ProShares

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Via Electronic Mail
March 28, 2016

Mr. Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15)

Dear Mr. Fields:

ProShares[1] appreciates this opportunity to comment on the proposal ("Proposal") of the Securities and Exchange Commission (the "Commission" or "SEC") with respect to the Use of Derivatives by Registered Investment Companies and Business Development Companies.[2]

I. Executive Summary

We believe that the current approach of the Commission and SEC staff toward the use of derivatives and senior securities by funds, which has developed since the Commission issued Investment Company Act Release 10666 in 1979,[3] generally has provided an effective framework and protected investors by ensuring funds have sufficient liquid assets segregated to meet their obligations. However, as the Commission notes in the Proposal, much of this guidance has been developed on an *ad hoc* basis over several decades. ProShares therefore supports the Commission's stated goal to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives and the senior security restrictions in Section 18 of the Investment Company Act of 1940 ("1940 Act").

ProShares generally believes the proposed asset segregation requirements (with modifications) and the proposed derivatives risk management program requirements set forth in

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1 "ProShares" is the business name of ProShare Advisors, LLC, ProFund Advisors, LLC, and their affiliated companies.

2 *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Investment Company Act Release No. 31933, 80 Fed. Reg. 80884 (Dec. 28, 2015).

3 *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 18, 1979)("Release 10666").

the Proposal provide a strong framework for investor protection consistent with the intent of the 1940 Act. We believe this framework satisfies the Commission's goals as stated in the Proposal.

While ProShares supports some elements of the Proposal, we believe several key requirements of proposed Rule 18f-4 are unnecessary and potentially detrimental to investors. In particular, we believe the express portfolio limits based on notional amounts set forth in proposed Rule 18f-4 are not necessary. Further, we believe the limits as proposed are potentially detrimental to funds and fund shareholders. As noted by the Commission in the Proposal, notional amount is a "blunt measurement" of exposure.[4] Notional amount does not necessarily represent a fund's settlement obligation or amount at risk pursuant to a derivative contract. For this reason, we do not believe notional amount is an appropriate measure of a fund's economic exposure. We therefore recommend against implementing portfolio limits based on notional amount.

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. For funds that must change their investment objectives and strategies, investors may be deprived of useful investment strategies and may pay higher fees as a result of potentially less effective and/or more expensive strategies. 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). This could drive investors who currently benefit from these strategies in a 1940 Act fund to invest in products not subject to the protections of the 1940 Act, including the oversight of a board of directors subject to rigorous 1940 Act standards and the proposed new protections of the derivatives risk management program and risk management officer. With respect to funds that are forced to close, investors would lose their preferred investment choices and be forced to choose other, potentially less appropriate investment options.

To the extent that Rule 18f-4, if adopted as proposed, forces funds that have been operating pursuant to long-standing SEC guidance or exemptive orders to go out of business or operate under different regulatory regimes with fewer investor protections, we believe the rule is fundamentally unfair and potentially harmful to investors.

We therefore urge the Commission to adopt a rule that does not contain express portfolio limitations based on notional amounts for senior securities transactions. We also note that, in general, we support the comments submitted by the Investment Company Institute. Our specific comments on the Proposal are therefore limited to the key points discussed in more detail below.

II. Introduction to ProShares

ProShares is a leading provider of exchange-traded funds ("ETFs") and mutual funds. ProShares was founded in 1997 and launched its first ETF in 2006. Today, we manage over 260 funds with approximately $30 billion in assets.

ProShares offers a broad spectrum of funds across a range of investment categories,

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4 Proposal at 70.

including:

- *Core strategies*: Equity and fixed income funds that can serve as replacements to core portfolio allocations. Examples include dividend growth funds and currency hedged funds.

- *Alternative strategies:* Liquid alternative investment strategies designed to help manage risk or enhance returns. Examples include managed futures funds and long/short funds.

- *Tactical investing tools*: Funds generally designed to be employed on a tactical basis to obtain specific market exposure. Examples include leveraged and inverse funds.

ProShares is the world's largest provider of leveraged and inverse ETFs and mutual funds. Leveraged and inverse funds are a category of index funds that are designed to deliver returns (before fees and expenses) equal to a specified multiple (or inverse multiple) of the return of a given benchmark, typically for one-day periods.

The Proposal recognizes that leveraged and inverse funds use derivatives extensively and seeks specific comment on certain aspects of their operation. For example, in connection with a discussion of Rule 18f-4's proposed 150% exposure limit, the Proposal asks whether a higher exposure limit for leveraged and inverse funds would be appropriate because these funds "operate as trading tools that seek to provide a specific level of leveraged exposure to a market index over a fixed period of time and because the amount of leverage is an integral part of their investment strategy."[5]

In light of this, the next section provides a brief overview of the operation and key attributes of leveraged and inverse funds.

A. About Leveraged and Inverse Funds

Leveraged and inverse funds (which generally are referred to collectively herein as "geared funds") have been widely embraced by investors, including financial professionals, institutions and knowledgeable self-directed investors. Geared mutual funds were first introduced in the United States in 1993 and the first geared ETFs were launched by ProShares in 2006. Geared funds have operated successfully for over 20 years in a variety of market conditions, including periods of significant market volatility. Today, these funds are available in the United States, Canada, eleven European and five Asian countries. Globally, more than $60 billion is invested in geared funds, with more than $40 billion invested in the United States alone. Globally, billions of dollars in geared ETFs trade on a daily basis. ProShares currently manages over 180 geared funds with approximately $25 billion in assets under management. We believe the long-term and extensive use of geared funds demonstrates the inherent value of these products to a segment of investors.

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[5] Proposal at 105.

Investors typically use geared funds for tactical purposes or as part of an overall investment strategy. Geared funds may be used to help manage risk, reduce volatility and enhance returns by providing precise leveraged or inverse exposure to specified markets or market segments. For example, leveraged funds offer investors a cost-effective means to obtain a specified level of exposure to a given benchmark or specific segment of the market, allowing more money to be allocated to other investments in an investor's portfolio. Inverse funds offer investors an efficient way to hedge or protect against the risk that an asset they hold will decline in value.

A key feature of most geared funds, including all of the geared funds offered by ProShares, is that they have a daily investment objective.[6] Geared funds with a daily objective are designed to deliver a precise, constant and predictable amount of leverage from one day to the next. In order to ensure that the amount of leverage in each fund remains constant from day to day, ProShares adjusts the portfolio holdings of its geared funds on a daily basis. This process, which is often referred to as "daily rebalancing," allows each fund to maintain a daily level of exposure and risk consistent with its stated investment objective and is designed to ensure that a fund's leveraged exposure will not float unpredictably over time. As a result of this process, an investor in a daily leveraged or inverse fund generally can expect to receive the stated multiple (or inverse multiple) of the performance of the fund's underlying benchmark (before fees and expenses) each trading day.[7]

The use of leverage in the manner described above is an integral and clearly disclosed part of these funds' operations.[8] We believe most investors generally understand the key features and related risks of geared funds and use the funds to implement the investment strategies outlined above.

The Commission notes in the Proposal that some funds that seek to deliver two times the performance of an index may be able to achieve this level of exposure in compliance with the proposed rule.[9] ProShares is highly confident that we will be able to continue to offer and

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6 In this manner most geared funds are different from other types of funds, which generally have an investment objective which is not time constrained.

7 While the ProShares geared funds rebalance leverage on a daily basis, other geared funds rebalance leverage on a monthly basis. A monthly rebalanced fund's leveraged exposure would be expected to deviate from its stated multiple between monthly rebalances. Geared funds do not have long-term objectives because the daily impact of compounding on fund returns makes it impractical to create a fund that makes a continuous offering of its shares and consistently delivers for all of its shareholders a stated multiple of a benchmark over time.

8 ProShares discloses each fund's investment objective and leverage factor, along with its principal investment strategies and risks, in the fund's registration statement.

9 As noted by the Commission in footnote 553 of the Proposal, "some funds that seek to deliver two times the performance of an index may be able to achieve this level of exposure in compliance with the proposed rule's 150% limit by investing in securities included in the benchmark index and obtaining additional exposure through derivative transactions." Proposal at 288.

manage our funds that seek two times the performance or two times the inverse of the performance of an index consistent with their investment objectives under the rule as proposed.

III. Asset Segregation and Derivatives Risk Management Program Are Sufficient to Accomplish Commission's Stated Objectives

ProShares believes the combination of asset segregation and a risk management program would provide a strong framework for investor protection and would help establish appropriate limits on leverage and speculation. We therefore believe they are sufficient to accomplish the Commission's stated objectives. We support aspects of the Proposal in this regard, with certain recommended changes as discussed below.

A. Asset Segregation

For over thirty years, the existing asset coverage framework that has developed following Release 10666 has helped protect investors by placing a practical limit on fund investments that implicate senior securities while helping to ensure that funds have sufficient liquid assets to meet their obligations. We therefore believe appropriate asset segregation requirements, together with a robust risk management program, are sufficient to achieve the Commission's stated goals.

We generally support the enhanced asset segregation requirements of the Proposal which require funds to set aside qualifying coverage assets for each derivatives transaction in an amount at least equal to the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts, and for each financial commitment obligation in an amount at least equal to the full financial commitment obligation (*i.e.*, notional value). Such asset coverage requirements directly address a fund's actual exposures at the time of determination and provide a reasonable estimate of a fund's potential future exposure in the case of derivative transactions.

As noted in the Proposal, the proposed asset segregation requirements would address the asset sufficiency concerns of Section (1)(b)(8) of the 1940 Act, as well as the undue speculation concern reflected in Section 1(b)(7) of the 1940 Act. Further, as proposed, these concerns would be addressed under the purview of board-adopted policies and procedures for asset segregation and an ongoing program of board oversight. We believe that these requirements provide an entirely effective approach and that the blunt tool of exposure limits based on notional amounts should be eliminated from the Proposal.

However, although we generally support the proposed asset segregation requirements, we believe the Commission's proposal to limit "qualifying coverage assets" for each derivatives transaction to only cash and cash equivalents is overly restrictive. We do not believe this approach provides significant added investor protection benefits (as compared to the approach under current Commission and SEC staff guidance which would permit segregation of other types of liquid assets). Further, as discussed herein, we believe the proposed approach could have a potential negative impact on some funds. For example, requiring funds to hold cash and cash equivalents to cover obligations under senior securities transactions could cause funds to divert portfolio assets from other liquid investments that are more consistent with their investment objectives and strategies and that would otherwise provide appropriate cover for a fund's obligations. Such an allocation of assets to cash and cash equivalents could lead to unnecessary and detrimental cash drag on the performance of the funds. By allowing funds to use a broader range of qualifying coverage assets (with appropriate risk adjustments, if necessary, based on the asset class of the coverage assets) the Commission could provide for appropriate asset coverage, while minimizing the potential for disruption of fund investment objectives and strategies.

B. Derivatives Risk Management Program

The Proposal would require any fund that engages in more than a limited amount of derivative transactions, or that uses any complex derivative transactions, to adopt and implement a formalized derivative risk management program.

We generally support the requirement for funds to maintain formalized derivative risk management programs tailored to their specific operations and portfolio requirements. We understand that fund advisers who currently engage in senior security transactions on behalf of funds use a variety of risk management tools and board reporting mechanisms. We believe that adopting formal requirements with respect to risk management programs will help provide a standardized level of risk management across fund firms and provide valuable additional shareholder protections.

IV. The Commission Should Not Adopt Portfolio Limits

ProShares believes the express portfolio limits based on notional amounts set forth in proposed Rule 18f-4 are not necessary to achieve the Commission's stated goals and are potentially detrimental to shareholders.

Under the Proposal, the Commission would require funds that engage in senior security transactions to comply with one of two alternative portfolio limitations (together, the "Portfolio Limits"): (1) the aggregate exposure of a fund must not exceed 150% of the value of the fund's net assets ("Exposure-Based Limit"); or (2) the aggregate exposure of a fund must not exceed 300% of the value of the fund's net assets, as long as the value-at-risk ("VaR") of the fund's full portfolio including the derivatives transactions is less than the VaR of the fund's portfolio of securities and other investments not including derivatives transactions ("Risk-Based Limit"). For purposes of the proposed rule, a fund's "exposure" generally includes the aggregate notional amount of its derivative transactions, together with its aggregate obligations under financial commitment transactions and other senior securities transactions.

The Portfolio Limits represent a significant and unwarranted departure from prior precedent which has relied on asset segregation to establish functional limits on fund use of senior securities. We do not believe that existing data or events indicate a specific leverage limit is necessary or would otherwise benefit investors. In fact, we believe Portfolio Limits based on notional amounts are likely to be harmful to fund shareholders, as discussed in more detail below.[10] As noted, we believe that asset segregation, when combined with the added protections of the proposed derivatives risk management program, provides a strong framework for investor protection and appropriate limits on leverage and speculation. For these reasons, we do not believe the Commission should depart from its prior approach, which has worked well for over 30 years, by implementing Portfolio Limits.

A. Notional Exposure Is Not an Appropriate Method to Measure Exposure Limits

We do not believe that notional exposure is an appropriate method to measure and calculate Portfolio Limits.[11]

In the Proposal, the Commission states that the Portfolio Limits "are designed primarily to address the undue speculation concern expressed in Section 1(b)(7) of the 1940 Act by imposing an overall limit on the amount of exposure to underlying reference assets, and potential leverage, that a fund would be able to obtain through derivatives and other senior securities transactions."[12] The Proposal goes on to state that "for most types of derivatives, the notional amount generally serves as a measure of the fund's economic exposure to the underlying reference asset or metric."[13] We disagree. Notional amount typically serves only as a reference point for derivative transactions and generally does not serve as an appropriate means of measuring a fund's exposure. Notional amount does not necessarily represent an amount at risk or stand as a contractual settlement obligation of the parties to a derivative transaction. It therefore does not provide a consistent, reliable measurement of the potential economic loss to a fund from its derivative transactions and may often overstate the amount of a fund's actual economic exposure pursuant to such contracts.

In the Proposal, the Commission acknowledges that notional amounts are, at best, a crude measure of a fund's exposure:

> "we recognize that a derivative's notional amount does not reflect the way in which the fund uses the derivative and that the notional amount is not a risk measure. An exposure-based test based on notional amounts therefore could be viewed as a relatively blunt measurement in that different derivatives transactions

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[10] In addition, the Risk-Based Limit would not be a meaningful alternative to the Exposure-Based Limit for many funds. Because the Proposal contemplates that a fund would cover its obligations under senior securities transactions with cash and cash equivalents, for funds that use derivatives requiring substantial asset coverage and/or that hold mainly cash and cash equivalents in addition to derivatives, the VaR of such portfolios without including derivatives would in most cases exceed the VaR of the portfolios including derivatives transactions. Accordingly, we expect that the more restrictive Exposure-Based Limit would be the applicable Portfolio Limit for many funds.

[11] Under the Proposal, "notional amount" is generally defined as the market value of an equivalent position in the underlying reference asset for the derivatives transaction, or the principal amount on which payment obligations under the derivatives transactions are calculated, subject to various adjustments required by the rule.

[12] Proposal at 66.

[13] Proposal at 67.

having the same notional amount but different underlying reference assets – for example, an interest rate swap and a credit default swap having the same notional amount – may expose a fund to very different potential investment risks and potential payment obligations."[14]

We agree, and we believe that the notional exposure of a fund is therefore a poor measurement of the potential leverage of a fund. As such, we do not believe it is appropriate to use notional amount in an effort to determine and control whether a fund is "unduly speculative."[15] Accordingly, each of the Portfolio Limits would be inappropriate in light of the reliance on notional amounts.

B. Portfolio Limits Based on Notional Amounts Will Be Detrimental to Funds and Fund Shareholders.

In addition to being an unnecessary and inappropriate measure of fund exposure, we believe Portfolio Limits based on notional amount are likely to be detrimental to funds and fund shareholders. We believe that the Commission should avoid imposing such a "blunt measurement" in light of the clear adverse consequences.

We understand that, if adopted as proposed, the Portfolio Limits would likely cause a significant number of funds to substantially modify their investment strategies, to shut down or to reorganize outside the 1940 Act.[16]

To the extent funds are forced to modify their investment objectives or strategies, such funds may be forced to substitute investments in physical securities for investments in derivative transactions or make other changes to portfolio strategies. This could potentially inhibit the ability of funds' to achieve their stated objectives, decrease fund returns and increase fund expenses and transaction costs as less effective and potentially more expensive instruments are substituted for derivatives exposure.[17] As a result, many investors will no longer have access to their preferred investment choice, or if they do, such choice may be modified in ways they did not anticipate when they made their initial investment.

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14 Proposal at 70.

15 We also note that even as a measure of overall economic exposure, notional amount is not a reliable reflection of risk. A fund with a high notional exposure may be more, less or equally risky as a fund with little or no exposure to derivative contracts.

16 While the Proposal highlights the potential impact of Portfolio Limits on alternative strategy funds and certain types of leveraged and inverse funds, it is our understanding that a much broader array of funds pursuing a variety of investment strategies would be negatively impacted if Portfolio Limits are adopted as proposed.

17 To the extent the proposed rule, if adopted, causes funds to adjust their portfolio investments it could cause adverse tax consequences for certain funds that realize gains as a result of the sale or other adjustment of fund investments. This could, in turn, result in higher capital gain distributions and taxes to fund shareholders. We expect that these negative tax consequences could be potentially higher for funds that may be forced to liquidate or reorganize.

Further, we expect that some types of funds that have been operating successfully and without incident as 1940 Act investment companies may be unable to comply with the Portfolio Limits as proposed. Some of these funds may be forced to shut down, depriving investors of valuable investment opportunities and leaving investors with fewer, and in some cases less desirable, investment choices. Other funds may choose to reorganize and continue operations as exchange traded commodity pools ("ETPs") registered under the Securities Act of 1933 only. Alternately, substantially identical strategies may be publicly offered as exchange traded notes ("ETNs") or through private placements in the form of unregistered investment vehicles. These products are not subject to the important investor protections of the 1940 Act, including the oversight of a board of directors, restrictions on transactions with affiliated persons, and the proposed new protections of the risk management program and risk management officer under Rule 18f-4. Further, investors in ETNs generally are subject to the credit risk of the issuer of the ETN. Therefore, while the Proposal is intended to address the investor protection purpose and concerns of Section 18, a potential consequence of the Proposal is that fund investors who currently enjoy the protections of the 1940 Act may be driven to invest in products completely outside the scope of the 1940 Act.

To the extent that Rule 18f-4, if adopted as proposed, forces funds that have been operating pursuant to long-standing SEC guidance to go out of business or operate under different regulatory regimes with fewer investor protections, we believe the rule is fundamentally unfair and potentially harmful to investors.[18]

The Proposal indicates that Portfolio Limits based on notional amounts are designed to balance concerns about the limitations of an exposure measurement based on notional amounts with the benefits of using such amounts. We strongly urge the Commission to weigh the benefits of using Portfolio Limits based on notional amount, which we believe are minimal, against the potential negative impacts identified above.

V. Response to Specific Requests for Comment.

In addition to the Commission's general request for comments on the proposed rule, the Proposal seeks comment on a number of specific questions. Certain of these questions, and our responses, are set forth below.

1. Is 150% an appropriate exposure limit? If not, should it be higher or lower, for example 200% or 100%?[19]

For the reasons stated herein, we do not believe Portfolio Limits should be adopted and do not believe 150% is an appropriate exposure limit.

In proposing to set Portfolio Limits at 150%, the Commission stated in the Proposal that "a 150% exposure limit would account for the variety of purposes for which funds use

[18] As discussed in more detail in Section V herein, we believe this is especially true for funds, such as certain types of ETFs that operate pursuant to exemptive orders approved by the Commission. These orders are based on a finding under Section 6(c) of the 1940 Act that such orders were necessary or appropriate in the public interest, consistent with the protection of investors, and consistent with the purposes fairly intended by the policy and provisions of the 1940 Act.

[19] Proposal at 105.

derivatives" and would "appropriately balance the proposed rule's effects on funds and their investors...with concerns related to funds' ability to obtain leverage."[20] Given our understanding that a large number of funds may not be able to comply with the 150% requirement, and given the potential negative impact of the requirement on funds and fund shareholders discussed above, we do not believe the requirement satisfies the Commission's objectives.

The Commission also observed that setting the exposure limitation at 150% would allow a fund to use derivatives transactions to obtain an amount of market exposure that could approximate the level of market exposure that would be possible through securities investments augmented by borrowing from a bank, as permitted under Section 18 of the 1940 Act.[21] We respectfully suggest that this comparison is flawed for the reasons discussed above regarding the limitations of using notional amount to measure exposure and the actual amount at risk under different types of derivative transactions. The dollar amount of a bank loan generally would be an appropriate measure of a fund's exposure as a fund typically would be contractually obligated to repay the full dollar amount borrowed. Notional amount, on the other hand, typically would not represent the payment obligations of the parties to a derivative contract upon settlement of such contract.

2. Should we consider a higher limit for ETFs (or other funds) that seek to replicate the leveraged or inverse performance of an index? Would a higher exposure limit be appropriate for these funds because they may operate as trading tools that seek to provide a specific level of leveraged exposure to a market index over a fixed period of time, and because the amount of leverage is an integral part of their strategy? Conversely, do those same considerations suggest that these funds—which are not restricted to sophisticated investors—should be subject to the same exposure limitations as other types of funds?[22]

While ProShares does not support express exposure limits, to the extent that the Commission adopts such limits, we believe it would be appropriate to adopt a higher exposure limit for funds seeking to replicate the leveraged or inverse performance of an index. We suggest an exposure limit of 300% as the Commission has previously issued exemptive orders (discussed below) to funds seeking to provide up to 300% of the return (or inverse return) of an index. A 300% limit would permit these funds to continue to operate in their current manner. We believe this is appropriate for several reasons.

First, as the Commission notes, the amount of leverage is an essential feature of geared funds. By their very nature, these funds are designed to provide a specific amount of leveraged exposure to a market index over a fixed period of time. ProShares clearly discloses this information in its funds' registration statements. Investors use geared funds to implement a variety of investment strategies precisely because they are seeking this level of exposure.

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20 Proposal at 96-97.

21 Proposal at 95 and accompanying note 208.

22 Proposal at 107.

Capping exposure at 150% of net assets may not be sufficient to allow certain of these funds to achieve their investment objectives as currently operating.

Second, unlike more traditional funds, most geared funds track the daily performance of an underlying index and are managed to deliver a precise, constant and predictable amount of leverage from one day to the next. This process limits the amount of risk from the use of senior security transactions and is designed to ensure that a fund's leveraged exposure will not float unpredictably over time. The daily feature of these funds distinguishes them from funds with longer-term investment objectives, which may employ leverage over longer periods of time or in a manner that may float up or down at the discretion of the fund's adviser.

Finally, to the extent the Commission does not adopt a higher limit for geared funds, certain types of geared funds may be required to substantially modify their investment strategies, liquidate or operate outside the 1940 Act. This could have a negative impact on shareholders, as discussed above. A 300% limit would permit these funds to continue to operate in their current manner.[23]

3. *Some of these funds are ETFs that operate pursuant to exemptive orders granted by the Commission. Would it be more appropriate to consider these funds' use of derivatives transactions in the exemptive application context, based on the funds' particular facts and circumstances, rather than in Rule 18f-4, which would apply to funds generally? Would the exemptive application process be a more appropriate way to evaluate these funds in order to consider their use of leverage together with other features of these products (such as their objective of seeking daily returns) that are not shared by funds generally?*[24]

We do not believe it would it be appropriate to require derivative transactions of geared ETFs to be considered in the exemptive application context, based on their particular facts and circumstances, rather than in proposed Rule 18f-4 which would apply to funds generally.

The use of senior securities and derivative transactions is a central element of these ETFs and was fully disclosed to the Commission and discussed with the SEC staff during the exemptive application and order process for such ETFs. The resultant orders were approved by the Commission based on a finding under Section 6(c) of the 1940 Act that such orders were necessary or appropriate in the public interest, consistent with the protection of investors, and consistent with the purposes fairly intended by the policy and provisions of the 1940 Act. These ETFs were not required to obtain any relief from Section 18, nor have geared mutual funds been required to obtain such relief. Adopting a rule that would require some or all geared ETFs to obtain additional relief from Section 18 would thwart the explicit purpose, findings, and relief provided in the Commission's prior orders with respect to such funds.

In addition, we do not believe that it would be a good use of resources for funds or the SEC staff if the Commission adopts a rule with an understanding that affected funds immediately would need to seek exemptive relief from that rule. This administrative process potentially

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23 See supra note 9.

24 Proposal at 107-108.

would call into question the public policy basis of either the rule or the exemptive orders, resulting in unnecessary regulatory uncertainty. Also, this process seems inconsistent with the Commission's goal of developing a comprehensive approach to use of derivatives through the Proposal.

4. Should we grandfather funds that are operating in excess of the proposed rule's portfolio limits as of a specified date? If we were to grandfather funds, which funds should we grandfather and why? Should we apply any grandfathering to funds that are operating on the date of this proposal, for example? Alternatively, should we, for example, grandfather leveraged ETFs on the basis that they operate pursuant to the terms and conditions of exemptive orders granted by the Commission? If we were to grandfather funds, should the grandfathering be subject to conditions? Should any grandfathered funds be required to comply with some, but not all, aspects of the proposed rule? For example, should they be required to comply with the proposed rule's asset segregation requirements and the requirement to have a formalized derivatives risk management program? Should they be required to comply with any other conditions?[25]

If the Commission adopts the Portfolio Limits as proposed, we believe it would be appropriate to grandfather existing geared funds so that the Portfolio Limits do not apply to such funds.[26]

As noted, the history of geared funds is over 20 years old, extending back to 1993. During this time, fund sponsors have devoted a significant amount of capital resources and invested millions of dollars to build and expand their businesses. They employ hundreds of people and their products are used by many investors. The business of these sponsors has been built, in part, in reliance on the guidance and other comments of the Commission and SEC staff. In addition to public guidance applicable to funds generally, the Commission and SEC staff have provided guidance and comments in the form of, as applicable, registration statement comments, routine exam findings, and in the case of ETFs, Commission exemptive orders and other regulatory relief. In light of this, we believe it would be fundamentally unfair for the Commission to adopt a new rule which could potentially force certain types of funds offered by these sponsors, which have long operated in accordance with such guidance and comments, to shut down or operate outside the 1940 Act. We therefore believe it would be appropriate for the Commission, if Portfolio Limits are adopted, to grandfather geared funds that are in operation as of the date the proposed rule is adopted.

In particular, we believe that geared ETFs should be grandfathered on the basis that they operate pursuant to the terms and conditions of exemptive orders previously granted by the Commission.

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25 Proposal at 110.

26 We believe it would be appropriate to require such funds to comply with the other requirements of Rule 18f-4, if adopted, to the same extent as non-grandfathered funds.

The administrative history of geared ETFs is extensive. As noted above, the first exemptive order to permit geared ETFs was granted to ProShares by the Commission in 2006.[27] The application for this relief was granted by the Commission after an extensive review process involving SEC staff from the Division of Investment Management and Division of Trading and Markets, the Office of the General Counsel, and the offices of the various Commissioners, among others.[28] The use of senior securities and derivative transactions, as a central element of the operation of geared ETFs, was fully disclosed to the Commission and discussed with the SEC staff during the exemptive application and order process for such ETFs. The original order included the Commission determination that the exemptions were "appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the [1940 Act]."

Subsequent to the original ProShares order, the Commission granted additional orders related to ProShares, including an order to permit registered investment companies to invest in geared funds to a more significant extent than normally permitted under Section 12(d)(1) of the 1940 Act,[29] and orders permitting ProShares to introduce additional geared ETFs, including ETFs that would seek up to 300% of the returns (or inverse returns) of underlying indices.[30] The Commission also has granted orders to other geared funds.[31] In 2008, the Commission approved listing standards that would permit the listing of geared ETFs without the need for specific listing approval from the Commission.[32] In addition, the SEC staff has granted exemptive, interpretive, and no-action advice relating to various provisions of the Securities Exchange Act of 1934 ("Exchange Act") and rules under the Exchange Act in connection with the trading of shares of geared ETFs and certain operational aspects of these ETFs.[33]

Because the investment objectives and strategies of the existing geared ETFs were clearly described in the various ProShares exemptive applications and other submissions to the

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27 ProShares Trust, et al., Investment Company Act Release Nos. 27323 (May 18, 2006)(notice) and 27394 (Jun. 13, 2006) (order).

28 The process for obtaining the necessary exemptive relief and launching the first geared ETFs represented a significant and expensive entrepreneurial effort by ProShares.

29 ProFunds, et al., Investment Company Act Release Nos. 27599 (Dec. 14, 2006) (notice) and 27658 (Jan. 9, 2007) (order).

30 ProShares Trust, et al., Investment Company Act Release Nos. 27609 (Dec. 22, 2006) (notice) and 27666 (Jan. 18, 2007) (order); ProShares Trust, et al., Investment Company Act Release Nos. 27975 (Sep. 21, 2007) (notice) and 28014 (Oct. 17, 2007) (order); ProShares Trust, et al., Investment Company Act Release Nos. 28696 (Apr. 14, 2009) (notice) and 28724 (May 12, 2009) (order).

31 *See, e.g.*, Rafferty Asset Management, LLC, et al., Investment Company Act Release Nos. 28379 (Sept. 12, 2008) (notice) and 28434 (Oct. 6, 2008) (order).

32 Order Approving Proposed Rule Change Amending NYSE Arca Equities Rule 5.2(J)(3) in Connection with Generic Listing Standards for Multiple Fund Shares and Inverse Fund Shares, Securities Exchange Act Release No. 58825 (Oct. 21, 2008).

33 *See, e.g.*, ProShares Trust, Letter from Brian B. Bussey, Assistant Chief Counsel, Division of Market Regulation (pub. avail. Jun. 20, 2006).

Commission, changing the Commission regulation of senior securities in the proposed manner, most specifically through the imposition of new Portfolio Limits, would be contrary to the explicit purpose, findings, and relief provided in the previously granted Commission approvals.

5. For derivatives transactions that provide a return based on the leveraged performance of an underlying reference asset, the rule would require the notional amount to be multiplied by the applicable leverage factor. Do commenters agree that this is appropriate?[34]

We do not believe it would be appropriate for derivatives transactions that provide a return based on the leveraged performance of an underlying reference asset to require the notional amount to be multiplied by the applicable leverage factor.

As discussed above, the notional amount of a derivative contract does not represent an amount at risk and may not reflect the contractual settlement obligations of the parties to a derivative transaction. Requiring a fund to multiply the notional amount of its derivative contracts by the reference factor of underlying reference assets would compound the flawed aspects of using notional amount to set Portfolio Limits without taking into account a fund's economic exposure or amount at risk. In this sense, it simply magnifies the problems caused by using notional amount as a measurement of exposure.

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Once again, we appreciate the opportunity to comment on these important matters. Should you have any questions or wish to discuss any aspect of our comments, please feel free to contact me at [redacted].

Sincerely,

Richard F. Morris

Richard F. Morris
General Counsel

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[34] Proposal at 84.

Cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar

David W. Grim, Director
Diane C. Blizzard, Associate Director
Division of Investment Management