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Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
Rule-comments@sec.gov

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies

File S7-24-15

Dear Securities and Exchange Commission:

Here are my comments on this proposal:

Summary

- Banning 2X and 3X ETFs is a bad idea.
- Leveraged and inverse ETFs often have risk levels comparable to individual stocks.
- Problems with ETF settlement failures and inefficient stock lending market need to be addressed.
- Inverse and leveraged ETFs will use less efficient means to achieve their stated goals.
- Leveraged and inverse ETFs should have different limits from non-index-based funds.
- Liquid alt funds should not be banned either.
- There is no economic rationale given for the 150% portfolio limitation.
- There is no calculation of the optimal level of segregated assets.
- The 1/3 limit on securities lending is excessively conservative.

The goal of this proposal is to provide a standard regulatory approach to the use of derivatives in investment funds rather than to engage in case-by-case rulemaking by no-action letter. This is a laudable goal. The proposed rule would permit funds to engage in derivative transaction as long as the total "exposure" was no more than 150% of net assets, or 300% if the net result of the derivatives was to reduce risk as measured by a VaR model. The proposal also provides for asset segregation designed to insure that funds have sufficient assets to meet their obligations, and that heavy derivative users have and document a derivative risk management program.

However, parts of this proposal are based on an interpretation of the Investment Company Act of 1940 that has drifted far beyond Congressional intent. The proposing release implies 18 times that the Act expresses an "undue speculation concern" whereas the '40 Act actually expresses a concern not about undue speculation, but about senior and opaque instruments that unduly increase volatility without appropriate corporate governance.

In Section 1 of the '40 Act, Congress enumerates eight evils that befell the investment funds industry prior to the passage of the '40 Act.[1] In summary form, these are:

1. Investors had bad information.
2. Investment companies were not run in the best interest of the shareholders.
3. Investment company securities had provisions that hurt shareholders.
4. Control of investment companies was concentrated through pyramiding and bad management.
5. Bad accounting.
6. Bad corporate governance.
7. "Excessive" leverage that would "increase unduly the speculative character of the junior securities."
8. Inadequate assets and reserves.

Fortunately, most of these evils have been substantially reduced as a result of the SEC's diligence in implementing the '40 Act. Furthermore, modern information technology has resulted in far higher levels of transparency and investor access to information than could have been dreamed of only a few short years ago.

"Increase unduly" is very different from "undue speculation."

The proposing release repeatedly (18 times) refers to an "undue speculation concern." The '40 Act does *not* use phrase "undue speculation" even once. Indeed, a concern over excessive speculation is

[1] For the convenience of the reader, the exact text is attached as an appendix.

conspicuously absent from the ’40 Act, especially when compared with the explicit mandate that Congress gives to the CFTC with regard to “excess speculation.”[2]

Section 1(b)(7) of the ’40 Act finds that investors are adversely affected “when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities;”

Notice that the adverb “unduly” here is modifying the verb “increase,” not the noun phrase “speculative character.” Congress is not stating here that there is anything undue or wrong with the fact that investment company securities are speculative. They are speculative, and Congress was well aware of this.

Congress is stating that there is a problem when leverage *unduly* increases the “speculative character” (what we now call risk) of the investments. This was particularly a problem back in the 1930s due to the opaque nature of investment companies as they were operated at that time. The combination of opaque products, complex capital structures, pyramiding, bad corporate governance, and leverage created a toxic brew that resulted in serious losses for unwary investors. When funds used hidden leverage in an attempt to boost returns, investors were unaware of the additional risk they were taking on. This leverage was compounded by complex capital structures that were difficult to understand. Hence, Congress decided to ban ’40 Act companies from using complex opaque capital structures that unduly increased the risk.

However, this rule proposal appears to be based on a belief that Congress was trying to put an absolute limit on the risk that investors could take. That is not what the statute says. Congress is stating that investors are harmed when leverage unduly increases risk. Congress is not saying that investors are harmed when leverage *duly or incidentally* increases risk.

<u>Banning 2X and 3X ETFs is a bad idea.</u>

As currently structured, this proposal appears designed to eliminate 2X, 3X, and their inverse ETFs. As the proposal states, such funds “could not continue to operate as they do today under the proposed rules.”[3]

I wish to join the chorus of commentators beseeching the SEC to permit us to continue trading these inverse and leveraged ETFs. These products are useful trading tools for investors who wish to take very specific positions. Their popularity, and thus their perceived utility to investors, is demonstrated by their large trading volumes. They are easy to understand, and cheap to trade. If these products are banned,

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[2] Section 4a (17USC6a) of the Commodity Exchange Act explicitly declares that excess speculation is a burden on interstate commerce because of its impact on commodity prices, and gives the CFTC authority to set commission limits.

[3] Proposing release, page 283.

investors seeking similar trading tools will have to use more complicated tools such as options and futures, with additional attendant risks that may trap the unwary.

The riskiness of various ETFs such as leveraged and inverse ETFs is not a bug, it is a feature. The whole point of those products is to give investors efficient tools for transferring or taking on the risk of the underlying indices or commodities. The leverage does not unduly increase the risk of the products; the leverage duly and appropriately creates the products that investors are seeking.

Leveraged and inverse ETF products are clearly marked and investors know what they are getting.

One of the clear concerns expressed by Congress in the '40 Act is that investors have sufficient information to make their trading decisions. Leveraged and inverse ETFs are generally very clearly marked. For example, an investor can tell from the name that the Direxion Daily S&P500 Bull 3X ETF is a leveraged ETF that attempts to provide 3 times the daily return of the S&P500. Clearly it will thus have a risk level approximately three times that of the S&P500. There is no problem here with hidden leverage leading to more risk than investors are anticipating.

It is likely that some investors do not understand the "beta drift" that occurs with leveraged products.[4] This risk factor is generally disclosed in their prospectuses. As these products are mostly used for short-term trading (as seen by their extremely high trading volumes compared with shares outstanding), this should not be a major problem for most users of the product and is no reason to ban them.

Problems with ETF settlement failures and inefficient stock lending market need to be addressed.

Although I do not believe that leveraged products should be banned, there are some imperfections in their markets that need to be fixed. Although the SEC's passage of Regulation 204 has substantially reduced the problem of settlement failures in the equity market, there are still very high levels of settlement failures in many leveraged ETFs. Furthermore, many of these products are very expensive to borrow, making it difficult if not impossible to short them. The Reg SHO Threshold List is overwhelmingly dominated by leveraged and inverse ETFs. This seriously reduces their utility for investors. The SEC should examine the causes of these settlement failures and seek ways to eliminate them. For example, reducing the sizes of Creation Units from 50,000 shares to 1,000 shares would make it easier for

[4] Over long periods of time, a 2X or 3X product that rebalances daily will not deliver exactly the 2X or 3X the return of the index, even without any transactions costs, due to the daily rebalancing. Here is a simple example. Suppose that the index goes up 10% on day 1 and down 5% on day 2. The index will thus have a two day return of (1+.1)*(1-.05)-1 = 4.5% A 2X fund will go up 20% on day 1 and down 10% on day 2, for a total two day return of (1+.2)*(1-.01)-1 = 8%, which is less than the 9% that one would expect from twice the index return of 4.5%. However, in a trending market a leveraged product may deliver even higher returns. Suppose that on day 1 the index goes up 10% and on day two it goes up another 10%, for a two day return of (1+.1)*(1+.1)-1 = 21%. The 2X fund would return (1+.2)*(1+.2)-1 = 44%, which is more than twice the 21% return of the index.

Authorized Participants to create such ETFs when needed rather than to fail to deliver. Furthermore, the SEC should examine the frictions in the stock lending market that are leading to high borrowing costs. Modernizing Rule 15c3-3 to make it easier to lend ETFs out of fully paid accounts could be a great improvement.

The rule will not ban 2X and 3X products, just make them run less efficiently.

If the intent of this proposals is to ban 2X and 3X products, it will fail. Instead, it will push the products into obtaining their exposure in different and more costly ways that will harm investors. As pointed out on page 283 of the release, funds could seek the economic exposure they target through other instruments, albeit less cost effectively than they are now doing. For example, a 3X ETF could buy options that would give it the daily 3X exposure that seeks. However, that would be much more complicated than trading with swaps and futures. This added complexity will lead to more trading costs, with the potential of more trading mistakes and more days when the fund does not achieve its objective, to the harm of investors. There is absolutely no benefit or risk reduction to anyone by making a 3X fund obtain its leverage by purchasing an option rather than engaging in a swap.

Instead of trading with derivatives, leveraged funds could purchase debt securities with embedded options that result in the same payoff. Given the demand for leveraged ETFs, it is highly likely that Wall Street firms will invent and market such securities to the ETFs.

Even worse, leveraged and inverse exchange traded funds could be replaced with exchange-traded notes with similar payoff structures. Such products would add the credit risk of the underlying note provider to the products.

Leveraged and inverse ETFs often have risk levels comparable to individual stocks.

There is nothing inherently bad or extreme about the risk in the leveraged and inverse ETFs. The volatilities of the leveraged ETFs are often very similar to those of ordinary common stocks. This is because the underlying indices are well diversified and thus have lower risk than individual securities due to the well-known risk-reducing properties of diversification. For example, the Direxion Daily Tech Bull 3X fund has a historical volatility as of this writing of 43.67%.[5] Compare this with the historical volatility of Tesla Motors (61.06%), Bank of America (39.79%), or United States Steel (102.4%). Thus, the leveraging of these indexed products brings their risk up to levels comparable to individual stocks. Smaller stocks can have extremely high levels of risk. For example, Xtera Communications has a historical volatility of 137.5%.

Since the level of risk of the leveraged products is comparable to those of individual securities, it is hard to argue that they are unduly risky. It can be far safer for retail investors to use leveraged ETFs to implement short-term portfolio views than individual stocks.

[5] The historical volatilities here were obtained from Interactive Brokers on March 28, 2016.

Investors have other far more risky choices.

Investors can also trade options, futures, and leveraged foreign exchange contracts, all of which involve much higher degrees of risk than leveraged ETFs. Trading in futures and options can easily result in leverage of 50X depending on the particular instrument. Consequently, it makes no sense to ban 2X and 3X products just because they are perceived to have a high degree of risk. Whereas in fact, their risk levels are below those of many individuals stocks and far below the leverage and risk levels they can attain through options.

If the SEC wants to limit fund risk, it should do so explicitly.

There is an undercurrent in the proposing release that there should be some limit on the total risk of an investment fund. The feeling appears to be that retail investors need to be protected from products that are too risky. This is contrary to the basic philosophy of U.S. securities regulation, which is not merit regulation, but disclosure. The SEC should resist the urge to drift into merit regulation.

If the SEC really wants to limit total fund risk in products aimed at retail investors, which I think is a bad idea, it should say so explicitly and go through the rule making process. There should be a solid economic rationale for why a limit would be appropriate, how to measure the risk, and how to go about setting the limit.

Leveraged and inverse ETFs should have different limits from non-index-based funds.

If the Commission does proceed with the proposed rule, it should create different exposure limits for index-based products such as leveraged and inverse ETFs that would permit these products to continue in their current form.

Liquid alt funds should not be banned.

This proposal would also impact so called “liquid-alt” funds or “liquid alternative” funds. These funds attempt to provide returns to investors similar to the so-called “alternative” asset classes that hedge funds invest in. Such funds are attractive to investors because they attempt to provide attractive returns with a low correlation to other asset classes such as common stocks. Such funds may use a wide variety of strategies including derivatives in their attempt to meet their investment objective. As long as such funds clearly communicate their risks to investors, there is no reason to restrict them from using derivatives. Limiting their use of derivatives could limit their returns and their ability to hedge their exposures.

<u>If systemic risk is the issue, the Commission should address it explicitly in a context beyond derivatives.</u>

Perhaps the Commission is concerned about systemic risk. Some observers allege that leveraged ETFs create systemic risk in that transactions in ETFs affect the markets in the underlying assets. Indeed, ETFs depend upon arbitrage to keep ETF prices in line with the underlying assets. ETFs are no more likely to create a systemic meltdown than futures, options, or other derivative instruments. Others are concerned that the large amount of short activity in ETFs presents a systemic problem. I am skeptical that these represent a systemic risk. However, if the Commission is concerned about systemic risk, it did not mention this in the release. Indeed, the word "systemic" is not mentioned even once in the release. If the Commission is concerned about systemic risk with respect to funds, it should raise and analyze the answer in a coherent framework that looks beyond just the use of derivatives in funds, but all aspects of investor and fund behavior.

<u>There is no economic rationale given for the 150% portfolio limitations.</u>

The 421-page proposal seems to take as a fundamental and unalterable axiom that the 300% asset coverage for "senior securities" that Congress decreed 75 years ago should apply to financial products that had not even been invented in 1940. Indeed, many of the derivatives at issue are not even securities in the usual legal sense.[6] Fortunately, Congress had the foresight to give the SEC broad authority to interpret our securities laws, and also broad exemptive authority to let investors out of an ill-fitting straightjacket from an overly literal interpretation of the venerable '40 Act. The SEC has used its interpretive and exemptive authority many times with respect to new financial products and it should continue to do so.

The release does not examine in a rigorous manner what would happen if the portfolio limitations were 100% or 500% instead of the proposed 150%, although it does seek comment on this. A limit that is set too low will inhibit good use of derivatives, leading to potentially higher risk and higher costs for investors. A limit set too high could lead to some funds that overdo derivatives in opaque ways that surprise investors with losses. However, the problem there would be opacity and consumer understanding of the risks, not the derivative use itself.

<u>Notional exposure is not the same as risk to investors.</u>

The Commission notes many of the defects of using notional amount exposure to set limits in on pages 70-71 of the proposing release, but does not provide a very convincing argument as to why it chooses to

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[6] I am not now nor have I ever been an attorney, and I am not stating a legal opinion as to what is or is not a security with respect to Section 18 of the '40 Act. This non-lawyer does note, however, that the assertion that derivatives are senior securities for the purposes of Section 18 seems to be a bit of a stretch.

use notional exposure. This is puzzling. If the concern is to limit undue increases in risk, then it should set the rule to do just that, and focus on total risk, regardless of how it is achieved.

Communication with investors is the real concern.

The real issue, then, is whether funds have communicated to investors the true risk of their investment positions. With some products, such as the 2X and 3X leveraged ETFs, the risk is clearly embedded in the names of the funds. However, for other funds, particularly open-end funds with generic titles, the risk may not be clear at all. If the SEC is concerned about protecting investors, it will focus on the degree to which investors understand the risks they are taking on, rather than trying to ratchet down all risk. The commission should consider improving communications about risk. Notice here that I use the word "communication" rather than disclosure. A 1,000 page disclosure may disclose everything while communicating nothing. What matters is not so much what is on paper, but what gets into the investors head.   The SEC should consider making funds disclose risk levels with clear and simple graphic icons, such as those restaurants use to display the spice levels of various dishes. In addition, the SEC should consider that funds with a higher than usual degree of risk should include the words "high risk" in their name.

There is no calculation of the optimal level of segregated assets

The Commission has a legitimate concern to make sure that funds have the ability to meet their obligations. If a fund does not have sufficient liquid assets to meet its obligations, then it imposes counterparty risk on its counterparties. If a fund has too many assets tied up as a form of collateral, then its investors lose the returns that they could be earning on more productive assets.   The optimal level of effective collateral represents a tradeoff between the cost of the risk imposed on the rest of the financial system and the cost of under producing assets tied up as collateral.

This issue is reminiscent of a discussion of optimal margin levels. Under this proposal, a fund would be required to maintain "qualifying coverage assets" that is the sum of a "mark to market coverage amount and a "risk-based coverage amount." I can't find any calculations in the proposing release as to why this is the right amount.

This is an area where the CFTC has considerable experience, and it is a pity that this expertise is housed in another agency which should have been combined with the SEC long ago.

Indeed, it is not clear what the Commission is trying to achieve with these limits. Is it merely trying to shove square derivative pegs into the round senior security holes of the '40 Act? Is it trying to reduce risk to retail investors? Or protect counterparties?   In general, the collateral or margin demanded by counterparties should be enough to protect those counterparties and assure that the fund can meet its obligations. This implies that the rule should not require much more margin, if any, than a reasonable counterparty would require.

The 1/3 limit on securities lending is excessively conservative.

Portfolio managers can earn better returns for their investors by lending out portfolio securities. The portfolio holds collateral from the borrower which must be returned when the loaned security is returned by the borrower. This is a very safe practice as long as the fund invests the collateral in safe and liquid assets. It does NOT add leverage to returns on the portfolio, but instead adds a small amount of additional revenue commensurate with the very low risk of the activities.

Page 62 of the proposing release quotes an SEC staffer's opinion that a fund should not lend out more than 1/3 of the value of its securities. This is excessively conservative. Funds should be allowed to loan out 100% of their securities as long as the collateral is invested in safe and liquid short-term cash instruments such as are permitted under Rule 2a7. Freeing up more securities for lending will reduce bottlenecks in the securities lending market that can result in short squeezes and settlement failures.

The SEC should use less repetition in its rule proposals and highlight the key details more clearly.

The 421-page rule proposal is burdened with excessive and needless repetition. This can be seen in the use of "as noted above" 35 times and "as discussed" 167 times. Such needless repetition is a tremendous waste of taxpayer resources to write, of paper to print, and of the readers to read. It also makes it much harder for readers to understand what is written as the repetition obfuscates important and critical details.

The introduction should also be written in clear plain English, not SEC-ese, with bullet points to demonstrate the key items in the document.

Discussion of international approaches is the right way to go.

I don't only criticize, however. In past rule proposals, the SEC has rarely discussed what other jurisdictions do in similar matters. I am pleased that this release discusses the approach that the EU has taken on this issue. Examining what other jurisdictions do will help improve the quality of analysis and should be done for all rule makings.

Respectfully submitted,

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Appendix

Findings from Section1b of the Investment Company Act of 1940:

(a) Findings

Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z–4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves.