SHAREHOLDER ADVOCACY FORUM

Shareholder Advocacy Forum Comments Re: Leveraged/Inverse Funds & Due Diligence

March 20, 2020 {Comments Due: March 24, 2020}

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

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles **[File No: S7-24-15; Release No. 34-87607]**

Dear Ms. Countryman:

The Shareholder Advocacy Forum is a nonprofit, nonpartisan organization dedicated to preserving the long-term interests of all shareholders. We are affiliated with Americans for Tax Reform, also a nonprofit, nonpartisan organization focused on lower taxes and limited government. We appreciate the opportunity granted by the Commission to comment on the pending SEC proposal regarding derivatives use by Registered Investment Companies and Business Development Companies and the application of a due diligence standard on broker-dealers and investment advisors whose clients express interest in certain leveraged/inverse investment vehicles, and we urge the Commission to withdraw the proposal.

On November 25, 2019, the Commission re-proposed rule 18f-4 under the Investment Company Act of 1940 — a rule originally proposed in 2015 during Obama administration — alongside the proposal of new Rule 15*l*-2 under the Securities Exchange Act of 1934 and new Rule 211(h)-1 under the Investment Advisers Act of 1940. These rules represent an intrusive, burdensome, patriarchal, and expensive "solution" to an ill-defined and potentially non-existent "problem." Not only do these rules clash with the Trump administration's goal of freeing the economy with less red tape, they would foster further inequality in financial markets by making certain ETFs and mutual funds functionally unavailable to the average American investor. Regulation is proposed for both the buy and sell side of common transactions in valuable investment assets. Each rule is met with unique concerns for investors and market functionality.

Brief Overview of Derivatives-Based Transactions and Leveraging

Derivatives are niche financial instruments or contracts whose value is based upon, or derived, from fluctuations in the underlying asset metric (a benchmark). Common underlying assets are stocks, bonds, commodities, interest rates, etc. Proposed Rule 18f-4 is promulgated as a direct response to the SEC's concerns over certain mutual funds and ETFs utilizing derivatives to leverage the fund. Leverage, generally speaking, is "achieving a right to return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument

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achieving a return."[1] In contrast, inverse funds employ similar leveraging practices while seeking to capitalize on a drop in price (as opposed to an increase). Leveraged/inverse investment vehicles (primarily ETFs for purposes of this letter) are generally referred to collectively as "geared" investment vehicles. Derivative use is almost inextricably tied to leveraging, whether through futures, swaps, or written options used to magnify gains or through purchased call options to magnify fund exposure.

Geared ETFs are predicated on leverage and serve particular niches in a portfolio. With 162 ETFs traded in U.S. markets, leveraged ETFs account for $44.57 billion in total assets under management, according to recent figures.[2] Often mislabeled as "speculative in nature," geared vehicles and derivatives are used practically to hedge investments, with only a consequential result of enhancing speculative capacity. Hedging appeals to many investors because it allows them to reduce potential loss by taking an offsetting position. While speculators may employ leverage and derivatives, the devices do not function primarily as speculative instruments.

The Proposed Rule 18f-4 Would Impose Intrusive and Expensive Requirements on a Fund's Ability to Use Derivatives

Proposed rule 18f-4 incorporates six extensive, costly, burdensome, and intrusive requirements that a fund must satisfy as a prerequisite for initiating derivatives transactions. A class of investments that are standard within the industry, derivatives-based transactions are unique in nature as returns exceed the market average. The 2015 rule proposal was met with overwhelmingly critical comments before ultimately being withdrawn. The SEC suggests that the current proposal took previous comments into consideration, including the resounding concern that funds would be less able to use derivatives for non-speculative purposes, to formulate and draft a better version.[3] However, the proposal is still overly prescriptive and expansive and should be withdrawn.

The creation of a derivatives risk management program capable of conducting the requisite stress testing, back-testing, internal reporting and escalation, and program review elements will require the use of advanced and costly systems. The SEC suggests that it is "critical" to formalize these risk management programs without identifying a single tangible explanation as to why such an intrusive program is necessary. The additional requirement that a funds' board of directors must oversee and approve the risk manager's designation will slow down trading activity and undermine the incentive to employ leverage.

The proposed rule also introduces a limit on fund leverage risk, generally determined as the outer limit determined through a value at risk (VaR) analysis comparing that of the fund to a designated reference index. This limit is wholly arbitrary and lacks empirical support independent of an overused justification of "investor protection." VaR is not a measure of leverage, rather, it merely provides a common and consistent measure of risk across different positions and risk factors.[4]

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1 *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)], at n.5 ("Release 10666").

2 *See* Leveraged ETF Overview, https://www.etf.com/channels/leveraged-etfs.

3 *See* Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices (November 26, 2019), https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices.

4 *See* Kevin Dowd, *An Introduction to Market Risk Measurement* (Oct. 2002), at 10.

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Funds, however, utilize a collection of financial instruments for which risk is analyzed through specific metrics. Mandating VaR analysis to determine a limit on allowed leverage will present a conflict between useful and particularized analytical metrics and the general applicability of VaR. As the Commission rightly notes, VaR does not capture *all* risk – such as counterparty or liquidity risk – because of the highly generalized results. As a means of *measuring* or *analyzing* leverage risk, VaR does not present such weighty concerns as does employing VaR to *limit* leverage. Limiting leverage based on a generalized and imperfect risk measure is unreasonably regulatory in nature and does little to truly protect investors from a poorly defined problem with current industry practices.

The contemplated alternative VaR methods – stressed VaR, expected shortfall, or both – are riddled with concerns and uncertainty not found in standard VaR. The SEC drew attention to such qualitative challenges yet still requested comment on whether these alternatives should be imposed. These alternatives do not warrant much discussion, as even the flawed rule proposal does not present confidence that such alternatives would be any more useful than a standard VaR measure.

<u>The Proposed Sales Practices Rules Place Excessive Burdens on Investors and Increase Liability Exposure for Broker-Dealers and Investment Advisers</u>

The SEC is charged with protecting investors, and often hides behind this mission to defend cumbersome regulations that have the opposite effect. The proposed "sales practices rules" impose a due diligence standard on (1) broker-dealers, or associated persons, through rule 15*l*-2 under the Exchange Act; and (2) investment advisers, or supervised persons, through rule 211(h)-1 under the Advisers Act, before approving retail investors to invest in geared investment vehicles. For purposes of this letter, broker-dealers and investment advisers will be referred to collectively as "financial professionals." Satisfying the due diligence standard first requires financial professionals to obtain personal and burdensome information from investors through client-completed questionnaires. The required information includes investment objectives, employment status, annual income, estimated net worth, estimated liquid net worth, the percentage of the customer's estimated liquid net worth that he or she intends to invest in geared investment vehicles. Of particular concern is the requirement for financial professionals to obtain information about the customer's investment experience and knowledge regarding geared investment vehicles, options, stocks and bonds, commodities, and other financial instruments to determine access to certain ETFs and mutual funds.

Based on this information, the financial professional would be required to specifically approve or disapprove, in writing, the customer's account for buying and selling shares of geared investment vehicles. Approval would be predicated on a finding by the financial professional that he "has a reasonable basis for believing that the customer has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles." However, the Commission has opted for a "facts and circumstances" approach for making such a determination. Such an approach is a form of paternalistic merit review and inconsistent with the disclosure principles of federal securities regulation. Many financial professionals will deny investors approval to invest in these instruments simply because of the regulatory risk created. Thus, the proposed rules would harm investors by limiting their investment options.

While the proposal does carve out an exception to the approval requirement for positions established before the rules' compliance date, it does not extend to investors who have accounts – without open positions – already established. Investors who have been regularly taking advantage of geared instruments could risk losing access to a preferred asset class. Additionally, financial professionals who have been granted discretionary control over client accounts still cannot trade such products before discerning if their client meets the requisite, and undefined, standard of understanding leveraged transactions. The additional requirements applied to existing customers and those who have authorized discretion over their account will slow down the trading process and undercut the advantages of investing in leveraged investments.

A. Lack of Clarity and Certainty Regarding Sales Practices Rules Functionality

The rules extend the use of a questionnaire and disclosure requirements to investors seeking to trade geared ETFs on their own initiative, rather than based on the advice of a financial professional. Even after opting to make investment decisions on his own initiative, an investor will inappropriately lose autonomy over highly valuable trading instruments. Whereas a financial professional would supply and review the questionnaire and required disclosures to make a due diligence determination for their client, investors who utilize a brokerage platform without consulting a personal financial professional are provided absolutely no guidance on how the rule functionally operates for them. For example, when a retail investor seeks to invest in a geared ETF through the brokerage firm's mobile app, how will he fulfill disclosure requirements? Will the platform not accept the investment? Will he be redirected to fill out the questionnaire and supply the required information for review by a broker who has had no prior contact with the investor? The SEC proposal has not contemplated this highly confusing element of implementation across various trading platforms.

B. Misappropriating SEC Goals

In a public statement issued on November 26, 2019, Commissioners Peirce and Roisman underscored crucial fears stemming from the proposed rules. The SEC needs to protect investors, but this should not be achieved by limiting their right to access products in the public markets.[5] The Commissioners opined the following:

> *[W]e disagree with this blunt, overly-paternalistic approach to investor protection. The SEC protects investors not by limiting their right to access products available in public markets, but by ensuring that they have material information at the ready to make informed buy, sell, and hold decisions.*[6]

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[5] *See* Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices (November 26, 2019), https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices.

[6] *Id*.

The goal is adequately served when investors have all material information upon which to base buy, sell, and hold decisions. The sales practices rules instead turn access to certain investments instruments into a privilege, reserved for those who present their financial professionals with the least risk exposure.

The proposed sales practices rules do little to increase investor protection, while supplementing other rules that have not been evaluated for workability – or lack thereof. For example, Regulation Best Interest was implemented on September 1, 2019 and served to replace the weak and outdated "suitability" standard for broker-dealers with one of "best interest" when making recommendations to retain investors.[7] This rule requires that broker-dealers have "a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer." Regulation BI has not been evaluated or proven unworkable in achieving its proffered goal. Certainly, the Commission should evaluate whether Regulation BI has addressed the perceived problem regarding retail investors' investment in leveraged or inverse funds before promulgating yet another expensive and intrusive rule that is more likely to harm investors than to protect them.

Commissioners Peirce and Roisman drew a stark comparison between Reg BI and related investment advisor regulations, which were principles-based, and the proposed rule, which appears to lack sound reasoning as to necessity. The Commissioners commented;

> *Each of [the prior] Commission actions [allowed] broker-dealers and advisers flexibility in gathering the information they need from customers or clients to carry out their responsibilities. In contrast, the Commission now proposes a requirement that would micromanage broker-dealers and advisers, and do so in a way that appears neither necessary nor sufficient for them to meet their existing regulatory obligations.*[8]

The sales practices rules, along with Proposed Rule 18f-4 present a common and dangerous misconception – that market regulation is the preferred way to protect investors. As Commissioners Peirce and Roisman have made clear, investors are protected by truthfulness in transactions. Federal anti-fraud statutes are the clearest example of investor protection because they foster truth in issuance and trading without restricting or unfairly regulating the individual investors access to attractive investment opportunities. In contrast, the sales practices rules confuse "investor protection" with "investor parenting" to create a disparity in opportunities.

The Proposed Rules Will Cost the Industry Billions while Providing Minimal Benefits

The SEC Division of Economic and Risk Analysis (DERA) estimates that the total industry cost for the proposed requirements of the sales practice rule in the first year for both broker-dealers and

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[7] *See* 17 CFR § 240.15l-1 - Regulation Best Interest.

[8] *See* Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices (November 26, 2019), https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices.

investment advisers would be an astounding $2.4 billion.[9] The cost of various derivatives risk management program requirements imposed on funds would be approximately another $450 million annually.[10] These costs will be largely borne by investors, as broker-dealers will need to recover these costs to remain profitable or to keep their profit margins competitive. Thus, the proposed rules would harm investors by increasing their costs and lowering their returns.

Moreover, DERA is "unable to quantify the effects on efficiency, competition, and capital formation because we lack the information necessary to provide a reasonable estimate."[11] The proposal release makes an entirely underwhelming qualitative case for the benefits of the proposed rules. The costs are unprecedented while the benefits of the rules are unclear and potentially non-existent. The rule, therefore, should be withdrawn on grounds that the costs exceed the benefits.

If the Proposal is Implemented, it Should be Narrowly Tailored

Geared investment vehicles are used by investors to for specific purposes such as hedging risk in their portfolio, seeking to achieve target exposure to a certain index while using less cash, or for expressing a point of view about the future performance of an index. Recognizing the unique role these products can play for certain investors, the SEC has (appropriately in our view) proposed an exception for such funds that would eliminate the need to comply with the proposed VaR-based leverage risk limit if certain "alternative provisions" are met. The ETF must: (1) meet the definition of "leveraged/inverse investment vehicle in the sales practices rules; (2) limit investment results sought to 300% of return (or inverse of return) of the underlying index; (3) discloses in its prospectus that it is not subject to 18f-4's leverage limit.

The first and third requirements do not present glaring concerns; however, the second requirement warrants brief discussion. The rationale behind exempting certain geared ETFs from the standard VaR-based leverage risk is sound: such funds, by their very nature, cannot operate under the proposed limit. Therefore, exemption from the requirement is necessary to prevent these funds from being made legally unavailable. The SEC acknowledges a lack of experience with funds seeking returns over 300% above the underlying index, yet still proposes imposing such a cap rather than allowing the market to naturally dictate the outcome. Commissioners Peirce and Roisman refer to the cap as "a direct mechanism to restrict investors' access to geared products that might otherwise seek to exceed this limit."[12] While the likelihood that fund managers would attempt to seek returns any higher than the industry norm, leaving the option there preserves the opportunity for certain funds to capitalize on a market move, develop a new practice, and advance the trading industry.

The elimination or alteration of the leverage cap will render the exception for geared investment vehicles less paternalistic. Buried within the nearly 500 page proposal, the SEC has captured a

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9 *See* Letter to SEC on Leveraged/Inverse Funds (February 7, 2020), https://heritageaction.com/blog/letter-to-sec-on-leveraged-inverse-funds

10 *Id.*

11 *Id.*

12 *See* Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices (November 26, 2019), https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices.

crucial consideration that geared investment vehicles are unique in nature and warrant customized treatment. However, the rules as proposed do not represent the appropriate treatment.

We applaud the SEC for its work to protect investors and promote market efficiency, and we thank the Commission for the opportunity to provide feedback on proposed rulemaking measures. However, we strongly urge the Commission to withdraw the current proposal from consideration.

If you should have any questions or comments, please contact James Setterlund by phone at [redacted]

Sincerely,

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Shareholder Advocacy Forum