auditing ETFs and other funds whether using derivatives or not under the current law for compliance with the 1940 Act? How can an auditor certify that the financial statements fairly represent the financial condition of a fund without understanding the level of liabilities a fund may have? It appears

¹⁷ Ernst & Young letter to the SEC, *Use of Derivatives by Registered Investment Companies and Business Development Companies* (Release No. IC-31933; Commission File No. S7-24-15), March 30, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-184.pdf>

¹⁸ The SEC Registered Investment Company Use of Senior Securities — Select Bibliography states: “The Commission and its staff have taken the position that reverse repurchase agreements, firm commitment agreements, standby commitment agreements, short sales, written options, forwards, futures, and certain other derivatives transactions may involve the issuance of a senior security subject to the prohibitions and asset coverage requirements of sections 18(a)(1) and 18(f)(1).” <https://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>

these are not fully audited funds and the auditor is not checking to see if a fund is in compliance with regulatory requirements. Where is it disclosed that the auditor is not conducting a full independent audit and these products may be essentially unaudited, depending on the funds VAR approach, subjective liquidity and valuation models? Should there be disclosure that auditors only certify that management determines its' methods of calculations and that management conformed to its' methods, which may vary for each different theory fund management may use?

Ernst & Young in its' comment confirms that Value at Risk calculations are simply an 'estimate of potential losses' (a guess based on unconfirmed/unaudited information it receives) and indicates that an auditor should not be responsible for certifying a funds' VAR, but only that the fund followed its' *stated procedures to calculate the Value at Risk*.

This raises a very strong conflict between industry representatives and fund auditors. ICI and SIFMA dedicated significant commentary to the VAR equation method and why it should be used while Ernst & Young as an auditor (gatekeeper) indicates it believes auditors should not have responsibility for auditing a funds' VAR model. It appears for some funds, additional auditing engagements would be required to accomplish these added tasks. In a complete audit where a portfolio's risk is viewed holistically, it seems that many funds may not meet the current valuation, liquidity and risk standards of the 1940 Act.

Specific Value at Risk Model Questions for Ernst & Young

Value at Risk models should exist today for registered funds under the 1940 Act and be audited and understood/in compliance by BODs of funds in order to comply with the portfolio evaluation requirements under the existing 1940 Act.

Again as the ICI examination reveals:¹⁹

“In sum, based on our analysis, at least 369 funds, with \$458 billion in assets under management, either will have to deregister or substantially change their investment strategies to continue their businesses as registered funds.”

Employing a Value at Risk model raises several 'subjectivity - gaming' questions regarding ETFs. How Ernst & Young deals with the following examples in its' evaluation of a registered fund may be enlightening for investors and regulators.

Ernst & Young has been the auditor for ETFs such as the PowerShares NASDAQ 100 ETF (Symbol: QQQ) and the 40 ETFs in the SPDR Series Trust, which includes the SPDR S&P Retail ETF (Symbol: XRT).

In our previous comment letters regarding this SEC proposal and other SEC requests, we have provided data for several different ETFs, including the XRT.²⁰

¹⁹ See ICI Comment Letter, page 38.

²⁰ *Response to SEC Questions Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies File Number S7-24-15*, <https://www.sec.gov/comments/s7-24-15/s72415-111.pdf>

The XRT is the standard ETF for U.S. blue chip S&P 500 retail companies. It is a 'bread and butter' fund in the ETF world, containing underlying retailers such as Walgreens, Office Depot and Amazon.

The XRT is one example ETF with multiple owners per share (at times, up to 7 just based on SEC 13-F reporting institutions²¹) on a continuous basis for years without significant corresponding NSCC settlement fails; resulting in undisclosed delivery/receivable liabilities, which likely will require settlement liquidity that is not readily available in a crisis market. A substantial shadow portfolio exists for this ETF. Do auditors, and in this case Ernst & Young, consider the public available information that confirms the existence of the XRTs shadow portfolio(s)?

The “big four” public accounting firms (including Ernst & Young) are sophisticated and should understand important market metrics and how they work together for accounting purposes.

In fact, there are just a few metrics auditors are required to have in order to recognize the shadow portfolios. This data is publicly available.

Our data points generally begin in November 2010, as this is the beginning of the most recent reporting of short sales by exchanges/SROs. Ernst & Young has been the auditor of the XRT during our entire examined periods since November 2010. We have looked at a variety of time periods over the years, which have concerned us that the auditors were not identifying substantial risks in ETPs.

Below, we show various periods where we believe the auditors of the XRT should have raised substantial red flags of risk. The available data raises concerns that auditors of these products are not doing a full independent audit in order to capture risks that management should be aware of and should be disclosed to public investors.

In the case of the XRT, auditors must know how many shares are outstanding (supplied daily by the XRT operator, State Street) and the number of shares publicly claimed to be owned by 13-F filers (filed with the SEC quarterly). These two metrics show an imbalance of owners versus shares outstanding over the past 5 years. Quarter after quarter, each share outstanding has been owned by multiple large institutional reporting firms. These ownership claims do not include retail and other financial firms that are not required to file 13-F reports.

XRT Long-Term Trading Metrics to Contemplate/Audit

Imbalances in XRT ownership versus shares issued has continued to be found from 2011 through December 31, 2015 (the most recent 13F filings, constituting 1,261 trading days, or 5 years). Despite continuous daily short selling averaging almost **70% of trade volume**, or nearly 3 of every 4 shares sold on the reporting markets, there has been ***no sustained increase in shares outstanding, reported short interest nor NSCC fails***. This is in complete contradiction to the expected natural results that should be found in a properly functioning supply and demand

²¹ Institutional money managers with over \$100 million in assets are required to report holdings on quarterly 13-F reports.

marketplace. Do auditors of ETPs consider the makeup/interaction of the shares outstanding vs. the shares trading in the marketplace?

As an example, on **March 31, 2014**, just reporting institutions owned more than **5 shares for every share of the XRT outstanding**. However, NSCC delivery fails were just 7,728 shares. Obviously, shares were not fully delivered for the 5 ownership claims (42 million shares), yet these unfulfilled securities contracts are not reflected in NSCC data. This is a ‘financial system’ red flag; the national clearance and settlement system is not capturing and disclosing these excess ownership contractual settlement deficiencies.

Would an auditor consider 5 ownership claims for the same security to be problematic for the XRT? As a gatekeeper to the public markets, if an auditor discovered a red flag regarding the national clearance and settlement system, should they inform management and alert regulators? Should the ETF auditor red flag the fact that for years, excess ownership of the shares outstanding continued without net ETF share creation expanding to reconcile with the shares owned by investors?

The XRT makes this issue simple; multiple investors claim ownership of the same shares while the NSCC reports virtually perfect settlement occurring on a continuous basis. It should be obvious to management, compliance officers and auditors in their respective roles that something occurring with the shares outstanding does not add up. There are excessive ownership claims and few or no fails within the national clearance and settlement system. The auditors should be pursuing these various paths to be able to provide an answer to management as to what may be occurring with the XRT shares outstanding and the potential risks involved. For example, the March 31, 2014 data is shown in Table 1.

Table 1 – XRT Data March 31, 2014

	Shares
Shares Claimed to be Owned by Institutions (13F Filers)	42,808,001
Shares Outstanding	8,550,113
Shares Owned by Institutions Above Shares Outstanding	34,257,888
NSCC Fails	7,728
Reported Short Interest	24,461,700
Shares Outstanding	8,550,113
Shares Outstanding Plus Short Interest	33,011,813
Ownership Claims by 13F Filers Above Shares Outstanding Plus Short Interest	9,796,188

The XRT data raises significant questions and red flags regarding what is being sold in the marketplace as XRT shares. How has the XRT’s management been able to currently and historically account for valuation risk and liquidity requirements under the 1940 Act, justified compliance with the securities laws and the Act and reported this accounting to the SEC and investors, when many shares exist beyond what the fund issued?

Examining these metrics, i.e. 70% short selling, no real net-creation of shares and no fails at the NSCC clearly suggests that the Authorized Participants of the XRT are internalizing/ex-clearing much of the trading that is occurring for the XRT. This should raise a significant red

flag for the fund management that along with the institutional ownership far exceeding the number of shares outstanding, there may be a large number of additional short shares (not owned by the sellers) internalized at clearing firms that could be required to be redeemed and potentially weigh heavily on the stability of the fund. In a full independent audit of the shares of the XRT, should the auditor investigate what the magnitude of these external fund positions are in order to do a true risk assessment?

Simply put, if there are 5 owners for each XRT share, the additional redemption of those shares can render the existing shares of the XRT essentially valueless, with no liquidity left in the shares issued to accommodate the additional ownership claims.

Here, there are 9.8 million more shares claimed to be owned above shares outstanding plus reported short interest. These securities positions were not owned by the sellers so they were short sales, but they did not get reported as short interest. These shares that are not registered long nor reported short should provide an audit trail to be followed in an independent investigation to find out the nature of these securities.

The excess ownership positions consist of a significant amount of securities in the status of fail to receive that are not reported to the NSCC, representing undisclosed delivery liabilities at clearing firms, which likely will require settlement liquidity that is not readily available in a crisis market.²² This should be of concern to auditors and fund operators because the ‘naked’ positions could heavily impact the ETF in adverse market conditions.

Moreover, the auditor should be concerned with the custodial relationship because there are obviously many more shares owned than exist, which presents a problematic scenario in the auditing processes if the shares outstanding issued by the ETF have been expanded at rates up to 7 or 10 times the number of shares issued. An auditor should investigate the custody/location of the shares that are claimed to be owned, but are not issued. Considering the XRT share ownership metrics have been problematic for years, shouldn't these circumstances have raised red flags for the audit team?

Example XRT Period – March 2011

The XRT metrics in March 2011:

- **All of the outstanding shares of the XRT (which were more than 100% institutionally owned, verifiable through the SEC’s EDGAR system) were turned over every day for 20 days in a row.**
- There were 10 **days** where XRT shares issued were turned over from two to **seven times**.
- On 10 days, **short sales exceeded the shares outstanding**. On March 9th, **short sales exceeded shares outstanding by over four times**.
- There were **65 to 73 million shares** reported to FINRA as established short positions, when there were only on average less than 8 million real shares outstanding.

²² See Section 2 – Exchange Traded Products Liquidity and Assets of the SEC Request for Comment on Exchange-Traded Products, *Response to SEC Questions Regarding Exchange Traded Products*, File Number S7-11-15 <http://www.sec.gov/comments/s7-11-15/s71115-19.pdf>

- On average, there were **over 8 owners of shares sold short for each real share issued.**
- NSCC fails started the period at 32 thousand and ended the period at 149 thousand, virtually net flat despite at least 8 owners per share.

Table 2 illustrates these metrics which logically indicate that ‘**reasonable grounds to believe**’ that **millions of shares each day could be located for legitimate short selling was a virtual impossible threshold to meet.** Again, short positions are multiple times higher than shares outstanding without corresponding NSCC settlement failures reported to regulators. Moreover, the 'turnover ratio' is not logical by any measurement. It is an impossibility to explain the turnover of all the shares outstanding each day given the bullet point metrics above.

This is not rocket science auditing, the shares outstanding are known/published each day and services such as Yahoo! report the daily trade volume from the marketplace consolidated tape. Turnover ratios are old and frequently used metrics by market participants. Should auditors be considering these basic elements relating to shares outstanding in their audit processes?

Table 2 – XRT Share Accounting and Trading in March 2011

Trade Date	Shares Outstanding Issued by ETF Distributor State Street Global Advisors	Total Daily Marketplace Volume (Consolidated Tape)	Total Daily Marketplace Volume as a Percent of Shares Outstanding	Percent of Short Sale Volume on SRO Reporting Markets	Settlement Date NSCC Reported Fails for Trade Date	Reported Short Interest ²³
3/1/2011	11,900,113	14,141,500	119%	83%	32,016	
3/2/2011	8,550,113	13,839,500	162%	70%	27,822	
3/3/2011	7,500,113	11,728,500	156%	76%	151,569	
3/4/2011	11,150,113	13,172,000	118%	81%	174,432	
3/7/2011	8,200,113	13,542,800	165%	77%	2,672,325	
3/8/2011	6,950,113	15,042,000	216%	78%	3,111,135	
3/9/2011	2,450,113	17,579,100	717%	81%	2,884,700	
3/10/2011	4,400,113	15,952,900	363%	77%	1,380,378	66,315,811
3/11/2011	5,000,113	14,444,800	289%	75%	218,745	
3/14/2011	11,000,113	13,972,700	127%	75%	98,595	
3/15/2011	11,900,113	16,880,300	142%	71%	4,052	
3/16/2011	12,400,113	16,005,300	129%	66%	84,502	
3/17/2011	12,650,113	17,281,200	137%	72%	97,961	
3/18/2011	11,150,113	24,381,500	219%	79%	140,899	
3/21/2011	6,300,113	14,521,000	230%	64%	1,867,320	
3/22/2011	7,850,113	12,303,200	157%	72%	3,469,764	
3/23/2011	5,500,113	14,426,700	262%	69%	4,539,685	
3/24/2011	2,650,113	15,078,800	569%	67%	4,929,698	
3/25/2011	5,000,113	13,772,300	275%	69%	662,020	
3/28/2011	6,900,113	14,297,900	207%	76%	149,243	73,022,120
Average Totals	7,970,113	15,118,200 302,364,000	190%	74%	1,334,843	

²³ Reported short interest was 65,642,975 shares on trade date February 23, 2011.

On March 9, 2011, there were **2.5 million XRT shares outstanding** and **11.6 million shares sold short** on just the reporting markets. Note on March 9th, the reporting markets show over **8 of 10 shares** traded were short sales, leaving less than two shares sold long and available to cover the day's short sales. At the same time, there were **more shares sold long than existed**. The fails that were reported to NSCC **were greater than all of the shares outstanding**. *In effect, the XRT was asset bankrupt and the trading consisted of a supply of shares that did not actually exist.*

Trade volume exceeded shares outstanding by over **7 times**. Short shares traded on just the reporting markets surpassed shares outstanding by **4.7 times**. Of the 11.6 million shares sold short, where did they originate? Moreover, where did the shares to borrow come from when **10 million** shares were sold short the next day and **9 million** shares the following day? While years of XRT trading suggests there were/are no reasonable grounds to believe that millions of shares could be delivered for settlement of short sales, 11 trading days later on March 24th, the same trading characteristics occurred.

Table 3 shows the value of trading and underlying assets in the XRT during March 2011. The values traded for the XRT put the magnitude of trading into perspective; using the reporting markets percent as a proxy for the consolidated tape, **short sales** were valued at **\$10.9 billion** in these **20 trading days** on assets with an average value of **\$388 million**. Along with virtually every other month of trading data examined for the XRT, March 2011 shows a continual buildup of large short positions versus the value of underlying assets.

The XRT shows that for long periods of time, regardless of the billions of dollars traded, the underlying shares issued for the XRT by State Street were not created in sufficient quantities to support the trading activity, short selling and ownership claims.

Table 3 – XRT Values of Trading and Underlying Assets in March 2011

Trade Date	Value of Total Underlying Assets	Value of Total Daily Marketplace Volume	Percent of Short Sale Volume on SRO Reporting Markets	Value of Short Sale Volume Based on Reporting Markets Percent
3/1/2011	\$575,772,190	\$684,218,914	83%	\$565,446,546
3/2/2011	\$416,630,487	\$674,372,097	70%	\$470,607,579
3/3/2011	\$370,119,450	\$578,784,070	76%	\$437,362,044
3/4/2011	\$547,662,297	\$646,971,719	81%	\$524,805,471
3/7/2011	\$396,699,089	\$655,163,706	77%	\$507,359,862
3/8/2011	\$337,878,898	\$731,264,995	78%	\$573,569,309
3/9/2011	\$119,978,164	\$860,820,770	81%	\$700,421,269
3/10/2011	\$214,086,382	\$776,184,297	77%	\$600,219,254
3/11/2011	\$246,155,391	\$711,117,013	75%	\$536,579,849
3/14/2011	\$536,359,471	\$681,301,181	75%	\$513,474,545
3/15/2011	\$579,394,318	\$821,870,342	71%	\$580,354,186
3/16/2011	\$597,441,451	\$771,140,524	66%	\$511,655,512
3/17/2011	\$607,692,290	\$830,162,702	72%	\$593,899,736
3/18/2011	\$536,050,516	\$1,172,159,923	79%	\$926,220,967
3/21/2011	\$307,403,458	\$708,527,858	64%	\$453,326,776
3/22/2011	\$379,970,732	\$595,514,472	72%	\$426,063,648
3/23/2011	\$267,742,881	\$702,284,889	69%	\$481,438,280
3/24/2011	\$131,123,226	\$746,074,189	67%	\$502,655,324
3/25/2011	\$249,667,248	\$687,682,905	69%	\$471,557,286
3/28/2011	\$342,040,061	\$708,749,934	76%	\$541,213,710
Average	\$387,993,400		74%	
Totals		\$14,744,366,497		\$10,918,231,154

The data for March 9th in Table 3 shows there were **\$700 million worth of shares sold short** while the XRT had only **\$120 million in underlying assets**. On the next day, there were **\$600 million** worth of short shares and another **\$536 million** of short shares the following day.²⁴

Collectively during these 20 trading days, \$14.7 billion worth of the XRT was sold when the average daily value of the shares outstanding was only \$388 million. Over **38 times the average daily value of the XRT** was **traded during just these 20 trading days**. This

²⁴ To dispel any questions, most of these short sales cannot be attributed to bona fide market making activity under the ownership circumstances that exist for the XRT. Bona fide market making requires a fair and orderly market to be conducted by market makers. The XRT has not had a fair and orderly market for years, thus trading from bona fide market making was limited at best, while millions of shares were traded and sold short each day. In 1993, the SEC discussed the bona fide market maker exemption for short selling: “The Commission believes that for the qualifier ‘bona fide’ to have any substance, it must mean more than the fact that the transactions in the account are effected in a market making account. At a bare minimum, to qualify for the exception, a market maker’s short selling activity must be reasonably related to its market making activities.” Exchange Act Release No. 32632, July 14, 1993.

In 2004, the SEC further clarified: “Bona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security.” Regulation SHO Final Rule and Interpretation, Release No. 34-50103, August 6, 2004

extraordinary turnover ratio occurred despite the fact that over 8 shares had already been purchased short (reported short interest) for every 1 share outstanding.²⁵

During the **20-day period, 302 million shares traded turning over the 8 million average shares outstanding 38 times, when all of the existing shares were and remained owned by institutions reporting SEC 13-F filings.** By any measure there appears to be an extreme amount of secondary market derivative leverage continuing to grow based on the XRT, i.e. the 'shadow portfolio'.

This trading/share accounting raises significant red flags of operational and systemic risks across firms involved with the XRT, which could accumulate into massive stress on the asset valuation and liquidity of the XRT.

The shadow portfolios exist because of the morphed (now flawed) nature of today's ETF structures/operating processes. An ETF portfolio contains the underlying assets, while the trading is executed through market professionals deemed Authorized Participants. Authorized Participants have agreements with ETF operators that provide the Authorized Participant with no obligation to interact with the ETF portfolio. Regardless of the trading in the marketplace, there is **no requirement for any party to create ETF portfolio assets.**

BlackRock, the largest global ETF operator by assets under management, explained the contractual requirements/obligations of Authorized Participants to the ETF:²⁶

“Authorized Participants are not agents of the ETF – they are **not required to create or redeem ETF shares under any circumstances,** and **only do so when it is in their interest.**”

The shadow portfolios could be leveraged with undisclosed liabilities of billions of dollars with no one required to reconcile with the main portfolios. Should auditors monitor the ETF shadow derivative portfolio risks?

Another XRT Period

We have previously discussed the time period from November 2010 through March 31, 2014 (858 trading days), when **70%** of the XRT volume on reporting markets was a product of a short sale. Using the reporting markets percentage as a proxy for the consolidated tape volume, nearly **4 billion XRT shares were sold short** in the marketplace.²⁷ During the 858-day trading period, there were on average only **12.4 million shares outstanding.** Marketplace volume

²⁵Reported short interest at the end of February/beginning of March 2011 versus the average shares outstanding during March 2011.

²⁶ In a previous comment letter submitted to the SEC regarding Exchange Traded Products, BlackRock stated: “A small group of investors, known as Authorized Participants (“APs”), can trade directly with an ETF..... Authorized Participants are not agents of the ETF – they are **not required to create or redeem ETF shares under any circumstances,** and **only do so when it is in their interest.**”

BlackRock Letter to the SEC Re: Exchange-Traded Products, Release No. 34-75165; File No. S7-11-15, Page 3, August 11, 2015 <http://www.sec.gov/comments/s7-11-15/s71115-10.pdf>

²⁷ From March 31, 2014 through April 5, 2016, the short selling remained at an average of 66% of the daily volume.

averaged **6.6 million** shares traded per day, turning over the average shares outstanding every **1.9 days**.

Moreover, short shares averaged **4.6 million** shares each day, or a turnover of the average number of shares outstanding by **just short sales every 2.7 days**.

This is an extreme rate of turnover for shares outstanding over a very long timeline. Considering all shares have been and are claimed to be owned by multiple institutional investors for the entire period, share turnover rates should be low in a normal well-functioning supply and demand market. The XRT turnover ratio has been as high as **7 times the shares outstanding** in a **single day**.

For the XRT on November 1, 2010, there were **10.5 million** shares outstanding and on March 31, 2014 (858 trading days later), there were **8.6 million** shares outstanding, despite 70% short selling on reporting markets between the two dates and multiple ownership claims for the shares outstanding. Between these dates total marketplace volume for the XRT was **5.6 billion shares**, with approximately **4 billion sold short** based on the reporting markets short sale percentage.

There is a consistent pattern of excessive short selling **without share creation** to accommodate the settlement of XRT securities. ETF operators, compliance personnel and auditors know the shares outstanding facts everyday; it is the ETFs' own data. Using the daily closing price during this 858-day period, the trade value equaled **\$326 billion worth of XRT shares sold with \$225 billion sold short (not owned by the sellers), while there was no net creation of shares outstanding to support this trading.**

The management, compliance personnel and auditors of the XRT need to be aware of the problems that exist in the XRT to properly assess the fund risks. When neither the shares outstanding or underlying assets are growing and short sales are turning over the shares outstanding every two days, it appears obvious that there are substantial growing risks that could affect the ETF at some point.

Auditors should be fundamentally concerned when the shares outstanding are turned over at this extreme level without net new assets being created. This indicates the XRT has consistently been building leverage and is not in any way representative of a mutual fund type investment as ETFs are thought to be.

A Current Regulation SHO Threshold Security

For the recent record, the XRT has been a **Regulation SHO threshold security every day since December 14, 2015** (77 straight trading days as of April 5, 2016).

During the 77 days from December 14 – April 5th (the end of this document examination period), the XRT averaged 13.5 million shares outstanding (which is close to what the XRT shares have averaged for years). The total trade volume on the consolidated tape was 320 million shares, which turned over the average shares outstanding more than **23 times** in the 77 days or just over every 3 days.

This turnover ratio is again astounding by any measure, but for a Regulation SHO threshold security with the following metrics, there is no explanation how this could occur with legally provided locates and full contractual settlement of the transactions. As we have stated, there appears to be a significant amount of washing/matching or similar type trading adding fictional volume to the marketplace, which we believe should also be of concern for auditors and management to understand in pursuit of a clean audit.

During the 77-day Regulation SHO period, XRT short sales as a percentage of total volume on reporting markets was **72%**, reaching a high on December 30, 2015 when 90% or 9 of every 10 shares were a product of a short sale. There are very few real XRT shares being sold. Nine of 10 shares sold short when a security is under Regulation SHO protections indicates in this case that the marketplace is filled with shares not owned by the sellers regardless of the laws, rules and regulations governing the U.S. markets.

This is an unusual period for the XRT. It is a current period spanning quarter ending dates, December 2015 and March 2016. It may be that a fairly large position is attempting to settle with shares issued by the ETF, but is not able to do so in a timely manner because shares are not readily available, resulting in fails for the last 77 days.

The Regulation SHO list information is published each day by exchanges, which is readily available to audit and for compliance personnel to monitor. Compliance departments should alert auditors and management of Regulation SHO designations (clear red flags). This should be able to be reported in real-time under a well functioning risk management system.

While the XRT should have been receiving protection under Regulation SHO for the 77 days, the total trade value was **\$13.6 billion**, with **approximately \$9.8 billion sold short** based on the reporting markets percent of short selling. The average XRT net asset value of \$578 million was turned over by the \$9.8 billion of just short sales approximately 17 times during the 77 days.

This is a large amount of transactional value in a security that essentially has no shares available to trade and is a Regulation SHO issue. Virtually nothing in the trading of the XRT changed after the Regulation SHO designation. This is not the apparent purpose of Regulation SHO and its amendments, i.e. to have ***no affect*** on securities that are being abusively sold short.

Certain ETFs, including the XRT, do not appear to be benefiting regular and long-term investors or the ETF's underlying securities capital formation processes; but rather are benefiting short sale transactional activity for a few, to the detriment of other market participants and perhaps ultimately the U.S. economy and taxpayers.

Table 4 shows five periods of extreme short selling since December 14, 2015, while the XRT was a Regulation SHO threshold security. These are market metrics we believe should be of concern for ETF management and auditors.

Table 4 – Short Selling on Reporting Markets/SROs on Consecutive Example Days
When the XRT was a Regulation SHO Threshold Security

Date	Consolidated Tape Volume	Percent of Short Selling on All Reporting Markets	Percent of Short Selling on BATS Markets Combined	Percent of Short Selling on NASDAQ Markets Combined	Percent of Short Selling on NYSE TRF and NYSE Arca Markets Combined
12/15/2015	4,927,800	83%	82%	93%	79%
12/16/2015	4,830,500	85%	82%	89%	85%
12/17/2015	4,053,800	81%	78%	85%	80%
12/29/2015	1,798,800	77%	78%	80%	72%
12/30/2015	2,117,500	90%	92%	86%	90%
12/31/2015	2,771,400	88%	86%	89%	92%
1/21/2016	4,241,300	78%	83%	70%	79%
1/22/2016	4,311,500	78%	87%	61%	84%
1/25/2016	3,780,700	78%	77%	80%	76%
1/26/2016	4,396,000	78%	76%	87%	74%
1/27/2016	3,541,000	76%	79%	67%	80%
1/28/2016	2,492,200	76%	78%	84%	67%
1/29/2016	3,331,500	75%	75%	77%	75%
3/11/2016	5,056,600	83%	81%	87%	82%
3/14/2016	3,246,200	85%	83%	91%	81%
3/15/2016	4,608,700	81%	81%	84%	80%
3/16/2016	4,524,600	89%	89%	91%	86%
3/17/2016	4,771,600	87%	84%	89%	88%
3/28/2016	3,027,300	79%	82%	75%	76%
3/29/2016	3,027,900	76%	77%	73%	80%
3/30/2016	3,744,500	84%	80%	91%	83%
3/31/2016	3,947,300	82%	85%	78%	79%

Should the above data be part of the audit processes? What data is not included in the investigation and audit processes? Why?

XRT Summary

The XRT is one of several major ETFs (along with their underlying equity securities) that have had ongoing excessive short selling, a high number of shares owned by reporting institutions (up to 7 owners per share at times for the XRT, considering just institutional 13-F reporting owners), inadequate share creation to support legitimate settlements, significantly under borrowed shares for short sale transactions, improper reporting of short interest and fails (ex-cleared/internalized) outside of the NSCC for several years.

There have been over 5 years of problematic trading behavior that has not been disclosed to regulators or investors.

In our view, the auditors of the XRT (and other ETFs) should be highly concerned with the disclosure issues within prospectuses and reports of ETFs they audit and provide an opinion on, as this information is referred to in virtually every document produced by the ETP industry for public investor consumption. ‘Read the prospectus’ is a disclosure in all ETF advertisements. The current prospectus for the XRT is packaged with its related SPDR Series Trust ETF products and is 271 pages. The semi-annual report is 449 pages and the annual report is 468 pages.

The audit team may be ‘looking in only one direction’ of how to audit the XRT and other ETFs without considering the broader information that might alter their view of securities like the XRT. In other words, a surface audit to determine whether the numbers provided by management were in compliance with their policies and procedures of supplying information to the auditors, does not appear to be an adequate/complete audit to discover/disclose ETP risks.

If they are only pursuing a limited view of the audit process, this should be clearly disclosed to investors. Such disclosure should include their reluctance to provide opinions on fund compliance with regulatory requirements and that valuations, including VAR models, may be ‘subjective and vulnerable to gaming’. Therefore, the audit processes cannot be relied upon if a 1940 Act registered fund uses certain modeling procedures for its’ risk management system.

Gatekeeper duties are a profound responsibility that must be taken extremely serious by the auditors. Auditors of ETPs should be very careful in sanctioning audits that are in fact based on a very limited view of the information available to them.

Conclusion

In this proposal, the SEC stated:

“The proposed rule is designed to address the investor protection purposes and concerns underlying section 18 and to provide an updated and more comprehensive approach to the regulation of funds’ use of derivatives transactions in light of the dramatic growth in the volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds.”

“The proposed rule’s conditions are designed both to impose a limit on the leverage a fund may obtain through the use of derivatives and financial commitment transactions and other senior securities transactions, and to require the fund to have assets available to meet its obligations arising from those transactions, both of which are central investor protection purposes and concerns underlying section 18.”

As discussed above, in response to this SEC proposal, the industry raised its’ concerns: a) the additional burden on fund boards, b) portfolio limits vs. VAR models, and c) the de-registration of certain funds from the 1940 Act that are employing strategies to increase leverage and risk through derivatives.

The industry did not address the building systemic risk in the market from the growing number of derivatives based on the same small group of important U.S. assets of concern that we have provided data for in previous comment letters.

The industry suggested the 1940 Act registered funds could utilize Value at Risk models instead of portfolio limits. We submit the suggestion to the SEC that if VAR models are substituted for portfolio limits, the models include all portfolio and derivative risks, which extend beyond the surface derivative transactions a fund enters into. Moreover, we suggest the secondary market ‘shadow portfolio’ risks are required elements to be considered in the VAR models.

We agree with SEC Commissioners Aguilar and Stein that additional board oversight is ‘necessary and appropriate’ and we have been questioning the 1940 Act registration of risky derivative ETPs that do not seem to fit with the other 1940 Act products and clearly ‘do not act like mutual funds’.²⁸ The case can easily be made that using flawed VAR models based on assumptions will likely result in underestimated risks and will fail in times of stress, as they have in the past.

The functional makeup of an ETF creates the primary ETF portfolio and an additional ‘shadow’ portfolio created by Authorized Participants and clearing firms, which are derivatives on the ETF trading in the secondary market. The shadow portfolios can sell shares not issued by the ETF without a requirement to create or replace the shares sold. This is a fatal flaw in the current structure of ETFs.

As we initially commented, the data suggests there is a very serious leverage issue existing for major ETPs that should not be dismissed. According to the data, ETP leverage has grown to systemic importance that could dwarf the mortgage-backed securities debacle prior to the last financial crisis.

We believe these issues need to be responded to by the industry and its’ auditors. It does seem audit firms should be able to give a clear response to the issues raised by the data, even though they may not have previously examined it, and explain exactly what has and is occurring in the creation, transactional activity and share accounting for ETFs such as the XRT.

²⁸ As SEC Commissioner Kara Stein recently stated: “It is increasingly apparent that ETFs behave very differently than mutual funds in our capital markets. The events of August 24 demonstrate that ETFs may act quite unusually in stressed market conditions and, frankly, break down in ways that we do not completely understand.”

“**Now is the time to be asking the hard questions about ETFs.** Broadly, we should be **considering whether we need new rules to address these innovative funds.** At a granular level, we should be examining the roles that all of the individual players in this ecosystem play (such as authorized participants). Systemically, I am particularly focused on how ETFs trade, as compared to mutual funds, and whether the way algorithmic traders utilize ETFs poses concerns to investors placing their retirement savings in these products.”

Commissioner Kara Stein, *Surfing the Wave: Technology, Innovation, and Competition – Remarks at Harvard Law School’s Fidelity Guest Lecture Series*, November 9, 2015 <https://www.sec.gov/news/speech/stein-2015-remarks-harvard-law-school.html>