NAAIM

NATIONAL ASSOCIATION OF ACTIVE INVESTMENT MANAGERS

RE: File Number S7-24-15

Dear Gentleman:

This letter is written on behalf of the National Association of Active Investment Managers ("NAAIM") to oppose regulations proposed by the SEC regarding the use and sale of leveraged and inverse funds under Release No. 34-87607.

NAAIM is a trade association of 200+ registered investment advisors throughout the U.S. who actively manage more than $15 billion in client assets to limit portfolio risk and meet our clients' investment objectives. Last year we celebrated our 30th anniversary.

Many of our members use leveraged and inverse funds in their investment strategies to manage risk in market downturns as well as capitalize on strong upward movements in the financial markets. NAAIM members were among the early adopters of leveraged and inverse funds when they first became available in 1993 and have continued to use these funds on the behalf of our clients for one very simple reason – they are an excellent tool for hedging risk and leveraging strong market moves.

The assumption of Release No. 34-87607 appears to be that this particular fund category poses risks beyond those of other publicly traded securities. We dispute that assumption. As the SEC acknowledges in its list of required disclosures, all investments have the potential for loss as well as gain. The risks of leveraged and inverse funds may be among the most widely recognized and documented throughout the investment industry. A search on Google for *how to use leveraged and inverse funds* returns more than *57 million references*. Search for *risks of using leveraged and inverse mutual funds* and you will find 3.1 million responses, including materials published by the SEC in 2009. The investment companies that offer these funds have extensive disclosure and educational information available to investors. Yes, inverse and leveraged funds have risks**,** but these risks are extensively documented, as well as how to invest using these funds.

Within our membership, Inverse and leveraged funds play an important role in managing risk in client portfolios. One of the greatest risks of short-term market volatility, as we have seen with the recent coronavirus pandemic, is selling a position and locking in losses that may be recovered in the next day's market action. Many retired investors, however, cannot take a chance on a major loss in their portfolios if what may be a short-term move turns into a multi-year bear market. Leveraged funds provide a very cost-effective means of minimizing portfolio transactions but still hedging positions.

- Inverse funds are especially useful to hedge against short-term market risk without dismantling and reconstructing portfolios.
- The funds are less expensive and simpler to use than taking many individual short positions.
- Because the funds reflect broad market segments, they are less risky that individual short positions.
- The liquidity of the fund structures assures the ability to respond quickly to changing market conditions.
- No margin accounts are required.

- Unlike using margin for leverage, investors can never lose more money than they have invested.
- Many options expire worthless and investors lose 100% of their investment (plus commissions). No leveraged or inverse mutual fund or ETF has ever lost 100% of its value.

At a time when the SEC is proposing opening more market segments to individual investors including private placements, it seems counterintuitive to place restrictions on an investment class that is very transparent, well understood, liquid and invaluable as a tool for limiting losses from down markets.

As registered investment advisors, NAAIM members are fiduciaries to their clients, who rely on the expertise of that advisor and the investment strategy articulated and outlined in their ADV. Our clients hire us to manage their portfolios because they lack the knowledge and time or are unwilling to manage their investments. Many are retired. Release No. 34-87607 requires that the advisor establish that the customer or client is capable of evaluating the risk associated with leveraged and inverse funds before we can include these useful tools in their portfolios yet provides no standards as to what is adequate client knowledge. What if they are retired, have minimal net income, limited net worth and no investment experience with leveraged and inverse funds? Are we then prohibited for using leverage and inverse funds regardless of their value to our clients? Or do we simply quit using them with the portion of our client base where they may offer the greatest value?

If the SEC can take one class of publicly traded securities and impose trading restrictions, what is next? Every asset class has risks and used improperly can cause tremendous damage to an individual's financial well being. In the last 10 years, Eastman Kodak has lost 94% of its value. Pacific Gas & Electric is down more than 60% in just the last few years. Solar stocks, once an investment mania, have lost up to 60% since 2008. Should trading in these stocks be restricted to knowledgeable investors? Release No. 34-87607, carried to what seems to be its intent of eliminating risk of the unknown, would apparently say yes.

With leveraged and inverse funds, advisors are trading major market segments, with exceptional transparency and liquidity and a vast knowledge base of risks and strategies. Placing restrictions on the ability of investors to use these funds, while encouraging the use of minimal transparency, crowd sourced investments by non-accredited investors is perplexing to the NAAIM membership, to say the least.

We are also concerned that the proposed rule would impose significant costs and compliance burdens on NAAIM membership, without any corresponding benefit to investors. Somehow we would have to determine what constitutes that a client is capable of evaluating the risk associated with leveraged and inverse funds and when we cannot include these very useful tools in their portfolio. New policies and procedures would be required to adhere to the new regulation. New forms and data collection procedures would need to be developed. Staff and investment advisor representatives would need significant training to make certain a client is not placed in an investment strategy the uses leveraged and inverse funds for risk management when we cannot prove they can evaluate the risk of these tools. As fiduciaries, our members are already required to put their client's interest first, it is their duty and obligation.

Release No. 34-87607 ignores over 20 years of leveraged and inverse fund history and development. This rule will not change the usefulness of these funds. It will simply prohibit their use by a large segment of the investing public. This is a proposed regulation that is better discarded.

Sincerely,

Matthew Spangler
2019-2020 NAAIM President
Signal Research Group President