Occupy the SEC
http://www.occupythesec.org

August 21, 2015

Secretary
Securities and Exchange Commission
100 F. Street NE
Washington, DC 20549-1090

Re: Request for Comment on Exchange-Traded Products
(File No. S7-11-15)

Dear Sir or Madam,

Occupy the SEC ("OSEC")[1] submits this comment letter in response to the Securities and Exchange Commission's ("SEC"; "Commission") Request for Comment ("RFC") on the agency's ongoing oversight over Exchange-Traded Products ("ETP"). We are pleased that the SEC has resolved to seek public comment on the burgeoning ETP market, which currently constitutes over a quarter of U.S. equity trading by dollar value.[2] This market is in dire need of enhanced regulation, and we appreciate the opportunity to comment on this issue of pressing public interest.

<u>The Current ETP Underwriting System Unfairly Privileges Non-Retail Investors</u>

As it stands, the current ETP underwriting system unfairly privileges certain "Authorized Participants," who are permitted to take the first bite at the ETP apple through block purchases of "Creation Units." This arrangement creates an unfair first-mover advantage for sophisticated financial parties and disadvantages smaller investors from the start. Authorized Participants are typically large financial institutions, like market makers or market specialists, who can utilize their size advantage to crowd out smaller competitors. The current ETP market structure not only disincentivizes smaller investors from entering the market, it also limits their ability to compete once they have entered.

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[1] Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.

[2] Exchange-Traded Products, 80 Fed. Reg. 34,729, 34,730 (proposed June 17, 2015) [hereinafter RFC].

In fact, the ETP arena, like much of the financial sector, can be described as an oligopoly, with a handful of firms controlling the market. This situation serves to inhibit efficient price allocation, which in turn inhibits liquidity. More importantly, oligopolies result in the concentration of risk, which, in the case of highly leveraged and illiquid ETPs, can have catastrophic consequences. Under classical economic theory, the most efficient markets are typically those having an almost infinite number of competitors, while the most inefficient markets feature monopolies and oligopolies.[3] Thus, it is paramount that the SEC espouse policies that permit everyday, retail investors to compete on an equal footing with sophisticated ETP underwriters and other parties enjoying information advantages.

<u>Market Forces and "Arbitrage" Are a Poor Substitute for Government-Enforced Discipline</u>

The RFC regurgitates industry arguments that market-based arbitrage opportunities are sufficient to correct any discrepancies between ETP prices and underlying reference prices.[4] It also notes that such price discrepancies have been small, on a percentage basis, during stable markets.[5]

First, even where arbitrage successfully corrects price mismatches, it does so by creating unfair windfalls for savvy institutional investors who can capitalize on information asymmetries and operational advantages to extract value from the market. Prices may eventually equalize through arbitrage but that equalization comes at the detriment of smaller, retail investors or the broader market, depending on the type of arbitrage. Arbitrage mechanisms allow Authorized Participants to make relatively higher returns on trading in an ETF's reference assets. Extremely few retail investors have the wherewithal to keep track of underlying assets and trade accordingly. In demonstrating considerable deference for extant arbitrage practices, the SEC is ensuring that big players can skim profits from the ETP market through so-called "riskless" arbitrage, while retail investors are the ones bearing the real risk.

Admittedly, ETPs will publish intraday indicative value (IIV) on a frequent basis, but the RFC itself acknowledges that IIVs may not correlate with portfolio value.[6] In fact, in many instances, the IIV published by an ETF lags behind the actual value of underlying assets. Only sophisticated parties (including insiders and privileged "authorized participants") have the capacity to assess the true value of the underlying securities. These "chosen few" often enjoy unfair advantages because they may be intimately familiar with the convoluted process behind an ETP's investment portfolio or they may have exclusive, nonpublic knowledge about underlying assets. The IIV system ends up serving as a mechanism that portrays the *illusion* of real-time valuation to smaller investors, while setting up those investors to be taken advantage of by larger ones. The

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[3] *See* K. Jothi Sivagnanam, *Business Economics* 155-56 (2010).
[4] *See, e.g.*, RFC at 34,733.
[5] *Id*. at 34,739.
[6] *Id*. at 34,733.

SEC should not sanction these features of the ETP system because they are fundamentally undemocratic.

Second, it is not clear that arbitrage in the ETP market produces the stabilizing effects that the SEC presumes. The Commission is too sanguine about the capacity of arbitrage to erase discrepancies. ETPs investing in derivatives and other alternative vehicles may be overleveraged, and may be dabbling in esoteric markets featuring low levels of liquidity. The SEC itself has expressed concern about the rapid growth of illiquid "liquid alternative" mutual funds.[7] If the market for an underlying asset is illiquid (or if a particular ETP is over-levered), no amount of arbitrage will be enough to equalize market discrepancies between underlying assets and the ETP price.

This is especially true during times of market stress. For instance, in the May 6, 2010 flash crash, 1 out of every 4 ETFs fell 60% or more, and ETF prices were wildly un-tethered from underlying asset values.[8] In such scenarios, ETP prices follow their own path, separate and distinct from underlying asset prices. As a result, arbitrage mechanisms can actually exacerbate price distortions. The simple fact is that arbitrage produces market efficiencies only during stable periods, and is therefore a poor substitute for government action.

The RFC minimizes the extent to which ETP prices deviate from underlying asset values (presumably to justify the SEC's inordinate reliance on arbitrage as a price-corrective mechanism). For example, it cites the fact that the average absolute value of the daily difference between the NAV and the closing market price of ETPs during a six-month period ending in December 2014 was just .21%.[9] The RFC fails to recognize, however, that the time period in question was one of market stability, and that similarly "minor" deviations are not guaranteed during times of market stress. Moreover, the cited figure is misleading because it ignores the gargantuan magnitude of the ETP market, which recently reached around $3 trillion in assets under management.[10] .21% of $3 trillion corresponds to a gross value of $6.3 billion, which is hardly an insignificant figure, especially in light of the fact that retail investors are the parties that are most likely to bear the brunt of that massive price discrepancy.

An "arbitrage opportunity" is just a euphemism for a pricing inefficiency. Instead of condoning such inefficiencies, the SEC should be focused more on avoiding them altogether. The best way for the SEC to reduce such inefficiencies is for it to implement a market structure for ETP under which retail investors are placed "in pari passu" with their more sophisticated competitors.

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[7] Norm Champ, Remarks to the Practising Law Institute, Private Equity Forum (June 30, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370542253660.
[8] Tom Lauricella, *A 'Flash Crash' Lesson*, Wall St. J., June 7, 2010, *available at* http://www.wsj.com/articles/SB10001424052748704113504575264323000687534.
[9] RFC at 34,739.
[10] *ETFs, ETPs Pass $3 Trillion Benchmark*, ThinkAdvisor, June 5, 2015, *at* http://www.thinkadvisor.com/2015/06/05/etfs-etps-pass-3-trillion-benchmark.

<u>The SEC's Prior Exemptions for ETPs Have Been Overly Deferential to Industry Concerns</u>

The SEC's past exemption decisions have undermined full and fair disclosure in the ETP markets, and have reinforced structural inequities that favor Authorized Participants and broker dealers. As we argue below, further exemptions along these lines would be detrimental.

Relaxation of Exchange Act Rule 10b-10 – a disclosure requirement for broker dealers – would not prove conducive to fair or equitable markets. Rule 10b-10's requirement of disclosure of transaction details is very basic and fundamental to the survival of an equitable market structure. It is of the utmost importance to allow an investor to properly understand risks when acting upon the recommendation of a broker-dealer. By providing full-disclosure, broker-dealers empower investors to understand the history, trends, and facts surrounding investment suggestions. Full disclosure is especially vital for investments involving convoluted, multi-layered securities like ETPs. Technological innovations should facilitate the provision of such information. If broker dealers find it infeasible to disclose up-to-date information about ETP securities, then that is probably an implicit admission that they should not be selling such securities to their customers in the first place.

The SEC must not allow securities to be sold free from meaningful disclosure about their contents out of solicitude for the "administrative burden" on broker dealers.[11] The more troubling "burden" is that placed on investors, who are left in the dark about their ETP investments by the SEC's disclosure exemptions. Under the SEC's prior Rule 10b-10 exemptions, disclosure can be omitted if "it is probable that" ETP transactions are only entered into by sophisticated investors.[12] *In other words, even if there is a 49% chance that simple, unsophisticated investors are engaging in the ETP transaction, the SEC is comfortable with depriving such investors of meaningful transaction data*. That position flies in the face of a fundamental purpose of the Commission: to protect investors through disclosure.[13]

The relaxation of Exchange Rule 10b-17 would provide ETPs with yet another opportunity to undermine the SEC's mission statement. It is unclear why the disclosures of Exchange Act 10b-17 are so difficult for ETP issuers. Given financial technology's continued improvement, it should be easy for issuers to provide projections on cash or security distributions in advance. If the reason why that is difficult is because the security is illiquid, then that means that the market for that security is risky, which in turn makes

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[11] RFC at 34,735.
[12] *Id*.
[13] Sec. & Exch. Comm'n, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, http://www.sec.gov/about/whatwedo.shtml (last modified June 10, 2013) ("The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public.").

timely disclosure *even more* vital. The SEC itself has implicitly acknowledged the importance of accurate disclosure by ETP issuers: recently the agency issued a Well Notice to an ETF issuer, PIMCO, for improper disclosures regarding the price of the PIMCO Total Return Active ETF (BOND).[14]

The relaxation of Exchange Act Rules 15c1-5 and 15c1-6, which contain certain disclosure requirements for broker-dealers, would also inhibit equitable market structures for retail investors. Investors rely on broker dealers to make "suitable" investment recommendations. It is the investor's basic right to know whether his broker dealer has any conflicts of interest that could taint a recommended transaction. It is a conflict of interest for an Authorized Participant to also serve as a broker-dealer in the ETP security because the broker-dealer would doubly benefit from churning the ETP security (both from broker-dealer commissions and from price appreciation for any ETP "Creation Units" held by the broker-dealer/Authorized Participant). By requiring broker dealers to disclose their participation in a distribution, Rules 15c1-5 and 15c1-6 equip investors with essential knowledge regarding these sorts of conflicts of interest. The SEC should not exempt ETP Authorized Participants from Rules 15c1-5 and 15c1-6, as granting such exemptions would allow ETP investors to be deluded into believing that the broker-dealer selling them a particular ETP has no competing interest.

Such an exemption also creates opportunities for Authorized Participants to utilize their role as broker-dealers to manipulate ETP prices. The possibility of ETP price manipulation is especially high in illiquid ETPs, which have blossomed in recent years. Even if an Authorized Participant/broker dealer cannot single-handedly manipulate an ETP market by recommending it to clients (as broker dealer), this dual role still creates incentives for the Authorized Participant to make unsuitable recommendations that can hurt particular investors. Accordingly, complete disclosure of potential conflicts is of paramount importance.

The RFC notes that listing standards currently require actively managed ETPs to make daily disclosures regarding their portfolio. It further observes that such standards do not require index-based ETP's to provide such disclosures, although most do "as a matter of practice."[15] We urge the Commission to mandate portfolio disclosures regardless of ETP type. The distinction between "actively managed" and "index-based" ETPs could become blurred with the ongoing proliferation of these instruments. Furthermore, while some market participants may indeed be able to "perform their own calculations of the per-share value of [the underlying] portfolio,"[16] the Commission has stated no reason why this onus must be placed on investors.

The Commission must enhance disclosure requirements, not dilute them, as these requirements are an important tool for tackling the fundamental lack of transparency that

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[14] Jenny Cosgrave, *Pimco Total Return ETF Outflows Doubled Ahead of SEC Warning*, CNBC, Aug. 5, 2015, *at* www.cnbc.com/2015/08/05/pimco-total-return-etf-outflows-doubled-ahead-of-sec-warning.html.
[15] RFC at 34,733.
[16] *Id*.

is inherent to the ETP market. Such requirements would help create opportunities for fair and equal investing.

The Commission Should Utilize the Exchanges to Regulate ETPs

Given the Commission's limited budget and operational capacity, the agency should require any exchange offering ETPs, in its capacity as an SRO, to monitor the ETP market for worrisome fluctuations. As implied by the RFC, the delisting of an ETP from an exchange can cause havoc on liquidity in the ETP's securities and on customer accounts. Thus, the best way to avoid delisting is for esoteric ETPs to not be listed in the first place. Since exchanges are the parties that are petitioning the Commission for exemptions and modifications to listing requirements, the agency should consider some mechanism to hold those exchanges liable in case of ETP failures. Increasing exchanges' "skin in the game" would reduce the proliferation of risk-prone ETPs. While exchanges enjoy absolute immunity over their SRO functions,[17] the Commission could nevertheless assign liability through case-by-case agreements with exchanges looking for ETP exemptions.

The SEC Should Proscribe the Number and Scope of ETPs if Necessary

As explained above, we believe that the Commission should expand the ability of retail investors to compete on an even-level with sophisticated parties in the ETP arena. At the same time, ETP issuers and broker-dealers must not be awarded broad exemptions from long-standing regulatory requirements. Industry proponents may counter that there would be no way for ETP sponsors to increase the number of products available to the public while still complying with regulations. Even if such were the case, the Commission should hold stead-fast on its regulatory responsibilities and allow the size of the ETP market to diminish in size as a consequence. The American capital markets have functioned admirably for decades without ETPs, and their "innovation" is no justification for the whole-scale dismantling of investor protections. If such protections prove to be too burdensome for purveyors of ETPs, those parties can always market their products as private placements. The privilege of general solicitation comes at a price.

The Commission should also focus on eliminating public access to the most illiquid ETPs. The RFC claims that arbitrage mechanisms can mitigate price volatility in ETPs. However, as argued above, arbitrage cannot lead to efficient price discovery where there is no real market. ETPs referencing illiquid markets are at great risk of suffering from an assortment of evils like insider trading, front-running, inaccurate valuations, high volatility, large tail-risks, etc. Similarly, where an ETP market (or the underlying market) is dominated by a handful of players holding large block positions, that market is prone to manipulation.

Moreover, runs in illiquid ETP markets can produce runs in underlying markets. In some cases, speculation in illiquid ETPs can have a devastating global impact, well outside of the capital markets. For example, assume that a particular ETP references wheat prices.

[17] *See, e.g.*, *Barbara v. NYSE*, 9 F.3d 49 (2d Cir. 1996).

An Authorized Participant holding a large position in the ETP falsely bids up the price of the ETF (through high-frequency trading, phantom orders, or some other means). Because of arbitrage processes, the underlying price of wheat concomitantly increases. In certain regions of the world, poor farmers and others rely heavily on wheat bread for basic nutrition.[18] Thus, the increase in wheat prices causes local bread producers to go out of business, thereby jeopardizing the availability of food in these regions. In this example, the profiteering of a single, well-fed ETF speculator will have caused widespread malnutrition and starvation elsewhere in the world. Such a scenario might seem far-fetched at first blush, but public health research has demonstrated that financial speculation in the run up to the recent financial crisis produced similar outcomes, causing starvation or malnutrition of millions of people.[19] *There is every chance that ETPs could produce a similar result in the future.*

<u>Conclusion</u>

The proliferation of speculative activity caused the 2008 financial conflagration. Unless the SEC implements effective controls over ETPs, these securities are likely to serve as an accelerant for the next fire. Thus far, the Commission has exhibited remarkable deference[20] to exchanges' and lobbyists' self-serving arguments about the stability of ETPs and the reliability of market forces ("arbitrage") to resolve discrepancies. We urge it to take a more circumspect position vis-à-vis ETP securities, especially as the size of that market continues to swell.

Thank you for your attention to this matter of grave public concern.

Sincerely,
/s/
Occupy the SEC

Akshat Tewary
Neil Taylor
et al.

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[18] Amy Waldman, *Poor in India Starve as Surplus Wheat Rots*, N.Y. Times, Dec. 2, 2002, at http://www.nytimes.com/2002/12/02/world/poor-in-india-starve-as-surplus-wheat-rots.html ("higher prices for food and inefficient distribution leave basic items like bread, a staple of the rural poor diet, out of reach for many.").

[19] *Millions will starve to death in crisis*, Metro, Mar. 29, 2009, *at* http://metro.co.uk/2009/03/29/millions-will-starve-to-death-in-crisis-587911/ (citing a study by Save the Children); Rajmil, L. at el., *Impact of the 2008 Economic and Financial Crisis on Child Health: A Systematic Review*, 11(6) Int'l J. of Environmental Research and Public Health 6528–46 (2014) ("Most studies suggest that the economic crisis has harmed children's health, and disproportionately affected the most vulnerable groups.").

[20] In fact, we would request the Commission to survey its records and disclose that percentage of ETP exemption requests that it has granted in the past, both with and without modification. The closer that percentage is to 100%, the more likely it is that the Commission has failed to act as an impartial and critical arbiter of financial innovation in the ETP arena.