3/28/2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number S7-24-15 Use of Derivatives by Registered Investment Companies and Business Development Companies

Dear Mr. Fields:

On December 11, 2015 the Commission issued Release No. IC 31-933 (the "Release") proposing rule 18f-4 (the "Proposed Rule"), which is "designed to impose a limit on the leverage a fund relying on the rule may obtain through derivatives transactions and financial commitment transactions, and to require the fund to have qualifying coverage assets to meet its obligations under those transactions."

If adopted, the Proposed Rule would restrict ETFs and other registered investment companies from investing in derivatives that provide more than 200% upside exposure to an index or 150% downside exposure to an index. We estimate the Proposed Rule would force 97 leveraged and inverse exchange traded funds ("ETFs") with approximately $17 billion in assets under management and $4.5 billion in daily trading volume to modify their investment strategies or shut down.

While the intent of the Proposed Rule is to protect investors from themselves, it will actually restrict investor choice and reduce investor protections. We raise three primary concerns regarding the Proposed Rule:

1. **The Proposed Rule rests upon a questionable legal foundation that could potentially be challenged.** The Release asserts the Commission's authority to issue the Proposed Rule pursuant to section 18 of the Investment Company Act of 1940 (the "Act"), which restricts the issuance of senior securities by registered investment companies. The problem with this assertion is that the bilateral swap agreements used by leveraged and inverse ETFs to provide amplified or inverse exposure to underlying indexes are not senior securities as defined in Section 18 of the Act[1].

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[1] The relevant portion of Section 18(g) of the Act provides that "'Senior Security' means any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness…."

The Release seeks to overcome this objection by claiming derivatives meet the definition of senior security because they "fall within the functional meaning of the term 'evidence of indebtedness' for purposes of section 18 of the Act … and thus may involve the issuance of senior securities."

This is fine as far as it goes, but it is not sufficient. Rather, to be a senior security, a derivative must also be a "bond, debenture, note, or similar obligation or instrument constituting a security." The Release cites no judicial authority for the proposition that bilateral swap agreements meet this element of the senior security definition (because none exists) and instead implies, contrary to the plain meaning of the language in the definition, that instruments that are not securities may still be senior securities under the Act.

The Commission's arguments amount to a rewriting of the definition of senior security contained in the Act. We respectfully suggest that this task should be left to Congress.

2. **The Proposed Rule will restrict investor choice and reduce investor protections.** The premise underlying the Proposed Rule is that investors who use leveraged and inverse ETFs will stop seeking out such exposure if it is not available in the ETF format. More likely, such investors will seek out such exposure through other investment vehicles, such as exchange traded notes ("ETNs").

   ETNs are obligations issued by banks and other issuers that promise to provide purchasers a specified return. Because they are considered debt instruments issued by operating companies rather than investment companies, they are not governed by the Act and will therefore not be restricted by the Proposed Rule. If the Proposed Rule is passed, we expect to see an explosion of new ETNs that promise to provide investors with precisely the same exposure they currently obtain through leveraged and inverse ETFs.

   This outcome will actually harm investors by leaving them with fewer choices and less investor protections. Unlike ETFs, ETNs have no independent board overseeing the actions of the product sponsor and are subject to fewer disclosure obligations than registered investment companies. Moreover, while leveraged and inverse ETFs generally seek to minimize their risk by entering into swap agreements with multiple counterparties and requiring such counterparties to post collateral on an ongoing basis, ETNs provide no such investor protections.

3. **The Proposed Rule fails to take into account the benefits to investors of leveraged and inverse ETFs.** Leveraged and inverse ETFs provide a means for investors to execute short-term trading strategies that might otherwise be more costly or risky for them to implement. Nothing speaks more clearly to the tangible benefits that these products provide than market usage. While total assets under management in leveraged and inverse ETFs represents a relatively small percentage of the ETF industry (less than two percent), leveraged and inverse ETFs represent over 20% of the top 100 most actively traded ETFs.

While we appreciate that the intention of the proposed rule is to enhance investor protections, the implementation will potentially result in a proliferation of new financial products that offer the same kind of exposure while eliminating the benefit of the protections afforded to investors under the Act.

Respectfully Submitted,

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