March 31, 2020

Via Electronic Submission: rule-comments@sec.gov

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

Re: File No. S7-24-15

Dear Ms. Countryman:

Please find attached for formal submission the comment letter of Rafferty Asset Management, LLC and Rafferty Capital Markets, LLC, including on behalf of the separate series of Direxion Funds and Direxion Shares ETF Trust.

Respectfully submitted,

RAFFERTY ASSET MANAGEMENT, LLC	RAFFERTY CAPITAL MARKETS, LLC
Angela Brickl, General Counsel	Barbara Martens, Chief Compliance Officer

Attachments

cc: The Honorable Walter J. Clayton, III
The Honorable Allison H. Lee
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman
Dalia O. Blass, Director, Division of Investment Management
Brett W. Redfearn, Director, Division of Trading and Markets
Cate Stetson, Hogan Lovells LLP
Robert J. Zutz, K&L Gates LLP
Stacy L. Fuller, K&L Gates LLP

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EXECUTIVE SUMMARY.

Rafferty Asset Management, LLC ("RAM") and Rafferty Capital Markets, LLC ("RCM"), including on behalf of the separate series of the Direxion Funds ("Direxion Mutual Funds") and Direxion Shares ETF Trust ("Direxion ETFs"), (collectively, "Direxion"), appreciate the opportunity to comment on proposed Rule 18f-4 under the Investment Company Act of 1940 ("1940 Act" or "Act") and its companion Sales Practice Rules, proposed Rule 15*l*-2 under the Securities Exchange Act of 1934 ("Exchange Act") and proposed Rule 211(h)-1 under the Investment Advisers Act of 1940 ("Advisers Act").[1]

Direxion is the sponsor of a family of leveraged and inverse leveraged mutual funds and exchange-traded funds ("ETFs") (collectively, the "Direxion funds"). The Direxion mutual funds, which currently seek to provide investors with monthly leveraged or inverse leveraged investment results, have been registered with the SEC and publicly offered since 1997.[2] The Direxion ETFs, which seek to provide investors with daily leveraged or inverse leveraged investment results, have been registered with the SEC and publicly offered, including traded on a national securities exchange pursuant to SEC-approved rules, since 2008.

All of the Direxion funds are subject to extensive SEC regulation. All of the funds are subject to the disclosure requirements prescribed by the federal securities laws, and consistent with these disclosure requirements, the Direxion ETFs announce **in boldface type on the cover page** of their prospectuses that investors **"could lose the full principal value of [an] investment within a single day**." The Direxion ETFs also comply with SEC-issued exemptive orders that impose particularized terms and conditions on their operations. Yet, notwithstanding this and other explicit disclosures and the raft of substantive regulatory requirements with which the Direxion funds already comply, the Commission now proposes to subject them to still *more* regulation as "leveraged/inverse funds" under the proposed rules (collectively, the "Derivatives Rules").[3]

According to the SEC, the proposed rules are "designed to promote funds' ability to continue to use derivatives in a broad variety of ways that serve investors, while responding to the concerns underlying section 18 of the Act and promoting a more modern and comprehensive framework for regulating funds' use of derivatives and the other transactions addressed" in the

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[1] 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, Exchange Act Release No. 87,607, Investment Advisers Act Release No. 5413, Investment Company Act Release No. 33,704, 85 Fed. Reg. 4446 (proposed January 24, 2020) [hereinafter Proposing Release]. The Sales Practice Rules would target all "leveraged/inverse investment vehicles," as defined therein and discussed *infra* at 38-64.

[2] The terms "Commission" and "SEC" are used variously to refer to the U.S. Securities and Exchange Commission.

[3] "Leveraged/inverse funds" are the subset of leveraged/inverse investment vehicles that are registered investment companies under the 1940 Act. Proposing Release, *supra* note 1, at 4491. "Leveraged/inverse investment vehicles" have the meaning ascribed to them by the Sales Practice Rules. *Id.* at 4558 and 4564 (proposed to be codified at 17 C.F.R. § 240.15*l*-2(d) and § 275.211(h)-1(d), respectively).

rules. With respect to the Sales Practice Rules in particular, the Commission says that they are "designed to address investor protection concerns with respect to leveraged/inverse funds," which the Commission describes as presenting unique "risks" stemming from "undue speculation and asset sufficiency concerns."

As proposed, Rule 18f-4 under the 1940 Act would provide open-end investment companies (generally, "funds") with an exemption from Section 18(f) of the 1940 Act. All funds, other than leveraged/inverse funds, could comply with Rule 18f-4 by complying with a "value at risk" ("VaR") test set forth in the rule. Uniquely, however, the exemption in Rule 18f-4 for leveraged/inverse funds would require them somehow to be sure that all purchases of their shares were subject to the Sales Practice Rules, whether or not they complied with the same VaR test as other funds.

Direxion does not believe that the proposed rules are lawful or that they will advance the Commission's stated "investor protection" goals. Accordingly, Direxion strongly opposes their adoption.

We begin with proposed Rule 18f-4. The Commission lacks the statutory authority necessary to promulgate proposed Rule 18f-4. For this proposed rule, the Commission ostensibly relies largely on its statutory authority in Section 18 of the 1940 Act. Section 18 imposes restrictions and requirements on funds' "capital structure," and for that reason is entitled "Capital Structure." Section 18(f) is most relevant here as it pertains to the capital structure of open-end funds, which mutual funds and ETFs are. As to such funds, it precludes the "issu[ance]" by them of "senior securities," but includes an exception for bank borrowings when certain asset coverage requirements are met. The Commission seeks to *infer* from this exception (for bank borrowings) authority to regulate all borrowings as senior securities.

Neither the text of the statute nor its legislative history, however, support the Commission's inference of authority to regulate all borrowings as senior securities. Rather, the Commission's authority under Section 18(f) is limited regulating issuances by funds of senior securities; and when funds transact in derivatives, they cannot realistically be described as "issu[ing]" "senior securities" for several reasons, as discussed in detail below. Among other things, they do not "issue" anything—and in particular, they do not issue a security that enters their capital structure—including because many derivatives are not even "securities," as defined in the 1940 Act and the other federal securities laws. As a result, the Commission simply cannot reach all derivatives as "senior securities" under Section 18(f).

The Commission also cannot use its exemptive authority to reach funds' transactions in derivatives. Funds do not need an exemption from Section 18(f) to engage in derivatives transactions because there is no restriction in Section 18(f) from which proposed Rule 18f-4 can provide an exemption. And even if funds did need an exemption to transact in derivatives, the Commission could not lawfully condition such an exemption, as it seeks to do here, on the compliance *by third parties* with *an entirely separate set of new rules* (here, the Sales Practice Rules) that are completely untethered to the Commission's stated Section 18 policy concerns of asset sufficiency and undue speculation.

Next, consider the Sales Practice Rules. The promulgation of these rules would mark a seminal moment in the history of the SEC—one in which the SEC renounced its role as a regulator, which protects investors by ensuring issuers' adequate disclosure of risks, and instead assumed responsibility for passing judgment on the merit of some issuers—and investors—and decided that they should not be allowed to participate in the public securities markets, *even if they comply with the federal securities laws, the same as everyone else*.

The proposed Sales Practice Rules, of course, do not announce themselves as such seminal regulations. Instead, they present themselves as comparable to rules that apply to options transactions. However, unlike such options rules, the Sales Practice Rules would require registered broker-dealers and registered investment advisers (together, "intermediaries")—*for the first time in history*—to determine that investments by *investors who make their own investment decisions* are suitable for them. Further, if an intermediary determined that certain investments were not suitable for such self-directed investors, it would be required to restrict such investors' free agency to invest their assets as they see fit.

There are several legal and policy problems with this approach. First, the Commission's authority under Section 15*(l)* of the Exchange Act and Section 211(h) of the Advisers Act, which are the primary provisions on which the Commission must rely for these rules, is limited to promulgating rules, after appropriate examination, that are related to "sales practices," conflicts of interest and compensation schemes of intermediaries. The Commission has conducted no examination to support the rules, and certain activities the rules purport to regulate—self-directed investors' investment of their own assets—do not involve any "sales practice" whatsoever. A "sales practice" requires an overt act by an intermediary directed at an investor. Congress has said this. The Commission has said this. FINRA has said this. And the courts have said this.

Second, the Sales Practice Rules target leveraged/inverse investment vehicles without a congressional directive. Under certain circumstances, Congress has authorized the SEC to target certain issuers or markets and impose additional, particularized regulation. The Commission has no such congressional authorization here, however, to take the targeted action embodied in the Sales Practice Rules.

Finally, the promulgation of the Sales Practice Rules pursuant to the current rulemaking effort would be arbitrary and capricious under the Administrative Procedures Act ("APA") for multiple independent reasons. The Commission has not set forth a sufficient evidentiary record of harm and abuse from leveraged/inverse investment vehicles to adopt the Sales Practice Rules, particularly to the extent that they cover transactions by self-directed investors that involve no sales practice. The Commission has not identified any change or shortcoming in the way that leveraged/inverse ETFs operate under their SEC-issued exemptive orders that justifies departing from the relief granted in those orders by subjecting purchases of their shares to the Sales Practice Rules. The Commission's comparison of the proposed Sales Practice Rules to the options rules is inapt, including because the Sales Practice Rules impose more regulation on self-directed transactions than the options rules do, even though options are statistically riskier investments than leveraged/inverse investment vehicles. The Sales Practice Rules will make leveraged/inverse funds *less* available to individual investors at the same time that the Commission's amendments to Regulation D under the Securities Act of 1933 ("Securities Act") will make private funds *more* available to individual investors—even though private funds *are not subject to any leverage restrictions whatsoever* and leveraged/inverse funds *are subject to leverage restrictions*. Finally, the Sales Practice Rules will incentivize regulatory arbitrage.

Under the proposed rules, certain investment vehicles, including exchange-traded notes ("ETNs") and retail structured products, would not be covered by the rules. Accordingly, offerors of these products could continue to offer the same strategies as leveraged/inverse investment vehicles without being subject to the Sales Practice Rules. The Commission even cites this regulatory arbitrage as a competitive *benefit* of the rulemaking.

This brings us to the Economic Analysis proffered by the Commission in support of the Derivatives Rules. The Economic Analysis fails to identify any material benefit to be realized by adoption of the proposed rules. Most importantly, notwithstanding certain Commissioners' ostensible commitment to move forward based only on "hard empirical evidence,"[4] the Economic Analysis provides no valid empirical evidence that proves that individual investors do not and *cannot* understand the characteristics and risks of leveraged/inverse investment vehicles, regardless of how well disclosed.

The Commission bases much of its argument for the proposed rules on a paper produced by its Division of Economic and Risk Analysis ("DERA"). But the DERA paper's assumptions and analysis are wrong. Critically, DERA assumed that investors hold leveraged/inverse investment vehicles for six months, without presenting any actual evidence of actual investor holding periods of leveraged/inverse investment vehicles, notwithstanding the Commission's broad authority over all intermediaries to examine them and request their required books and records, which surely would show actual investors' actual holding periods.

DERA's analysis, which was designed to show the similarity of returns between options and leveraged/inverse investment vehicles, was also mostly based on a limited set of rarely traded options—namely, deep-in-the-money options that represent the most conservative options strategies—as compared to more commonly traded options—namely, at-the-money or out-of-the-money options that represent far riskier options strategies—and expire worthless, resulting in a 100% loss to the investors, more often than not. As a result, DERA's analysis concluded that the risks of trading options and of investing in leveraged/inverse investment vehicles are comparable, even though they are not.

Finally, the DERA analysis assumed that leveraged/inverse investment vehicles could provide up to 400% positive or negative leverage. In fact, no vehicle that would be subject to the Sales Practice Rules provides 400% positive or negative leverage. Only ETNs that are proposed *not* to be subject to the Sales Practice Rules provide investors with such leverage. DERA's conclusions, therefore, cannot be relied upon to promulgate the Sales Practice Rules.

In addition, while the Economic Analysis acknowledges in passing that there is some overlap or redundancy between the Sales Practice Rules, on the one hand, and the Fiduciary Interpretation and Regulation Best Interest (each discussed below), on the other hand, it fails to analyze in any meaningful detail the extent of such overlap and redundancy. Indeed, in citing back to the administrative enforcement actions discussed in the Proposing Release, the Economic Analysis seems to suggest that they justify the adoption of the Sales Practice Rules. The very fact of such enforcement actions, however, indicates that *the law already provides a remedy* for

[4] Commissioner Robert J. Jackson, Jr., *Statement of Commissioner Robert J. Jackson, Jr. on Proposed Rules Regarding Exchange Traded Funds (ETFs)*, SEC (June 28, 2018), https://www.sec.gov/news/public-statement/statement-jackson-exchange-traded-funds-062818 [hereinafter Jackson Statement].

the types of abuses purportedly targeted by the rules; and Regulation Best Interest will only provide additional remedies, once effective.

Further, even though *the Commission estimates the cost of the Sales Practice Rules in the first year alone as over $2 billion*, that estimate *still* understates the true cost of the rules. It fails to account for the additional costs investors will incur to effectuate the strategies of leveraged/inverses investment vehicles on their own, once they become less available or unavailable through intermediaries. It also fails to address the fairness of imposing such costs on investors who do understand and trade leveraged/inverse investment vehicles in order to protect investors who the Commission, without discernable basis, believes wander into these products without understanding them, notwithstanding their forthright disclosures about their significant risks.

The Economic Analysis also fails to accurately estimate the cost of the Sales Practice Rules for intermediaries. It ignores that many intermediaries will have to hire customer-facing personnel to deal with self-directed investors. It also ignores the costs that intermediaries will incur in light of the significant litigation risk imposed on them by the Sales Practice Rules. That risk, and the related costs, are largely a function of the rules converting intermediaries into insurers of self-directed investors' trading activities. The rules force this conversion of intermediaries-into-insurers by requiring intermediaries to determine whether even self-directed investors' trades of leveraged/inverse investment vehicles are suitable for them. Once an intermediary determines that such trading is suitable, all will be well until the investor incurs losses. Once that happens, the investor may simply claim that they should not have been approved for trading such investments in the first place and sue their intermediary for their investment losses. Given this risk, it is unclear, including from the Commission's Economic Analysis, why intermediaries will continue to host self-directed investors' investments in leveraged/inverse investment vehicles. It seems obvious that many of them will not. Yet the Commission's Economic Analysis does not estimate significant costs to intermediaries or sponsors of leveraged/inverse investment vehicles from intermediaries' abandonment of them.

Finally, the Commission fails to consider reasonable alternatives. For example, although the Commission says that only six funds would need to change their investment strategies to comply with Rule 18f-4, the Commission does not seriously address the possibility of simply codifying existing asset segregation practices—even though these are the very practices that are causing all but six funds in the country to exhibit the same level of risk as proposed Rule 18f-4 would. Moreover, codifying existing practices would be virtually costless.

Similarly, the Commission does not consider a disclosure alternative to the Sales Practice Rules. Although Congress has explicitly authorized the Commission to adopt additional disclosure requirements under certain circumstances, the Commission does not even address this possibility.

In sum, in light of the litany of flaws in this rulemaking—the lack of statutory authorization, evidentiary support, reasoned decision making, and reasonable policy—Direxion strongly opposes the adoption of the proposed rules.

BACKGROUND: DIREXION AND EXISTING REGULATION.

THE DIREXION MUTUAL FUNDS AND THE DIREXION ETFS.

RAM is the sponsor of and investment adviser to the Direxion Mutual Funds and the Direxion ETFs. RCM serves as the principal underwriter (or distributor) of the Direxion Mutual Funds.

The Direxion Mutual Funds are a family of leveraged and inverse leveraged mutual funds. Most Direxion Mutual Funds seek *monthly* investment results, before fees and expenses, of up to 200% of the performance or inverse performance of a market index.

The Direxion ETFs are a family of leveraged and inverse leveraged exchange-traded funds ("ETFs"). Most Direxion ETFs seek *daily* investment results, before fees and expenses, of up to 300% of the performance or the inverse performance of a market index. Together, the trusts currently offer over 100 different series, including approximately 90 leveraged/inverse funds, as defined in the Derivatives Rules.

Direxion began offering leveraged and inverse leveraged strategies as mutual funds in 1997. In 2008, Direxion made substantially similar strategies available as ETFs. The Commission has thus exercised regulatory oversight of the funds for more than 20 years.

The Direxion ETFs operate in reliance on a pair of exemptive orders issued by the Commission in 2008 and 2009,[5] after the conclusion of a lengthy exemptive application process. During that process, the Commission's Division of Investment Management ("Division") considered the nature of the funds; and the exact amount of leverage to be obtained by the funds was an important factor considered by the Division.[6]

Pursuant to the 2008 Order, the Direxion ETFs were allowed to seek investment results, before fees and expenses, of up to 400% of the performance or the inverse performance of a market index. However, they were required to invest at least 80% of their total assets in the component securities of their target indexes. Stated differently, the Direxion ETFs were allowed to obtain exposures of up to 400% of their assets, but were only allowed to obtain exposures of approximately 320% of their assets from investments in derivatives. The Commission granted the 2008 Order, finding the relief requested to operate the Direxion ETFs to be "necessary or

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[5] Investment Company Act Release No. 28,379 (Sept. 12, 2008) (notice) and 28,434 (Oct. 6, 2008) (order) ("2008 Order") and Investment Company Act Release No. 28,889 (Aug. 27, 2009) (notice) and 28,905 (Sept. 22, 2009) (order) ("2009 Order") (the 2008 Order and the 2009 Order together, the "Exemptive Orders").

[6] In this regard, the Commission's notice of the Direxion ETFs' 2008 Order stated, "The [Direxion ETFs] will seek daily investment results, before fees and expenses, that . . . (b) provide up to 400% of the return of their Underlying Indices . . . or (c) provide up to 400% of the inverse performance of their Underlying Indices."

appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act."[7]

Subsequently, in connection with Direxion's proposal to increase the ETFs' usage of derivatives, the 2009 Order limited the Direxion ETFs to seeking up to 300% of the performance or inverse performance of a market index, but permitted the Direxion ETFs to obtain 100% of their leveraged and inverse exposure from derivatives. The Commission again granted the requested order, finding it "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act." In sum, the Commission has *twice* examined the appropriate amount of derivatives usage by the Direxion ETFs and *twice* concluded that it was "necessary or appropriate in the public interest and consistent with the protection of investors" to permit the funds to obtain at least 300% leverage from derivatives.

Consistent with the Exemptive Orders, the Direxion ETFs' portfolio holdings have been fully disclosed on a daily basis since the funds' inceptions. As a result, all market participants have been able to verify the simplicity of each fund's portfolio, which is routinely comprised largely or entirely of total return swap contracts (described below). Taking this approach, the Direxion ETFs have operated as anticipated and as described in the applications for the Exemptive Orders since 2008. For over a decade now, they have complied with the Exemptive Orders and not experienced any "asset sufficiency" concerns, meeting all redemption requests within the timeframes required by the 1940 Act.

As discussed at length in Direxion's applications for the Exemptive Orders, the Direxion ETFs have routinely used total return swap contracts ("TRS" or "swap contracts") to pursue their investment objectives.[8] Total return swap contracts are bi-lateral contracts between two private parties pursuant to which each agrees to pay the other a return based on the performance of, for example, a market index. Such swap contracts are referred to as "total return swaps" because they provide returns equal to the returns of their reference asset.

The Direxion ETFs normally enter into TRS that provide leveraged or inverse leveraged returns on a broad-based market index, meaning an index comprised of more than nine component securities, whether such securities are fixed income or equity securities.[9] For example, the Direxion ETF that seeks to provide three times the daily performance of the S&P 500 Index would normally enter into a notional amount of total return swaps that return three times the daily total return of the S&P 500 Index. In this example, the S&P 500 Index is the reference asset for the TRS, as agreed by the Direxion ETF with its swap counterparty. Swap counterparties are typically institutional broker-dealers that are subsidiaries of investment banks and some of the most sophisticated investors on Wall Street.

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[7] *See* 15 U.S.C. § 80a-6(c) (setting forth the standard for the issuance of exemptive relief by the Commission).

[8] *See infra* at 26–35.

[9] Although not required by regulation, all of the TRS into which the Direxion ETFs have historically entered have included "loss caps" that are designed to preclude the funds from gaining (losing) more than 90% on any one day, regardless of larger changes in the value of their market index.

Separately, each Direxion ETF establishes a tri-party account (among itself, its custodian and its counterparty) into which it deposits assets equal to the amount that it may, from time to time, be obligated to pay to its swap counterparty. During the life of the contract, the tri-party account will hold the net out-of-the-money amount then-due to the swap counterparty until the swap settles and the counterparty (or fund) is paid. As markets move and the amount owed by (to) a Direxion ETF to (from) its counterparty changes, such amounts are marked-to-market and netted on a daily basis such that the tri-party account balance changes until settlement occurs. At settlement, the party owing money transfers the amount owed to the other. TRS can require such a transfer (or payment) as frequently or as infrequently as desired.[10]

THE DIREXION FUNDS ARE SUBJECT TO EXTENSIVE SEC REGULATION.

All Direxion funds are registered under the 1940 Act and the Securities Act. As the investment adviser to the Direxion products, RAM is subject to the Advisers Act, which regulates the activities of investment advisers to funds.

Each Direxion fund is subject to specific SEC reporting and disclosure obligations imposed by the 1940 Act and the Securities Act in its registration statement and shareholder reports relating to the Fund's investment objective, strategies, risks, expenses, performance and other information. For example, each Direxion fund registers on Form N-1A under the 1940 Act in order to offer its shares.[11] All investors receive a summary prospectus before or at the time of purchase of shares of a Direxion fund and may request a statutory prospectus and/or SAI. By completing Form N-1A, the Direxion funds satisfy their obligations under each of the Securities Act and the 1940 Act with respect to their registration statement requirements; and they accept civil liability for material misstatements and omissions in such registration statements.[12]

Because each Direxion fund is registered under the 1940 Act, it must also file various reports. For example, each Direxion fund is required to file a monthly report on Form N-PORT. In addition to certain identifying information about the registrant, Form N-PORT requires comprehensive disclosure about the fund's portfolio holdings and certain risk metrics, along with other data.[13] Additionally, all Direxion funds are required to file and mail to shareholders semi-annual and annual shareholder reports on Form N-CSR. In addition to the shareholder report,

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[10] Most of the Direxion ETFs' TRS currently require the parties to transfer the net amount owed (by one to the other) at least every 13 months, with such amount marked to market daily and netted upon request in the intervening period.

[11] In its summary prospectus, every Direxion fund prominently discloses its investment objective, fees and expenses, investment strategies and risks, and past performance. The same document includes information on the fund's investment adviser and portfolio manager, as well as information about how to purchase and sell fund shares, tax considerations and financial intermediary compensation. *See* Items 2–8 of Form N-1A. More detailed information on these and other matters appears in the statutory prospectus and the SAI, each of which contain extensive information on the fund's investment strategies, risks, management, operations and governance. *See* Items 9–35 of Form N-1A.

[12] Thomas P. Lemke, et al., REGULATION OF INVESTMENT COMPANIES § 5.14 "Prospectus Disclosure Issues and Litigation" (2019).

[13] *See* Form N-PORT.

among other things, Form N-CSR filings include copies of the registrant's code of ethics, the name of the audit committee financial expert (if applicable), disclosure of the principal accountant fees and services for the previous two fiscal years, information about the audit committee, and the registrant's security holdings.[14] Finally, as 1940 Act registrants, the Direxion funds are required to file Form N-CEN, which provides census-type information about them to the SEC.[15]

Additionally, because, the Direxion ETFs rely on exemptive relief in the form of the Exemptive Orders, they comply with the following material terms and conditions of the Exemptive Orders:

- Daily website disclosure of each Fund's portfolio holdings, which form the basis of the Fund's NAV calculation and reflect the portfolio trades made on the immediately preceding business day;
- Publication of each Fund's indicative intraday value ("IIV") every 15 seconds during regular trading hours;[16] and
- Daily website publication of each Fund's prior business day's NAV, reported closing price and premium or discount, as well as data in chart format displaying the frequency distribution of premiums and discounts for each of the four previous calendar quarters.

The Direxion ETFs are also subject to regulation under the Exchange Act because their shares are listed for trading on a national stock exchange, and the Exchange Act applies to all listed securities. The Exchange Act prohibits fraud in the purchase and sale of listed fund shares and imposes additional disclosure and proxy solicitation requirements on registrants.

Also, as a result of being listed for trading on an exchange, the Direxion ETFs are subject to regulation by their listing exchange (*i.e.*, NYSE Arca, Inc.). The listing exchange has rules that require the Direxion ETFs' target indexes to meet certain diversification requirements and to make certain disclosures.[17]

In short, the Direxion funds are subject to a raft of requirements imposed by the various federal securities laws.[18]

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[14] *See* Form N-CSR.

[15] *See* Form N-CEN.

[16] The IIV is an estimated value in U.S. dollars of a share of an ETF, which is disseminated every 15 seconds during trading. The IIV may be based upon current information regarding the ETF's holdings. *See* NYSE Arca Rule 5.2-E(j)(3)(c). The IIV may be published by either the Fund or the listing exchange.

[17] Thomas P. Lemke, et al., REGULATION OF EXCHANGE-TRADED FUNDS § 6.01 "Overview of Regulation" (2020). *See also* NYSE Arca Rules 5.2-E(j)(3) and 8.600-E(c)(2).

[18] Thomas P. Lemke, et al., REGULATION OF INVESTMENT COMPANIES § 1.01 "Background and Introduction" (2019).

THE DIREXION FUNDS PROVIDE CLEAR AND EMPHATIC DISCLOSURE.

Direxion works closely with SEC Staff to ensure that the characteristics and risks of its funds are clearly and emphatically disclosed. Those disclosures take several forms. [19]

1. NAMING. Direxion uses a distinctive naming convention to clearly communicate the risks and characteristics of its products. This naming convention tells an investor—even if s/he reads nothing but the *name* of the fund—that the fund is an index fund that seeks leveraged (or inverse leveraged) returns of a particular market index on a daily basis. The naming convention is as follows: [20]

Direxion + Daily + [Reference to Underlying Index] + Bull (or Bear) + [leverage factor]X + Shares

Thus, for example, the Direxion ETF that seeks to provide 300% of the performance of the S&P 500 is named the Direxion Daily S&P 500 Bull 3X Shares. The Direxion ETF that seeks to provide 300% of the inverse performance of the S&P 500 is named the Direxion Daily S&P 500 Bear 3X Shares. This naming convention clearly conveys that: the fund is a short-term (daily) investment vehicle that seeks to provide the long leveraged (Bull 3X) or inverse leveraged (Bear 3X) performance of a market index (*e.g.,* S&P 500).

2. CAUTIONARY COVER PAGE DISCLOSURE. Direxion provides the following up-front disclosure in **boldface** type on the first page of every summary prospectus.

> **The Fund is not suitable for all investors. The Fund is designed to be utilized only by knowledgeable investors who understand the potential consequences of seeking daily leveraged (3X) investment results, understand the risks associated with the use of leverage and are willing to monitor their portfolios frequently. The Fund is not intended to be used by, and is not appropriate for, investors who do not intend to actively monitor and manage their portfolios. For periods longer than a single day, the Fund will lose money if the Index's performance is flat, and it is possible that the Fund will lose money even if the Index's performance increases over a period longer than a single day. An investor could lose the full principal value of his/her investment within a single day.**

The disclosure describes in detail the *type of investor* for whom the Fund is designed: an investor who understands the risks associated with leverage, and plans to monitor his or her portfolios frequently. The disclosure explains *the short-term nature of the intended investment*, highlighting the risks associated with investing in the Fund for a period longer than a single day.

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[19] This letter focuses on Direxion's investor education efforts. Other product sponsors have engaged in similar investor education campaigns. *E.g.,* ProShares Trust, Registration Statement (Form N-1A) (Sept. 25, 2019), https://www.sec.gov/Archives/edgar/data/1174610/000119312519254811/d768061d485bpos.htm; *see also Basics of Alternative and Geared Investing*, PROSHARES, https://www.proshares.com/resources/education_geared_investing.html (last visited Mar. 22, 2020).

[20] Because the Direxion Mutual Funds pursue *monthly* rather than *daily* investment objectives, their names replace the word "Daily" with "Monthly" in this naming convention.

The disclosure also explains *the significant risk* of investing in the Fund, noting that an investor could lose the full value of his or her investment in a single day.

Similar, but even more detailed, up-front disclosure appears in boldface type on the cover page of every statutory prospectus and SAI:

> **The Funds are not suitable for all investors. The Funds are designed to be utilized only by sophisticated investors, such as traders and active investors employing dynamic strategies.**
>
> ***   *   ***
>
> **Investors who do not understand the Funds, or do not intend to actively manage their funds and monitor their investments, should not buy the Funds.**
>
> **There is no assurance that any Fund will achieve its investment objective and an investment in a Fund could lose money. No single Fund is a complete investment program.**
>
> **If a Fund's underlying index moves more than 30% on a given trading day in a direction adverse to the Fund, the Fund's investors would lose all of their money. The Funds' investment adviser, Rafferty Asset Management, LLC, will attempt to position each Fund's portfolio to ensure that a Fund does not gain or lose more than 90% of its net asset value on a given trading day. As a consequence, a Fund's portfolio should not be responsive to underlying index movements beyond 30% on a given trading day, whether that movement is favorable or adverse to the Fund. For example, if a Bull Fund's underlying index was to gain 35% on a given trading day, that Fund should be limited to a gain of 90% for that day, which corresponds to 300% of an underlying index gain of 30%, rather than 300% of an underlying index gain of 35%.**

Each Direxion fund further includes robust risk disclosure in its summary and statutory prospectus. Such risk disclosure prominently addresses the risks of compounding and leverage, which may cause a long-term investment in the fund to be more volatile than, and provide returns that differ from a long-term holding of an unleveraged fund. The text of this disclosure is attached as Appendix A to this letter.

3. Additional Safeguards. Direxion's website contains extensive educational materials designed to apprise investors of the characteristics and risks of leveraged/inverse funds. The website includes a prominent "Education" tab on its main page, containing a library of material to help investors or prospective investors better understand how leveraged/inverse funds may fit into their investment objectives.[21] The resources included in the "Education" section of the website are categorized by product type under the headings "Leveraged & Inverse ETFs," "Thematic Weight ETFs" and "PortfolioPlus ETFs."

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[21] *See Education Overview*, DIREXION, http://www.direxion.com/education (last visited Mar. 22, 2020).

Within the "Leveraged & Inverse ETFs" portion of the "Education" section, a user can access a publication titled "Understanding Leveraged Exchange-Traded Funds," which provides a detailed explanation as to how leveraged ETFs operate, as well as a primer on the composition, risks and potential benefits of leveraged ETFs.[22] Additionally, a user can access a publication titled "An Example of Daily Investment Results— Leveraged Exchange Traded Funds," which provides an actual market example of daily investment results for Direxion Bull ETFs.[23] And the list goes on. This paragraph describes only a fraction of the educational resources Direxion provides to seek to ensure that investors in its funds have ready access to a plethora of information that can assist them with understanding leveraged/inverse funds and trade them successfully.

INTERMEDIARIES HAVE IMPLEMENTED SCREENS ON INVESTMENTS IN LEVERAGED/INVERSE INVESTMENT VEHICLES.

1. INVESTMENT ADVISERS. The Advisers Act imposes a comprehensive federal fiduciary duty on investment advisers, which broadly "applies to the entire adviser-client relationship."[24] An adviser owes its clients a duty of care and a duty of loyalty and must act in the best interest of its client at all times. That means an adviser must render advice that is suitable, including recommending suitable investments and having "an understanding of the [client's] investment profile," including risk tolerance for certain investments. With respect to leveraged/inverse investment vehicles, in particular, the Commission has stated that an adviser must daily monitor the investment to ensure that holdings of leveraged investment products are consistent with "short-term, client specific trading objectives."

2. BROKER-DEALERS. Like investment advisers, broker-dealers that recommend leveraged/inverse investment vehicles, or use delegated discretion to invest client assets in such products, are subject to extensive regulation by self-regulatory organizations ("SROs") like the Financial Industry Regulatory Authority ("FINRA"), which has broad regulatory authority over broker-dealers.[25] As relevant here, FINRA has adopted a suitability rule (Rule 2111), which was codified over 80 years ago and continues to exist today. The FINRA Suitability Rule generally requires a firm, when recommending a security to any customer, to have a reasonable basis to believe the recommended investment is suitable for the customer, based on relevant facts and

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[22] *See Leveraged ETF Video Series*, DIREXION, http://www.direxion.com/literatures/leveraged-etfs-video-series (last visited Mar. 22, 2020).

[23] *See An Example of Daily Investment Results—Leveraged Exchange Traded Funds*, DIREXION, http://www.direxion.com/literatures/an-example-of-daily-investment-results (last visited Mar. 22, 2020).

[24] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, 84 Fed. Reg. 33,669, 33,670 (July 12, 2019) [hereinafter Fiduciary Interpretation].

[25] FINRA's broad rulemaking authority permits it to adopt rules to regulate, in part, "just and equitable principles of trade." *See* 15 U.S.C. § 78o-3(b)(6) (rulemaking authority of FINRA); 15 U.S.C. § 78o-4(b)(2)(C) (rulemaking authority of the Municipal Securities Rulemaking Board); and 15 U.S.C. § 78f(b)(5) (rules of the securities exchanges).

information about the customer. This rule has been the standard applied to sales practices since 1939.

FINRA imposes heightened suitability requirements on broker-dealers recommending leveraged/inverse investment vehicles. In June 2009, FINRA issued Regulatory Notice to Members 09-31 ("Notice 09-31"). Notice 09-31 stated (without analysis) that leveraged ETFs "typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets."[26] Notice 09-31 also "remind[ed]" member firms of their sales practice obligations "relating to leveraged and inverse exchange-traded funds," indicating that such obligations are heightened and include ensuring that they have written supervisory procedures, which require, among other things, that an "appropriate reasonable-basis suitability analysis is completed" in connection with the recommendation.

Subsequently, in January 2012, FINRA issued Regulatory Notice to Members 12-03 ("Notice 12-03"). Notice 12-03 was entitled "Heightened Supervision of Complex Products" and indicated that sales of "complex products," such as leveraged/inverse investment vehicles, require greater supervision.

The Commission, for its part, recently added to these existing requirements by adopting a comprehensive sales practice rule, "Regulation Best Interest."[27] Regulation Best Interest establishes a sweeping investor-protection regulatory regime covering broker-dealers' retail sales practices and applies a best interest standard to recommendations by broker-dealers. Under Regulation Best Interest, which will not be effective until June 30, 2020, broker-dealers must not place their interests ahead of any customer's interests when recommending securities, including leveraged/inverse funds—or even an investment strategy that might include such funds.

Regulation Best Interest was explicitly designed to impose a higher standard than traditional "suitability" on broker-dealers. Indeed, under Regulation Best Interest, according to the Commission, a "broker-dealer must understand potential risks, rewards, and costs associated with [any] recommendation." A firm additionally must evaluate its understanding of an investment product or investment strategy and consider the "risks, rewards, and costs in light of the customer's investment profile and have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest."

Regulation Best Interest applies broadly, well beyond broker-dealers that provide "personalized investment advice." Because the Commission expanded the reach of Regulation Best Interest to apply to any securities or investment strategy recommendation, Regulation Best Interest occupies the entire space for regulating recommendations and solicitations of securities by broker-dealers to individual investors.

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[26] FINRA Regulatory Notice 09-31, Non-Traditional ETFs at 1 (June 2009).

[27] Regulation Best Interest, 17 C.F.R. § 240.15*l*-1 (2020). *See also* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86,031, 84 Fed. Reg. 33,318 (July 12, 2019).

3. ADDITIONAL SAFEGUARDS.[28] Since the inception of leveraged/inverse funds in 1997 and their increased prominence after 2006 as ETFs, it has become increasingly unlikely that any investors invest in such funds without understanding them. Brokerage firms have established screening mechanisms to sort out which investors may trade leveraged/inverse funds, and Direxion has partnered with brokerage platforms in developing these screening mechanisms in order to educate potential investors about leveraged/inverse funds' characteristics and risks.

For example, brokerage platforms have—with Direxon's encouragement—implemented explicit risk disclosures about leveraged/inverse funds at the point of sale and begun to require that shareholders acknowledge the risks associated with such products. Such point-of-sale disclosure is used by broker-dealers to, among other things, obtain confirmation from investors that they are experienced investors who understand such investments, including their "unique features and risks," and to remind investors that leveraged/inverse funds are "not generally intended for long term investing."

Besides point-of-sale disclosure, broker-dealers may obtain annual or semi-annual affirmations from investors who trade leveraged/inverse investment vehicles that they understand and accept the risks of doing so. Such affirmation requirements can be used to again remind investors that leveraged/inverse investment vehicles "involve special risks" and, as a result, are "not appropriate for most investors." They may also be constructed to further educate investors on compounding and explain that leveraged/inverse investment vehicles have a "compounding effect that can cause [them] to perform worse than their multiple would suggest over any period longer than a day." Together, such efforts combined with those of Direxion and similar product sponsors provide a "belt and suspenders" approach to limiting trading of leveraged and inverse strategies to persons who understand them and plan to use them in an informed manner.

THE PROPOSED RULES.

Notwithstanding Direxion's exemplary regulatory history, its robust disclosure and educational regime, a customer base that seems to be well-informed, and the intermediaries' compliance with a panoply of existing regulations and voluntary screening mechanisms, the Commission proposes still *stricter* regulation of these funds. According to the Commission, their use of derivatives poses vaguely described "investor protection concerns" from "leverage-related risks," warranting an unprecedented level of paternalistic micromanagement.

PROPOSED RULE 18F-4.

The heart of the Derivatives Rules is found in proposed Rule 18f-4. The Commission styles proposed Rule 18f-4 as an "exemption" from Section 18(f)(1) of the 1940 Act, discussed at length below. Under proposed Rule 18f-4, registered open-end investment companies may invest in derivatives, which the Commission assumes that they otherwise could not do under Section 18(f)(1), provided that they comply with the conditions of the rule. As relevant here,

[28] The information provided directly responds to the Commission's request for comment on what special procedures, either at account opening or at point of sale, intermediaries currently undertake in permitting or not permitting retail investors to trade products. Proposing Release, *supra* note 1, at 4496 (responding to Request for Comment #181).

funds must either [1] comply with a "relative VaR test" or, alternatively, an "absolute VaR test," or [2] satisfy the definition of "leveraged/inverse investment vehicle" in the Sales Practice Rules and, among other things, seek to return no more than 300% of the performance (or inverse performance) of a market index.

Proposed Rule 18f-4 defines "value-at-risk" or "VaR" to mean "an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's net assets, over a specified time horizon and at a given confidence level." In short, VaR is a measure of the risk to a portfolio from its investments in derivatives.[29]

Under proposed Rule 18f-4, a fund generally must comply by implementing a relative VaR test to ensure that its VaR does not exceed 150% of the VaR of its designated reference index.[30] If a fund cannot comply with the rule by implementing a relative VaR test "because [it] is unable to identify a designated reference index," then the fund must comply with the rule's absolute VaR test. In that event, the VaR of the fund's portfolio may not exceed 15% of the value of the fund's net assets.

Under proposed Rule 18f-4, a fund's VaR test must use a 99% confidence level and a time horizon of 20 trading days to determine the VaR. Such test must be based on at least three years of historical market data. And it must "take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments." As examples of "significant, identifiable market risk factors," the rule identifies equity and commodity price risk, interest rate risk, credit spread risk, foreign currency risk, non-linear price risks (such as with options) and the sensitivity of the fund's portfolio to market volatility.

The Commission proposes what it describes as an "alternative approach" for leveraged/inverse funds.[31] In proposing this "alternative," the Commission explains that "[m]ost leveraged/inverse funds could not satisfy the limit on fund leverage risk in [the proposed rule] because they provide leveraged or inverse market exposure exceeding 150% of the return or inverse return" of a market index. Thus, the Commission indicates that it has designed the "alternative approach," as set forth in proposed Rule 18f-4(c)(4) to allow sponsors to continue to offer such funds in their current form.[32]

Pursuant to this "alternative approach," proposed Rule 18f-4(c)(4) would permit such vehicles to comply with proposed Rule 18f-4 by satisfying three specific requirements. First, they must disclose in their prospectus that they do not comply with the other leverage limits in proposed Rule 18f-4 (*i.e.*, any VaR test). Second, they must not "seek or obtain, directly or indirectly, investment results exceeding 300% of the return (or inverse of the return)" of a market

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[29] *See id.* at 4469 n.178 and surrounding text.

[30] The rule defines a "designated reference index" to mean "an unleveraged index" that, among other things, "reflects the markets or asset classes in which the fund invests" and is an "appropriate broad-based securities market index," as defined in Form N-1A. Under the rule, a designated reference index cannot be created or administered by an affiliate of the fund. *See id*. at 4559.

[31] *Id.* at 4492.

[32] *Id.*

index.[33] Third, they must satisfy the definition of "leveraged/inverse investment vehicle" provided in the Sales Practice Rules, subjecting all purchases of their shares to the Sales Practice Rules.

As drafted, however, proposed Rule 18f-4(c)(4) would not, in fact, provide an "alternative" to compliance with the rule's VaR test at all. Nothing in the definition of "leveraged/inverse fund" in proposed Rule 18f-4(c)(4) or in the definition of "leveraged/inverse investment vehicle" in the Sales Practice Rules carves out leveraged/inverse funds that comply with the relative VaR test in 18f-4(c)(2). As a result, even leveraged/inverse funds with a relative VaR of less than 150% would be subject to the Sales Practice Rules.

THE SALES PRACTICE RULES.

The Sales Practice Rules seek to regulate the use of leverage by a particular class of funds through their distribution networks. They apply to any "leveraged/inverse investment vehicle," as defined in the Sales Practice Rules.[34] As noted above, even leveraged/inverse funds that comply with the relative (or absolute) VaR test in proposed Rule 18f-4 would be subject to the Sales Practice Rules.

The key elements of the Sales Practice Rules apply at the time that an intermediary accepts an order or opens an account for an individual investor (*i.e.*, a natural person or legal representative thereof).[35] Before an intermediary can do either of these things, it must "seek to obtain" the following detailed information about the customer:[36]

(1) investment objectives (*e.g.*, safety of principal, income, growth, trading profits, speculation) and time horizon;

(2) employment status (name of employer, self-employed or retired);

(3) estimated annual income from all sources;

(4) estimated net worth (exclusive of family residence);

(5) estimated liquid net worth (cash, liquid securities, other);

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[33] For consistency with the other provisions of proposed Rule 18f-4(c)(2)(ii) and (iii), we believe "seeks or obtains" should instead read "seeks to obtain."

[34] *Id*. at 4558 and 4564 (proposed to be codified at 17 C.F.R. § 240.15*l*-2(d) and § 275.211(h)-1(d), respectively).

[35] This letter uses the terms "individual investor" and "retail investor" interchangeably. In addition, the letter uses the terms "customer" and "client" to mean, in the context of an intermediary, an individual or retail investor. In all cases, these terms refer to "a natural person (or the legal representative of a natural person)," as identified in paragraph (a) of each of the Sales Practice Rules.

[36] Proposing Release, *supra* note 1, at 4558 and 4564 (proposed to be codified at 17 C.F.R. § 240.15*l*-2(b)(2) and § 275.211(h)-1(b)(2), respectively).

(6) percentage of the customer's estimated liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and

(7) investment experience and knowledge (*e.g.*, number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and other financial instruments.

In addition, before *accepting* from any individual investor any order to purchase or sell shares of any leveraged/inverse investment vehicle, the intermediary must establish 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 funds.[37] This "reasonable basis" requirement imposes a suitability obligation on intermediaries, *even when the transaction has been directed solely by the client on an unsolicited or unrecommended basis*.

In connection with the Commission's formal proposal of the rules, Commissioners Peirce and Roisman issued a separate statement. As they observed, "the general requirements of the proposal would severely restrict the availability of geared ETFs" unless offerors and intermediaries accede to certain "alternative conditions." They also described the hard limit on leverage imposed on leveraged/inverse funds by proposed Rule 18f-4 as a "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. Thus, wouldn't good disclosure about the leverage in these products obviate the need for this type of cap?[38]

As to the rules requiring broker-dealers and investment advisers to require investors to fill out a detailed questionnaire, even for "investor[s] trading . . . products on [their] own initiative," the Commissioners "struggle[d] with the rationale for adding such a prescriptive requirement." This proposed rule, they said, proposes "micromanage[ment]" of intermediaries. The Commissioners could think of "little precedent for placing such a barrier between an investor and a financial product," aside from the accredited investor standard applicable to *private* markets, un-governed by SEC and federal disclosure requirements. As they put it, "Why would we introduce such a thing now, with respect to such a narrow subset of products?"

That is the right question to ask, and Commissioners Peirce and Roisman are right to be concerned.

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[37] *Id.* at 4558 and 4564 (proposed to be codified at 17 C.F.R. § 240.15*l*-2(b)(1) and § 275.211(h)-1(b)(1), respectively).

[38] Commissioners Hester M. Peirce and Elad L. Roisman, *Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices*, SEC (Nov. 26, 2019), https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices [hereinafter Peirce/Roisman Statement].

THE COMMISSION CANNOT REGULATE DERIVATIVES *PER SE* OR RISK UNDER THE 1940 ACT.

The Commission purports to adopt proposed Rule 18f-4 pursuant to its authority under Sections 6(c), 12(a), 18, 31(a), 38(a) and 61 of the 1940 Act. Some of these sources of authority collapse immediately on review. The remaining ones collapse with mild pressure.

To begin, two of the statutes cited by the Commission are not relevant to this analysis. Section 31(a) authorizes the Commission to adopt rules requiring the maintenance of certain records related to the operation of registered funds; that narrow statutory authority is not relevant to the adoption of the leverage limits proposed for leveraged/inverse funds. Similarly, Section 61 relates to the Commission's authority to regulate business development companies ("BDCs"); that narrow statutory authority also is not relevant to leveraged/inverse funds as they do not operate as BDCs.

Section 38(a) is merely an empowering provision. It authorizes the Commission "from time to time to make [and] issue . . . such rules and regulations and such orders as are *necessary or appropriate to the exercise of powers conferred upon the Commission elsewhere in [the 1940 Act]*."[39] The Commission cannot expand the sweep of the 1940 Act or enlarge the Commission's authority under this simple executory provision.

That leaves Sections 18(f) and 12(a) as potential bases of affirmative authority for proposed Rule 18f-4, and Section 6(c), an exemptive provision. None of these statutory provisions gives the Commission the authority that it needs to adopt the proposed rule.

SECTION 18(F) DOES NOT AUTHORIZE THE SEC TO REGULATE DERIVATIVES.

Section 18(f) provides:

> It shall be unlawful for any registered open-end company to *issue any class of senior security* or to *sell any senior security of which it is the issuer*, except that any such registered company shall be permitted to borrow from any bank: *Provided*, that immediately after any such borrowing there is an asset coverage of at least 300 per centum for all borrowings of such registered company. (Emphasis added.)

To regulate derivatives under this section, the Commission must establish that such derivatives constitute "senior securities" that are "issued" by a fund. It cannot establish these predicates.

[39] 15 U.S.C. § 80a-37(a) (emphasis supplied).

SECTION 18 REGULATES A FUND'S "CAPITAL STRUCTURE," AND DERIVATIVES ARE NOT PART OF A FUND'S CAPITAL STRUCTURE.

Section 18 is entitled "Capital Structure." It limits a fund's ability to issue classes of "senior securities," and to "sell any senior security of which it is the issuer" as part of its capital structure. The 1940 Act does not define the term "capital structure." But the seminal study by the SEC that led to the adoption of the 1940 Act, the *Study of Investment Trusts and Investment Companies*,[40] defined a fund's "capital structure" as follows:

> The "capital" or "capitalization" of an investment trust or investment company is the fund raised by the trust or company to devote to the purpose for which the trust or company has been formed. The capital may be entirely capital contributed or may be in part capital contributed and capital loaned. … The capital stock and the instruments evidencing the long-term promises to repay constitute the 'capital securities' of the company."[41]

In sum, the "capital structure" of a fund is its corpus.

As the Investment Trust Study explained, a fund's corpus can come from capital contributions to the fund or from long-term loans taken out by the fund. In the case of the former, the stock issued by the fund (in exchange for capital) enters its capital structure. In the latter, "long-term promises to repay" the lender enter the fund's capital structure. In 2020-speak, the equity securities and long-term debt securities issued by a fund in exchange for corpus assets "constitute" the capital structure of a fund.

These capital-structure concepts from the Investment Trust Study find voice in Section 18(g) of the 1940 Act. Section 18(g) defines the term "senior security" to mean—

> *any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness*, and <u>any stock of a class having priority over any other class as to distribution of assets or payment of dividends</u>.[42]

Stated differently, Section 18(g) defines "senior securities" to mean the securities *in a fund's capital structure*: long-term debt securities (the italicized portion of the provision) and equity securities (the underlined portion of the provision) issued by a fund.

The legislative history of Section 18 confirms that it was intended to reach only equity securities and long-term debt securities issued by a fund. The overwhelming majority of the

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[40] H.R. Doc 279, 76th Cong., 1st Sess. (1939) [hereinafter Investment Trust Study].

[41] *Id*. at Part 3, Chapter V, Section I.B. at 2.

[42] 15 U.S.C. § 80a-18(g).

references there regarding the types of security issuances prohibited by Section 18 were to preferred stock, debentures and bonds.[43]

Further, the Investment Trust Study's discussion of "capital structure" matters (like the discussion of Section 18 during the Senate hearings) focused primarily on *publicly issued* securities. Testifying before Congress, an SEC official explained the concern with allowing for sales of senior securities to the public, noting that "a senior security in an investment company is, in many ways, comparable to a fourth or fifth mortgage." Thus, he concluded, "To let a company borrow money *from the public*, in effect, on that type of security seems to us unsound."[44]

Notably, the securities that the Investment Trust Study called out as those at which Section 18 was aimed were all *publicly offered* at the time, including "(a) [] bond[s] or debenture[s] . . . in addition to the company's stock issues, (b) . . . preferred stocks in addition to one or more issues of common stocks, [and] (c) more than one class of common stock."[45] And the Commission has previously reported to Congress that Section 18 is designed to capture only securities sold to the public.[46]

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[43] *See, e.g.*, Investment Trust Study, *supra* note 40, at Part 3, Chapter V, Section II ("An investment company achieves a complex capital structure when it ahs issued: (a) a bond or debenture issue or issues in addition to the company's stock issues, (b) an issue or issues of preferred stock… or (c) more than one class of common stock. …Many companies possess capitalization consisting of bonds or debentures, preference stock and common stock."); Legislative History of the Investment Company and Investment Advisor's Act of 1940: Pub. L. 76-768: 54 Stat. 789 (1940), Hearings on S. 3580 held before a Subcommittee of the Senate Committee on Banking and Currency, Part 1, at 269 [hereinafter Senate Hearings Part 1] ("The fact of the matter is that in Great Britain they do have senior securities in the investment company, but, traditionally and historically, what do they do? They balance their portfolio so that the investments correspond to the outstanding senior securities. They have a certain amount of *debentures, preferred and common stock*. Their portfolio will have a comparable amount of debentures, preferred and common stock. That was to assure the debenture holder of the investment company that he is going to get an income which will meet his obligations. (Emphasis added.)); Legislative History of the Investment Company and Investment Advisor's Act of 1940: Pub. L. 76-768: 54 Stat. 789 (1940), Hearings on S. 3580 held before a Subcommittee of the Senate Committee on Banking and Currency, Part 2, at 1025 (Provisions Of The Proposed Bill Related To Capital Structure (Sections 18, 19(B), and 21(C)) ("Raymond D. McGrath, the executive vice president of General American Investors Co., Inc., urged that the *senior securities* of his company must be considered good investments because the *bonds and preferred stock* of that company are at present selling in the marker near their call price.") (Emphasis added.)

[44] Senate Hearings Part 1, *supra* note 43, at 265 (emphasis added).

[45] *See* Investment Trust Study, *supra* note 40, at Part 3, Chapter V, Section II.

[46] A 1994 memorandum sent by the then-Chairman of the SEC to Congress recommended that the Commission "reexamine the application of Section 18 to derivative instruments," saying that Section 18 "was originally designed to address . . . the leverage created by the issuance of *public* senior securities." *See* September 26, 1994 Division of Investment Management Memorandum to then-Chairman Arthur Levitt (transmitted by him to the House Subcommittee on Telecommunications and Finance) at 21 [hereinafter *1994 IM Memo*] (emphasis added).

Section 18 was, in fact, largely designed to protect *senior* security holders. Prior to the 1940 Act, funds had been structured to have multiple classes of securities—sometimes multiple classes of equity securities and sometimes a class (or classes) of equity and debt securities. Fund "insiders," meaning management, typically held all of one class of equity securities, called "junior securities;" and typically that class held all of the voting rights with respect to the fund and benefitted (or suffered) from management's investment decisions on behalf of the fund. Management then issued a second class of equity securities or issued debt securities, called "senior securities," in order to obtain additional assets on which to generate performance for the junior securities. These senior securities often did not provide the kind of investor protections that were (and still are) common in the bond and public debenture markets, such as requirements that adequate earnings or asset coverage ratios be maintained; and for those that did, the controlling insiders frequently did not comply with such requirements. As a result, purchasers of those senior securities were unprotected when the fund began to incur losses and only some (holders of preferred stock) could share in the funds gains—a "heads you win, tails I lose" situation. The legislative history of Section 18(f) speaks extensively of concerns about such conflicts of interest between senior and junior security holders. [47]

The Commission contends that the legislative history of Section 18 shows that a "core purpose" of it was to limit fund leverage.[48] And the legislative history does, in fact, reflect some concerns about leverage and its affect on junior security holders.[49] However, what the Proposing Release fails to mention is that the principal concern for junior security holders was that *when leverage was manifested in the capital structure of a fund*, it concentrated profits and voting control in the hands of insiders, just as described above. This concern was a focus of the Senate Hearings on the 1940 Act. In introducing S. 3580, Senator Robert Wagner (D. NY) furnished a written "Explanatory Statement" stating, in pertinent part:

> Capital structures, which are often confusing and incomprehensible to investors, have been created with the ulterior motive of vesting in the controlling groups complete control of the public stockholders' funds and a disproportionate share of the companies' profits. . . . As a consequence, unsound capital structures have been created—structures which fostered and perpetuated sharp conflicts of interests between the holders of senior securities and junior securities. These conflicts have often been resolved to the detriment of the public senior security holders and to the advantage of the common stock held by the insiders. . . . These companies with senior securities have been, in essence, margin accounts—margin accounts not subject to further margin calls—for trading in common stocks for the

[47] Legislative History of the Investment Company and Investment Advisor's Act of 1940: Pub. L. 76-768: 54 Stat. 789 (1940), Hearings on S. 3580 held before a Subcommittee of the Senate Committee on Banking and Currency, Part 2, at 1025 (Provisions Of The Proposed Bill Related To Capital Structure (Sections 18, 19(B), And 21(C)).

[48] Proposing Release, *supra* note 1, at 4450.

[49] *Id*. at 4450 n.26.

> benefit of the inside common-stock holders. Unwarranted speculative activities have resulted.[50]

In additional Senate testimony, an SEC official echoed similar concerns about allowing investment companies to have more than one class of stock or to issue debt, stating that "the real reason" investment companies do that "is just to get capital to establish a margin account for the common stock."[51] Stated differently, the drafters' concerns about leverage were not about the presence of leverage *per se*, but rather about the creation or exacerbation of conflicts of interest as a result of leverage.

Against this backdrop, the framers of the Act sensibly drafted Section 18(f) to include only two specific restrictions on the types of securities funds could issue. One restriction makes it unlawful for an open-end fund to "issue any class of senior security."[52] The other makes it unlawful for a fund to "sell a senior security of which it is the issuer." Both provisions of Section 18(f) thus require a fund to "issue" a senior security to run afoul of the Act.[53] Because funds do nothing of the sort when they enter into TRS, they do not run afoul of Section 18(f).

TRS ARE NOT "SENIOR SECURITIES" UNDER SECTION 18.

Under the Derivatives Rules, the Commission proposes to define a "derivatives transaction" to mean:

> (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; and
>
> (2) any short sale borrowing.

To be a "senior security" within the meaning of Section 18(g), however, a derivatives transaction must be either a "*bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness*," or "stock of a class having priority over any other class as to distribution of assets or payment of dividends."[54] The Commission nowhere contends (nor could it) that derivatives transactions are the equivalent of "stock" (*i.e.,* equity security) issued by a fund. Instead, the Commission seeks to shoehorn them into Section 18(g) as a "bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness."

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[50] Cong. Rec., March 14, 1940 at 2844–45.

[51] *See* Proposing Release, *supra* note 1, at 4450, n.28 (citing Senate Hearings at 265–78 (discussing the abuses of senior security holders)).

[52] Section 18 contains different provisions for open-end and closed-end funds. Section 18(f) pertains only to open-end funds, and all of the Direxion funds are open-end funds.

[53] The Commission agrees. *E.g.,* Proposing Release, *supra* note 1, at 4448–49, 4453.

[54] 15 U.S.C. § 80a-18(g)

To fit the square peg of a derivatives transaction into the round hole of Section 18(g), the Commission relies on its reasoning in Release 10666. The Commission says that, in 1979, it "concluded that the[] agreements [reviewed in Release 10666] fall within the 'functional meaning of the term "evidence of indebtedness" for purposes of Section 18 of the Investment Company Act,' noting 'the unique legislative purposes and policies underlying Section 18 of the Act.'" The Commission also notes that in 1979 it stated that, for purposes of section 18, "evidence of indebtedness" would include "all contractual obligations to pay in the future for consideration presently received."[55] As the Commission knows, however, Section 18(g) does not reach *all* "evidence of indebtedness." Indeed, on its face, the general phrase "evidence of indebtedness" does not appear in Section 18(g); that provision speaks only of a "bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness." If Section 18(g) had reached all "evidence of indebtedness," its text would not have separately required that any evidence of indebtedness also "constitut[e] a security" to be a senior security because, under Section 2(a)(36) of the 1940 Act, every "evidence of indebtedness" is a "security." In sum, to date, the Commission has yet to explain how a future payment obligation is a "bond, debenture, note, or similar obligation or instrument," which "constitut[es] a security," "evidencing indebtedness."[56] Nevertheless, with the Derivatives Rules, the Commission seeks to "apply the same analysis to all derivatives transactions" to transform them into senior securities.[57]

The Commission has no basis for doing so based on the statute. Under Section 18(f), a "senior security" is not just *anything* that "evidenc[es] indebtedness." To be a senior security, it must be "issued." And, it must be a "bond, debenture, note, or *similar* obligation or instrument *constituting a security* and evidencing indebtedness." In sum, before the Commission can classify a derivatives transaction as a senior security within the meaning of Section 18(f), it must demonstrate that it is:

[1] "issued," *and* is

[2] an instrument "similar" to a bond, debenture, or note that

[3] "constitut[es] a security," *and*

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[55] Proposing Release, *supra* note 1, at 4450 (quoting Securities Trading Practices of Registered Investment Companies, Investment Company Act Rel. No. 10,666, 44 Fed. Reg. 25,128 (Apr. 27, 1979) [hereinafter Release 10666]).

[56] The closest the Commission comes to providing an explanation is in the Proposing Release, where, addressing short sales and the trading practices addressed in Release 10666, it says "all impose on a fund a contractual obligation under which the fund is or may be required to pay or deliver assets in the future to a counterparty. These transactions therefor involve the issuance of a senior security for purposes of section 18." *Id*. at 4451. This explanation, however, still fails to connect the dots. Among other things, it fails to explain why *all* contractual obligations under which a fund is required to pay or deliver assets in the future to counterparty are not senior securities. Why is a fund's custodial contract, pursuant to which it agrees to pay its custodian fees, not a senior security? Why is a fund's transfer agency agreement, pursuant to which it obtains transfer agent services for a fee, not a senior security?

[57] *Id*. at 4451.

[4] "evidenc[es] indebtedness."

The list is in the conjunctive. It is not enough to pick off the last of the factors and declare the definition met. For the reasons discussed below, the definition plainly is not met.

TRS ARE NOT "ISSUED."

Companies "issue" securities when they offer stocks and bonds for public investment to raise capital.[58] In the context of proposed Rule 18f-4, the Commission stretches to apply the term to derivatives transactions generally, and TRS in particular. Specifically, the Commission seeks to characterize TRS as "issue[d]" by funds that transact in them in order to reach them with Section 18(f). TRS, however, cannot reasonably be characterized as "issued."

As the Commission must recognize, TRS are merely portfolio holdings of funds (*i.e.*, a source of performance returns), not securities issued by them as part of their capital structure. Besides in Section 18, the term "capital structure" is used in only two other places in the 1940 Act—Sections 6(b) and 64(b)(1)—both of which suggest that a fund's capital structure and its portfolio holdings are two distinct and different things. Section 6(b) authorizes the SEC to grant exemptions to "employees' security companies" and provides that, in considering such exemptive requests, the SEC is to give due weight to, among other things, [1] "the capital structure" of such company and [2] "the character of the securities in which such proceeds [of sales of securities issued by the company] are invested," thus implying that the securities that comprise the capital structure are different than the company's portfolio holdings. Similarly, Section 64(b)(1) provides that a BDC must file and distribute to its shareholders a statement describing its risk factors "due to the nature of the company's *investment portfolio* and *capital structure*." This usage even more clearly distinguishes the items comprising an entity's "capital structure" from its investment portfolio. Both instances, however, make it clear that that a fund's portfolio holdings are not part of its capital structure.

Yet here, the Commission seeks to read the statute in a way that would effectively convert the portfolio holdings of a fund into senior securities issued by it. The SEC, of course, is not the first administrative agency to seek to broaden its jurisdiction with an untenable reading of a statute. In *Association of American Railroads v. U.S.*,[59] the D.C. Circuit considered a similar effort by the Interstate Commerce Commission ("ICC"). In that case, the American Association of Railroads sued the ICC for adopting an interpretation of the statute that, if not struck down, would have significantly expanded the definition of "securities" under the Interstate Commerce Act ("ICA") and broadened the ICC's authority over carriers' financial transactions.

At issue there was Section 20a of the ICA, which required carriers to obtain ICC approval before issuing "securities." Section 20a defined "securities" to mean "any share of capital stock

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[58] *Issue*, INVESTOPEDIA.COM, https://www.investopedia.com/terms/i/issue.asp ("An issue is the process of offering securities in order to raise funds from investors. Companies may issue bonds or stocks to investors as a method of financing the business. The term "issue" also refers to a series of stocks or bonds that have been offered to the public and typically relates to the set of instruments that were released under one offering.")

[59] 603 F.2d 953 (D.C. Cir. 1979) ("*AAR*").

or any bond or other evidence of interest in or indebtedness of the carrier." And in referring to the securities which the ICC must approve, Section 20a(2) required an "investigation by the commission of the purposes and uses of the proposed Issue and the Proceeds thereof."[60]

Homing in on the word "issued" as a guide to its eventual holding, the D.C. Circuit struck down the ICC's interpretation because it "d[id] not comport with the language of Section 20a." More specifically, the ICC interpretation would have caused a variety of instruments other than stocks or bonds, including credit agreements and security agreements, also to be "evidence of indebtedness." As the court explained, the types of financing the ICC identified as constituting "evidence of . . . indebtedness" bore "no resemblance to the stocks and bonds expressly mentioned in the first two portions of the phrase." Under the canon of *ejusdem generis*—a general word is confined to the class of specific words around it—the court concluded that the Commission could regulate "other evidence of interest in or indebtedness of" a carrier "only when that 'evidence' is of like kind to stocks and bonds." To read the statute to include stocks and bonds "as well as financing dissimilar to these securities," the court explained, would "render[] nugatory the statute's express reference to specific securities."[61]

In reaching this conclusion, the *AAR* court "dr[ew] . . . support for its reading of Section 20a(2) from the statute's use of the words 'issue' and 'proceeds,'" saying, "Although both words are commonly used in connection with stock, bonds, and the like, they are awkward and meaningless when employed in the context of many of the financial transactions specified in [the ICC order]. For example, an intercompany advance can hardly be described as "issued" or creating 'proceeds.'"[62]

So too here. The term "issued" is awkward and meaningless when employed in the context of TRS. Derivatives (in general) and TRSs (specifically) are not "issued," and they are not normally referred to or conceived of as being "issued." Rather, TRS are bi-lateral contracts between two private parties pursuant to which each agrees to pay the other a return based on the performance of a reference asset, such as in the case of the Direxion funds, a market index. TRS are not publicly issued or traded. In fact, they cannot even be assigned by either party without the counterparty's consent. Characterizing them as "issue[d]" therefore is a complete misnomer.

TRS ARE NOT A "SIMILAR OBLIGATION OR INSTRUMENT" TO A BOND, DEBENTURE OR NOTE.

The Commission's attempt to reach derivative transactions as senior securities within the ambit of Section 18 ignores the requirement that to be captured as a senior security, a security

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[60] *AAR*, 603 F.2d at 959–60. Interestingly, the ICA was referenced several times during the Senate hearings on S. 3840, which is the Senate bill that would become the 1940 Act. Ultimately, however, Congress settled on slightly different wording for the 1940 Act.

[61] *Id.*

[62] *Id.* In support of its rationale, the court noted that, "[i]n the business law sense, 'issue' has been defined as 'to put into circulation.'" BLACK'S LAW DICTIONARY 964 (Rev. 4th ed. 1968). The court also observed that "the word 'circulation' is strongly suggestive of [a] public tradability requirement," which the *AAR* court also addressed in its opinion. *AAR* at note 30.

evidencing indebtedness must be a “bond, debenture, note or similar obligation or instrument.” In understanding Section 18’s reference to “any bond, debenture, note, *or similar obligation or instrument*,” the D.C. Circuit’s opinion in *AAR* again provides a useful guide. In *AAR*, the D.C. Circuit explained that “[a] statutory reference to ‘other’ objects of a general nature,” must be understood to “embrace only objects similar in nature to those objects enumerated by the preceding specific words.”[63] Or put another way, the *ejusdem generis* canon provides that, where a seemingly broad phrase constitutes a residual clause in a statute, the proper interpretation of that residual clause is limited by the similarities between the specifically enumerated items.

In *Circuit City, Inc. v. Adams,*[64] for example, the Supreme Court analyzed a statute through the lens of the *ejusdem generis* canon and determined that “the words ‘any other class of workers engaged in . . . commerce’ constitute a residual phrase” that followed an “explicit reference to ‘seamen’ and ‘railroad employees.” Accordingly, the Court held that “[u]nder this rule of construction the residual clause should be read to give effect to the terms ‘seamen’ and ‘railroad employees,’ and should itself be controlled and defined by reference to the enumerated categories of workers which are recited just before it.”[65] The Court relied upon this interpretation based on the *ejusdem generis* canon to hold that “any other class of workers” meant “transportation workers.”[66]

Applying that canon to Section 18 means that Section 18’s reference to “any bond, debenture, note, *or similar obligation or instrument*” must be understood to embrace only those obligations or instruments that are similar in nature to bonds, debentures, or notes in a way that bonds, debentures, and notes are similar to one another. And bonds, debentures, and notes are similar to one another in that they represent actual borrowings in which someone has loaned money to a fund, it is deposited into the fund’s corpus, and the fund has agreed to repay it at a certain point in the future. In addition, bonds, debentures, and notes are similar to one another in that they represent long-term debt obligations and are normally sold to the public.[67] TRS do not share any of those characteristics. TRS are not actual borrowings. TRS are private, bi-lateral, non-transferable contracts entered into by two parties seeking performance from the other. Further, as observed by the *AAR* court in a different context, this conclusion is supported by “the statute’s use of the word[] ‘issue.’” Such term is “commonly used in connection with stock, bonds, and the like,” but is “awkward and meaningless when employed in the context of” swap contracts.[68] Thus, TRS cannot be described as an obligation or instrument that is “similar” to bonds, debentures and notes.

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[63] *Id.* at 963.

[64] 532 U.S. 105, 114 (2001).

[65] *Id.* at 105.

[66] *Id.* at 119.

[67] *See supra* note 43 (cataloguing the legislative history references to bonds, debentures and preferred stock as the types of long-term securities within the scope of Section 18).

[68] *See supra* notes 61-63 and surrounding text.

For all of these reasons, derivatives generally—and certainly TRS—should not be deemed to be obligations or instruments "similar" to bonds, debentures and notes. And the Commission's attempt to reach swap contracts through Section 18(f) should fail.

A TRS DOES NOT "CONSTITUTE A SECURITY."

The 1940 Act defines "security" as follows—[69]

> ''Security'' means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Under this definition, *certain* derivatives (such as options) are identified as securities. Swap contracts are not included in the list. Further, when Congress passed the Dodd-Frank Act in 2010, it determined *not* to expand the definition of "security" in the Securities Act or Exchange Act to include swaps on broad-based indexes.[70] Congress took this approach with respect to swap contracts, which are not security-based swaps, in order to clarify that they are *not* securities; rather, they are instruments over which the Commodity Futures Trading Commission ("CFTC") has primary jurisdiction.[71]

Further, the definitions of "security" under the Securities Act, Exchange Act and 1940 Act are substantially identical and are generally regarded as being functionally the same.[72]

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[69] 15 U.S.C. § 80a-2(a)(36).

[70] The Dodd-Frank Act modified the Securities Act and the Exchange Act definitions of "security" to include "security-based swaps," which in turn are defined to include only those swaps (as defined in the Commodity Exchange Act) that are based on "(I) an index that is a narrow-based security index [essentially, one having nine or fewer component securities or heavily weighted to just a few], including any interest therein or on the value thereof; (II) a single security or loan, including any interest therein or on the value thereof; or (III) the occurrence, non-occurrence or extent of the occurrence of an event relating to" the issuers of such securities or of the securities included in such indices. No such change was made to the 1940 Act definition, which still does not refer to any type of swap.

[71] *See Derivatives*, SEC, https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml (explaining that the "Dodd-Frank Act divides regulatory authority over swap agreements between the CFTC and SEC," giving the SEC "regulatory authority over security-based swaps," and including security-based swaps within the definition of "security" under Exchange Act and Securities Act).

[72] *Compare* 15 U.S.C. § 80a-2(a)(36) *with* 15 U.S.C. § 78c(a)(10).

Indeed, the SEC itself consistently took that view for decades.[73] That view is also consistent with the legislative history of the 1940 Act. In the original Senate and House bills that would become the 1940 Act, the drafters proposed to incorporate by reference (into the 1940 Act) the definition of "security" from the Securities Act. In the House hearings on the final bill, however, an SEC official testified that the 1940 Act, as adopted, would include a free-standing definition of "security" for ease of reference. More specifically, he said that the inclusion of the definition in the 1940 Act "was done at the suggestion of the industry. They felt that they would like to have the entire bill in one volume instead of having to refer to one act and then to another, you see."[74] In short, the definition of "security" in each of the federal securities laws was intended to be co-extensive. Accordingly, since the Securities and Exchange Acts' definitions of "security" were recently and explicitly amended so as not to encompass broad-based index swaps, the definition in the 1940 Act should not encompass such swaps either.

This conclusion is reinforced by the fact that, as a practical matter, TRSs are not "instruments ordinarily and commonly considered to be securities in the commercial world." In *Marine Bank v. Weaver*,[75] the Supreme Court ruled that certificates of deposit were not "securities" for purposes of the antifraud provisions of the Exchange Act. As the Court explained, "Congress intended the securities laws to cover those instruments ordinarily and commonly considered to be securities in the commercial world." Similarly, the D.C. Circuit stated in *AAR* that for an instrument to "constitute a security," it has to look and act like a

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[73] *E.g., American Express Income Shares, Inc.*, SEC No-Action Letter (pub. avail. Nov. 14, 1974) saying "the definitions of a security in the federal securities laws are coextensive"). The Commission has occasionally asserted that the 1940 Act definition may be broader. In an *amicus* brief filed in *Marine Bank v. Weaver,* 455 U.S. 551 (1982), it argued that whatever the decision with respect to the Exchange Act might be, certificates of deposit should be considered securities for purposes of the 1940 Act because the 1940 Act "presents a significantly different context." *See* Brief for the United States as Amicus Curiae at 22, Marine Bank v. Weaver, 455 U.S. 551 (1982) (No. 80-1562). The Proposing Release here similarly asserts that the 1940 Act's definition of "security" is broader than in the other securities laws. Proposing Release, *supra* note 1, at 4447, n.3 (citing *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Investment Company Act Release No. 29,776 (Aug. 31, 2011) [76 FR 55237 (Sept. 7, 2011)] ("2011 Concept Release")) as "explaining that the Commission has interpreted the term 'security' in light of the policies and purposes underlying the [40] Act." Proposing Release, *supra* note 1, at 4451 n.38. The SEC's position—that "securities" should have a broader meaning under the 1940 Act than the other federal securities laws—has not been widely accepted; indeed, it has been challenged as a "particularly egregious example of law-making by SEC administrative fiat." C. Steven Bradford, *Expanding the Investment Company Act: The SEC's Manipulation of the Definition of Security*, 60 OHIO STATE L.J. 995, 996 (1999). *But see* Joseph A. Franco, *The Investment Company Act's Definition of 'Security' and the Myth of Equivalence,* 7 STANFORD J. OF LAW, BUS. & FIN. 1, 4 (2001) (arguing that the "non-equivalence approach provides a far more convincing construction of the ['40] Act's definition of 'security'").

[74] Legislative History of the Investment Company and Investment Advisor's Act of 1940: Pub. L. 76-768: 54 Stat. 789 (1940), Hearings on H.R. 10065 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Congress, 3d Sess., at 101.

[75] 455 U.S. 551 (1982).

security. TRS, however, neither look and act like securities nor are they "instruments ordinary and commonly considered to be securities in the commercial world."[76]

Nevertheless, in the Derivatives Rules, the Commission ignores the actual statutory definition of the term "security," and seeks to give the term a special meaning when it is used in Section 18. Specifically, the Commission says that it defines the term "senior securities" "broadly to include instruments and transactions that other provisions of the federal securities laws might not otherwise consider to be securities."[77] Yet following the Commission's rationale, it could define "securities" differently for every section of the 1940 Act, whenever and wherever it wished. The statutory definition of "security" cannot be ignored, however, especially when, as here, it is separately used—as if for emphasis—in Section 18(g)'s definition of the term "senior security." Whether for "purposes of Section 18" or more broadly, the statutory definition controls.

TRS DO NOT "EVIDENC[E] INDEBTEDNESS."

Unlike bonds, debentures and notes, a TRS does not initially "evidence . . . indebtedness", and as explained above, it may never do so. When a Direxion fund enters into a TRS, it does not owe any money to its counterparty. Indeed, it may never owe any money to its counterparty, and whether it owes money to its counterparty—or its counterparty owes money to it—will depend entirely on market movements, specifically on changes in the market value of the broad-based index that serves as its reference asset. Based on such market movements, the character of a TRS typically changes throughout its life from asset to liability to asset to liability, until termination.

The legislative history makes clear that, given the transient nature of TRS obligations, they should not qualify as "evidencing indebtedness" within the meaning of Section 18. The Investment Trust Study made clear that Section 18 was intended to "deal[] primarily with the significance of the more permanent features of capital structure," and "[i]ncidental leverage of uncertain duration" was to be "ignored in the . . . classification."[78] The Investment Trust Study also explained that "[p]romises to repay short-term loans are not generally considered capital securities because money advanced does not constitute a sufficient stable increase in the capital fund of the company, and the relationship between the company and the creditor is transient."[79] Instead, Congress intended only for *long-term* debt securities (*i.e.*, instruments constituting securities and evidencing indebtedness) issued by a fund to be considered part of its "capital structure" and thus subject to regulation under Section 18. As TRS transform automatically and

[76] Under the Uniform Commercial Code ("UCC"), a "security" is an obligation of or an interest in an "issuer" that, among other things, "is one of a class or series or by its terms is divisable into a class or series of shares, participations, interests or obligations." UCC § 8-102(a)(15). TRS do not satisfy that test either.

[77] Proposing Release, *supra* note 1, at 4451.

[78] Investment Trust Study, *supra* note 40.

[79] *Id*.

continuously from assets to liabilities based on market movements, they can hardly be compared to long-term debt securities.[80]

The Commission nevertheless suggests that the exception in Section 18(f) for bank borrowings implies that *all* borrowings constitute "senior securities."[81] It cites no authority for this proposition. Nor is there any.

Instead, the Commission seeks to *infer* authority to regulate all borrowings from the bank borrowing provision of Section 18(f). Specifically, the Commission argues that, inasmuch as Section 18(f) prohibits the issuance of senior securities but includes an exception for bank borrowings, it "makes clear" that all borrowings—and apparently by extension all indebtedness—are senior securities.[82] That is simply not so, as Section 18(h) explains.

To recap, Section 18(f) permits bank borrowings "*Provided,* that immediately after any such borrowing there is an asset coverage of at least 300 per centum for all borrowings." Section 18(h), for its part, explains how "asset coverage" is to be calculated for these purposes and provides as follows:

> "Asset coverage" of a class of senior security representing an indebtedness of an issuer means the ratio which the value of the total assets of such issuer, *less all liabilities and indebtedness not represented by senior securities,* bears to the aggregate amount of senior securities representing indebtedness of such issuer. (Emphasis added.)

In short, the statute plainly anticipates funds having "liabilities and indebtedness" that are not senior securities. Otherwise, in calculating the asset coverage ratio, funds would not have any "liabilities and indebtedness not represented by senior securities" to deduct from total assets. And, importantly, Section 18(h) does not limit such other "liabilities and indebtedness" to "temporary" borrowings by cross-referencing Section 18(g).[83] Thus, the Commission's assertion that all borrowings and/or indebtedness constitute senior securities fails.

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[80] Given the transient but potentially recurring nature of a liability under a TRS, we do not contend that they fall squarely within the definition of a "temporary" borrowing, as defined in Section 18(g). Rather, at least to the extent that they contain 13-month or shorter terms, they should be considered short-term obligations, consistent with Rule 2a-7 under the 1940 Act, which treats debt obligations with maturities of 397 days or less as short term. *See* 17 C.F.R § 270.2a-7(h)(11)(i)(2), (4).

[81] *Cf.* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act No. 31,933, 80 Fed. Reg. 80,884, 80,890 (proposed Dec. 28, 2015) [hereinafter 2015 Proposing Release] (the "statutory permission to engage in a specific borrowing makes clear that such borrowings are senior securities, which otherwise would be prohibited absent this specific permission").

[82] Proposing Release, *supra* note 1, at 4451 (citing Release 10666).

[83] Notably, Section 18 contains *many* internal cross-references, suggesting that, had Congress intended funds to have only temporary liabilities, as defined in Section 18(g), in addition to bank borrowings, it would certainly have included a cross-reference in Section 18(h).

Most derivatives—and certainly TRS—are not borrowings. Unlike a borrowing, they do not have any principal amount or face value, and funds do not have any obligation to repay a principal amount from inception. In this respect, TRS are more akin to a fund custodial contract, under which a fund will owe its custodian money every month for the foreseeable future. The key difference with a TRS is that, in the future, a fund may (or may not) owe money.

To close this "gap" in its authority, the Commission goes even further than asserting that Section 18 reaches all actual borrowings, like bank loans. It maintains that it also has authority under Section 18(f) to regulate *contingent* liabilities. There is no authority for this proposition and the only authority that the Commission cites for it is its own statements in Release 10666.[84]

If adopted as originally conceived, Section 21(c) of the Act would at least have supported the Commission's contention that all fund borrowings are impermissible as it would have prohibited all non-temporary borrowings by funds.[85] But Congress explicitly determined *not* to include that section in the 1940 Act, opting instead to include only those restrictions embodied in Section 18.[86] The Commission cannot now be allowed to impute into the statute restrictions Congress itself rejected.

This is particularly true, given that the Commission itself has long acknowledged that its jurisdiction over derivatives is questionable. In Release 10666, the Commission hedged that the derivatives considered therein "*may* involve the issuance of a security," and "*may* involve the issuance of an evidence of indebtedness," which "*may* be" a senior security.[87] The *1994 IM Memo* was even more direct: it noted that "a prohibition or restriction on derivatives use would be inconsistent with the general approach of the [1940 Act], which imposes few substantive limits on mutual fund investments."[88] That is likely why the Commission now resorts to invocations of statutory "purpose" rather than relying on the actual statutory text.[89] It defends its

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[84] Proposing Release, *supra* note 1, at 4451 n.41.

[85] *See* Senate Hearings Part 1, *supra* note 43, at 15 (a copy of S. 3580).

[86] If Congress had wanted to empower the Commission to regulate all borrowings, it could have inserted clear authorizing language in Section 18(f), as it did in other paragraphs of Section 18. *E.g.* 15 U.S.C. §§ 80a-18(f)(1), (f)(2) and (j). It did not do so.

[87] Release 10666, *supra* note 55 (Firm Commitment Agreement and Standby Commitment Agreement discussion). *See also id*. (Agreements as Securities discussion) (defending the conclusion that certain derivatives "may be" senior securities based on the fact that gains and losses from them, relative to capital invested can be "extremely large," giving such derivatives "speculative aspects"). (Emphases added.)

[88] *1994 IM Memo*, *supra* note 46, at 20. In a footnote to that statement, the Division went on to explain that "[t]he provisions in the [1940 Act] that prohibit or restrict certain types of investments are quite narrow. . . . The framers of the [1940 Act] specifically disavowed any attempt to prohibit speculative mutual fund investments." *Id.* at n.82.

[89] The Commission performed a similar magic trick in Release 10666, explaining that its conclusion that the derivatives discussed in the release fell within the "functional meaning" of the term "evidence of indebtedness" was "based not so much on the conclusion that [they], considered in isolation, are inherently securities for all purposes, but more upon the proposition that trading practices involving the use by investment companies of such agreements for speculative purposes or to accomplish leveraging

classification of swap contracts as "securities" by saying that the contrary view "would frustrate the concerns" underlying Section 18.[90] Broad appeals to a statute's "purpose," however, cannot prevail over its clear language.

THE COMMISSION DOES NOT HAVE AUTHORITY UNDER SECTION 18(F) TO ADOPT A VAR TEST TO REGULATE "LEVERAGE RISK."

VaR is a measure of risk and specifically, the Commission says, a measure of "leverage risk."[91] But here, Congress did not authorize the Commission to regulate risk in Section 18, and the Commission admits as much in the Proposing Release when it says, "Section 18 . . . does not directly limit a fund's level of risk or volatility."[92]

The Commission contends that its proposed VaR test is within its Section 18(f) authority "because it resembles the way that section 18 limits a fund's leverage risk." It similarly asserts that Section 18 envisioned a "practical limit" on leverage and that proposed Rule 18f-4 will merely restore such a practical limit.[93] In support of these assertions, the Commission notes that the legislative history of the 1940 Act reflected an interest in limiting funds' leverage and volatility, and these interests are reflected in Section 1(b)(7) and (8) of the Act.[94] As the Commission knows, however, its authority to make rules based on the policy considerations reflected in Section 1 of the Act is questionable.[95] Further, even if the Commission were empowered under Section 18 to regulate leverage, VaR does not regulate leverage.[96] The Commission itself says so in the Proposing Release:[97]

> [I]f a derivatives transaction reduces (or does not substantially increase) a fund's VaR relative to the VaR of the designated reference index, the transaction would not be restricted by the VaR test proposed in Rule 18f-4.

In other words, applying VaR, a fund can employ extreme amounts of leverage as long as a portion of such leverage is expected to reduce leverage risk. Which circles back to the issue of whether Section 18 empowers the Commission to regulate risk, which it does not. Section 18

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fall within the legislative purposes of Section 18." Release 10666, *supra* note 55 (Agreements as Securities discussion) (emphasis added).

[90] *See* Proposing Release, *supra* note 1, at 4452.

[91] *Id*. at 4453.

[92] *Id*. at 4471. *See also id.* at 4516 (describing VaR as restricting "the incremental risk associated with a fund's portfolio relative to a similar but unleveraged" strategy); *id.* at 4532 (saying that Section 18 itself imposes a specific limit on the amount of senior securities that a fund may issue, "regardless of the level of risk introduced or the disclosure that a fund provides regarding those risks").

[93] *Id*. at 4471.

[94] *Id*. at 4450 n.26.

[95] *Id*. at 4451 n.45.

[96] *Id*. at 4469.

[97] *Id*.

empowers the Commission to regulate the "issu[ance]" by funds of "senior securities." The Commission's proposal to impose a VaR limit on funds is pure administrative overreach.

SECTION 12(A) DOES NOT AUTHORIZE THE SEC TO REGULATE SWAPS.

Section 12(a) provides, as relevant here:

> It shall be unlawful for any registered investment company, in contravention of such rules and regulations or orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors—
>
> (1) to purchase any security on margin, except such short term credits as are necessary for the clearance of transactions;
>
> . . .
>
> or
>
> (3) to effect a short sale of any security, except in connection with an underwriting in which such registered company is a participant.[98]

In Release 7221, the Commission described the SEC Staff's view as being that a margin account is equivalent to a "borrowing."[99] Release 7221 does not state the converse—that any borrowing is equivalent to the purchase of a security on margin. Thus, even if TRS could be deemed to be borrowings, which they cannot, they would not necessarily be "purchases of securities on margin," within the meaning of Section 12(a), or transactions effected "on margin" through a "margin account."

To rely on Section 12(a) to promulgate the Derivatives Rules and reach all types of derivatives, the Commission would have had to explain in the Proposing Release how each such derivative constitutes either the "effect[uation] [of] a short sale of a[] security" or the "purchase [of] a[] security on margin" in order to provide an opportunity for comment. The Proposing Release does not include any such explanation.

Further, the Commission could not establish that TRS are transactions effected "on margin" or through a "margin account." As the Commission knows, "margin" is a term of art that refers generally to the borrowing of money by a customer from, for example, a broker-dealer, pursuant to Regulation T under the Federal Reserve Act, for deposit into its customer's

[98] Section 12(a)(2) allows the Commission to make rules regarding funds' participation "on a joint or a joint and several basis in any trading account in securities, except in connection with an underwriting in which such registered company is a participant." 15 U.S.C. § 80a-12(a). We do not address Section 12(a)(2) as the Proposing Release provides no reason for commenters to believe that the Commission relies on such section for authority to promulgate Rule 18f-4.

[99] Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221, 37 Fed. Reg. 12790 (June 9, 1972) ("Release 7221") (citing Item 4(b)—The Borrowing of Money in guideline entitled "Purchases on Margin").

brokerage account for trading in securities; and such borrowing is secured by the customer's assets in the account.[100] TRS are not purchased on margin or through a margin account. They also do not bear the hallmarks of purchases of securities on margin inasmuch as when entering into a TRS, a fund receives no money whatsoever from its counterparty. There is no borrowing; there is no money that changes hands; and, therefore, no money owed by the fund to its counterparty. Rather, in connection with a TRS, a fund either moves collateral (usually cash equivalents or securities) into an account that is controlled jointly by it and its counterparty when it is out-of-the-money (based on the market movements of the underlying reference asset); or it transfers the money owed to the counterparty and settles the transaction. The opposite, of course, occurs when a fund is in-the-money on a TRS. As a result, there is never any borrowing. Any assets moved into the tri-party account or paid to the counterparty by a fund are, and always were, fund assets. They were never the counterparty's assets and they do not represent a repayment of any sort. For these reasons, TRS cannot be reached under Section 12(a).

The Commission essentially admits in its proposed definition of "derivatives transaction" that not all derivatives, including TRS, may be reached as purchases of securities on margin. For this very reason, the definition reaches all instruments pursuant to which a fund is or may be required to make a payment "*whether as margin or settlement payment or otherwise*."[101] In short, as the Commission realizes, some such payments could not be characterized as margin payments because they are not.

Similarly, not all derivatives effectuate short sales of securities. As the Commission recognizes in the Proposing Release, some funds use derivatives to obtain long exposure to securities.[102] These derivatives could hardly be characterized effectuating short sales.

In sum, the Commission cannot rely on Section 12(a) to sweep all derivatives transactions into proposed Rule 18f-4.

THE COMMISSION'S AUTHORITY UNDER SECTION 38(A) DEPENDS ON ITS BEING EMPOWERED "ELSEWHERE" IN THE ACT TO MAKE A RULE.

The Commission cites Section 38(a) as a source of its statutory authority to promulgate proposed Rule 18f-4. Section 38(a), however, is not an affirmative source of rulemaking authority. Section 38(a) provides:

> The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the *powers conferred upon the Commission elsewhere in this title*, *including rules and regulations defining accounting, technical, and trade terms used in this title*, and prescribing the form or forms in which information required in registration statements, applications, and reports to the Commission shall be set forth. For the purposes of its rules or regulations the

[100] *E.g.*, 12 C.F.R. § 220.

[101] Proposed rule 18f-4(a) (to be codified at 17 C.F.R. § 270.18f-4(a)).

[102] *See* Proposing Release, *supra* note 1, at 4447.

> Commission may classify persons, securities, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, or matters.[103]

In simple terms, in order to enact a rule under Section 38(a), the SEC must identify a separate source of affirmative rulemaking authority "elsewhere" in the Act.

The Commission itself acknowledged as much in the adopting release for Rule 38a-1 under the Act. There, the Commission cited a litany of statutory rulemaking authority provisions for the rule being adopted,[104] acknowledging that Section 38(a) is not itself a grant of power.[105] Rather, in order to promulgate the Derivatives Rules, the Commission must rely either on its authority under Section 18(f) and/or Section 12(a). For the reasons discussed above, the Commission does not have the requisite statutory authority, and Section 38(a) does not change that.

THE COMMISSION CANNOT INVOKE SECTION 6(C) TO CONDITION AN EXEMPTION FROM SECTION 18(F) ON COMPLIANCE WITH THE SALES PRACTICE RULES.

Section 6(c) is the sole remaining statutory provision on which the Commission may rely to promulgate the Derivatives Rules. Under Section 6(c), the Commission may grant an exemption from any provision of the 1940 Act, provided it finds such exemption to be necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. And the Commission clearly intends to rely on Section 6(c) to adopt proposed Rule 18f-4. It even describes the rule in the first paragraph of the Proposing Release as "a new exemptive rule."

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[103] 15 U.S.C. § 80a-37(a) (emphasis added).

[104] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, at 74,728 n.133 (Dec. 24, 2003) ("Section 38(a) authorizes the Commission to "make . . . such rules and regulations . . . *as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in [the 1940 Act]*." We are adopting rule 38a-1 as necessary and appropriate to the exercise of the authority specifically conferred on us elsewhere in the Act, including sections 9(b) (authority to prohibit certain persons from serving in certain capacities with respect to investment companies), 31(b) (authority to examine funds), 36(a) (authority to bring actions for the breach of fiduciary duty); and 42 (authority to enforce the provisions…) of the [1940] Act [15 U.S.C. 80a-9(b), 80a-30(b), and 80a-41]. Further, requiring the maintenance of internal compliance policies and procedures and an annual compliance report falls under the authority granted to us under section 31(a), which authorizes us to require funds to maintain and preserve records, including memoranda, books, and other documents.") (emphasis added).

[105] This narrow reading of Section 38(a) comports with its legislative history. As originally proposed, it would have authorized the Commissions to adopt rules "necessary or appropriate to carry out the provisions" of the Act. As adopted, however, following a robust debate in the Senate, it only authorizes the SEC to adopt rules "necessary or appropriate to the exercise of the functions and powers conferred upon the SEC elsewhere" in the Act. *See* Senate Hearings Part 1, *supra* note 43, at 24 (a copy of S. 3580).

The Commission may only use its authority under Section 6(c) to exempt registrants from restrictions actually imposed by the Act, however. If the Act does not impose a restriction, the Commission cannot grant an exemption from such restriction, conditionally or otherwise. Yet that is what the Commission is attempting to do here. Specifically, here, the Commission seeks to condition an exemption from Section 18(f) for leveraged/inverse funds on compliance by intermediaries with the Sales Practice Rules.

The Commission's effort, however, must fail. First, as discussed above, Section 18(f) does not restrict funds' usage of derivatives; accordingly, leveraged/inverse funds do not need an exemption from Section 18(f) to invest in them.

Second, the Commission cannot tie any exemption provided to them from Section 18(f) to compliance by intermediaries with the Sales Practice Rules for several reasons. To begin, funds have no control over intermediaries' regulatory compliance efforts at all, whether with the Sales Practice Rules or otherwise. Accordingly, their ability to rely on an exemption like Rule 18f-4 cannot depend on such third parties' compliance efforts. Further, there is no precedent for tying one registrant's exemption to performance by a third party of an unrelated obligation.

Third, the Commission cannot contend that compliance by intermediaries with the Sales Practice Rules is a condition of any exemption granted by proposed Rule 18f-4 as intermediaries are not funds and, therefore, have no 1940 Act compliance requirements.

Finally, the Commission cannot condition an exemption from Section 18, which the Commission contends is in place to limit funds' leverage, on compliance with a condition that has nothing to do with leverage.[106] Such a condition is a detour around not only the statutory text of Section 18, but also the legislative intent on which the Commission so heavily relies in asserting the "investor protection" purposes of proposed Rule 18f-4.

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[106] *See, e.g.,* Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988) ("It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress"); Am. Library Ass'n v. FCC, 406 F.3d 689 (D.C. Cir. 2005) ("categorically reject[ing]" the argument that an agency has "plenary authority to act within a given area simply because Congress has endowed it with some authority to act in that area").

THE SALES PRACTICE RULES ARE UNLAWFUL.[107]

The Commission's promulgation of the Sales Practice Rules would be unlawful for two primary reasons. First, Commission lacks the statutory authority to use "sales practice" rules to regulate self-directed investors who are buying and selling securities for their own accounts.[108] The proposed rule clashes with Section 913(*l*)'s text, context, and legislative history, not to mention the established history of sales practice rules—all of which apply to overt actions by broker-dealers directed at investors. For that reason alone, the Commission cannot lawfully finalize the rules on the basis of the cited statutory authorities.

Second, even if the Commission had the necessary statutory authority to promulgate the Sales Practice Rules, the Commission's promulgation of the proposed rules would still be unlawful because the Commission has failed to comply with the requirements of the APA. The APA forbids agencies to take actions that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" or that is "unsupported by substantial evidence."[109] The Commission's promulgation of the Sales Practice Rules would fall short of that standard for several reasons. Among them: The Commission lacks the evidentiary record to support the sales practice rules. The Commission fails to acknowledge or explain its departure from the reasoning underlying its 2008 and 2009 Exemptive Orders. The Commission imposes an options-like regulatory regime on leveraged/inverse funds without establishing either that leveraged/inverse funds are options-like or a record of abuses similar to those that led up to the imposition of the options rules. The Commission departs from its recent effort to facilitate individual investors' ability to invest in unregistered securities. The Commission distinguishes between similar products in a manner that will encourage regulatory arbitrage. Further, the Sales Practice Rules would require broker-dealers to micromanage even self-directed investors' investments. For all of these reasons, based on the record provided, the Commission cannot lawfully finalize the rules, as proposed.

THE COMMISSION LACKS THE STATUTORY AUTHORITY TO PROMULGATE PROPOSED RULE 15*L*-2.

THE PROPOSED RULE IS NOT A "SALES PRACTICE" RULE.

In 2010, Section 913*(l)* of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") codified Section 15*(l)* of the Exchange Act as part of Title IX, "Investor

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107 Although this discussion focuses on proposed Rule 15*l*-2, it would apply equally to proposed Rule 211(h)-1, to the extent that proposed Rule 211(h)-1 could similarly be applied to self-directed investors.

108 *See* City of Arlington, Tex. v. FCC, 569 U.S. 290, 307 (2013) (noting that an "agency cannot go beyond" the "statutory limits on [its] authority"); Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (striking down SEC rule regulating hedge funds under the 1940 Act as in conflict with the governing statute).

109 5 U.S.C. § 706(2)(A), (E).

Protections and Improvements to the Regulation of Securities."[110] Section 15*(l)*(2) of the Exchange Act grants the Commission authority to:

> examine and, where appropriate, promulgate rules prohibiting or restricting certain *sales practices*, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.[111]

Proposed Rule 15*l*-2 purports to be a "sales practice" rule. It directs, in relevant part:

> (b) Diligence in approving accounts. (1) *In determining whether to approve a customer's account to buy or sell leveraged/inverse investment vehicles*, the broker or dealer must exercise due diligence to ascertain the essential facts relative to the customer, his or her financial situation, and investment objectives, including, at a minimum, the information specified in paragraph (b)(2) of this section (and must seek to obtain information for all participants in a joint account). Based upon this information, *the broker or dealer must specifically approve or disapprove the customer's account for buying and selling shares of leveraged/inverse investment vehicles*. An approval of a customer account must be in writing. A broker or dealer may provide this approval if the broker or dealer 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.[112]

Proposed Rule 15*l*-2 thus essentially imposes a classic "suitability" inquiry on the broker-dealer—namely, having a "reasonable basis for believing that the client [is] capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles"—in a completely new and novel context—namely, by applying it to the broker-dealer's determination of "whether to approve a customer's account to buy or sell leveraged/inverse investment vehicles."

Suitability requirements have traditionally applied only to recommendations or solicitations of securities, investments or otherwise to assertions of discretion over a client's account. In sharp contrast, however, the Commission has expressly confirmed that proposed Rule 15*l*-2 would apply "where *no* recommendation or investment advice is provided by the firm."[113] As a result, the proposed "sales practice" rule captures all broker-dealers providing client-directed, execution-only and/or clearance and settlement services *at the express direction of a customer*, *without* any prior recommendation, inducement, promotion or solicitation. In short, proposed Rule 15*l*-2 does not regulate a "sales practice," at least with respect to self-

[110] Pub. L. No. 111-203, 124 Stat. 1376 (codified in scattered sections of 12 U.S.C and 15 U.S.C.).

[111] 15 U.S.C. § 80b-11(h)(2) (2020) (emphasis added).

[112] Proposing Release, *supra* note 1, at 4558 (proposed to be codified at 17 C.F.R. § 240.15*l*-2(b)(1) (emphases added)). Paragraph (b)(2) of the proposed rule requires broker-dealers to obtain the information listed in Section III.B, *supra.*

[113] *Id*. at 4493 (emphasis added).

directed transactions. Rather, it captures a class of intermediaries that engage in no sales practices whatsoever and impose suitability obligations that have *never* before been required by the Commission in connection with transactions in any other type of registered security.

As explained above, the statute permits the Commission to promulgate rules "prohibiting or restricting certain *sales practices*."[114] And the traditional tools of statutory interpretation indicate that the text of the statute means precisely what it says: the Commission may regulate sales practices. Both the D.C. Circuit and the Supreme Court have "categorically reject[ed]" any suggestion that an agency "possesses plenary authority to act within a given area simply because Congress has endowed it with some authority to act in that area."[115] "Agencies owe their capacity to act to the delegation of authority from Congress," and the Commission therefore "literally has no power to act . . . unless and until Congress confers power upon it."[116] But the proposed rule would apply even "where *no* recommendation or investment advice is provided by the firm."[117] As a result, the proposed rule purports to regulate activity that the statute does not: broker-dealers providing client-directed, execution-only and/or clearance and settlement services at the direction of the customer, *without* any prior sales recommendation. Thus, if the Commission were to finalize the proposed rule, the Commission would step beyond the boundaries of its statutory delegation of authority.

In *Financial Planning Ass'n v. SEC*, the D.C. Circuit invalidated a comparable Commission rule that unlawfully exceeded the scope of the Commission's congressionally delegated authority. The statute at issue there defined the category of regulated investment advisers broadly to include any person who is paid to advise others regarding securities.[118] The statute then exempted several categories of persons from regulation and gave the Commission authority to exclude "such other persons not within the intent of this paragraph, as the Commission may designate."[119] One of the statutory exemptions applied to broker-dealers who gave investment advice incidental to their normal business activities and "receive[d] no special compensation therefor."[120] The SEC issued a final rule that broadened the exemption for broker-dealers to apply even when they did receive special compensation. The D.C. Circuit held that this rule violated both limitations on the SEC's rulemaking authority: The rule was outside the intent of the statute because the text already provided an exemption for broker-dealers and there was no intent that the exemption's reach should be broadened. Moreover, because broker-

[114] 15 U.S.C. § 80b-11(h)(2) (emphasis added).

[115] Am. Library Ass'n. v. FCC, 406 F.3d 689, 708 (D.C. Cir. 2005).

[116] *Id*. (quoting Ry. Labor Executives' Ass'n v. Nat'l Mediation Bd., 29 F.3d 655, 670 (D.C. Cir. 1994) (en banc) and La. Pub. Serv. Comm'n v. FCC, 476 U.S. 355, 374 (1986)).

[117] Proposing Release, *supra* note 1, at 4493 (emphasis added).

[118] 15 U.S.C. § 80b–2(a)(11).

[119] § 80b–2(a)(11)(H).

[120] § 80b–2(a)(11)(C).

dealers were already specifically addressed in the statutory text, they did not constitute "such other persons not within the intent of this paragraph."[121]

Similarly, here, the relevant statute makes clear who should be regulated: any person who engages in sales practices. The Commission's interpretation would unduly broaden its scope and regulate persons who *do not* engage in sales practices. The statute cannot be broadened in that way because it is clearly contrary to Congress's intent in enacting the statute, and the Commission cannot promulgate a rule that exceeds the boundaries of its statutory authority, as conferred on it by Congress.[122]

BECAUSE PROPOSED RULE 15*L*-2 DOES NOT REGULATE "SALES PRACTICES," THE COMMISSION LACKS THE STATUTORY AUTHORITY TO PROMULGATE THE PROPOSED RULE.

In assessing the lawfulness of a proposed rule, courts ordinarily apply the familiar standards of review enunciated by the Supreme Court in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*,[123] which grants an agency substantial freedom to "make policy choices in interpreting the statute."[124] But courts "do not apply *Chevron* reflexively"; they "find ambiguity only after exhausting ordinary tools of the judicial craft."[125] Moreover, each of the ordinary tools of statutory interpretation—the text of the statute itself, the context in which it was enacted, the legislative history, the agency's earlier pronouncements on the subject, the court's interpretations of the statutory language, and more—indicates that the Commission lacks the statutory authority to impose a suitability requirement on customer-directed transactions.

THE STATUTORY TEXT INDICATES THAT A "SALES PRACTICE" REQUIRES AN OVERT ACT DIRECTED AT AN INVESTOR.

The starting point for our analysis is the text of the statute itself. The statute permits the Commission to promulgate rules "prohibiting or restricting *certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers* that the Commission deems contrary to the public interest and the protection of investors."[126] The Commission therefore has the ability to promulgate "for brokers, dealers, and investment advisers" rules that "prohibit[] or restrict[]" their "sales practices, conflicts of interest, and compensation schemes."

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[121] *See Financial Planning*, 482 F.3d at 488.

[122] *Id.*

[123] 467 U.S. 837 (1984).

[124] Arent v. Shalala, 70 F.3d 610, 615 (D.C. Cir. 1995).

[125] Mozilla Corp. v. FCC, 940 F.3d 1, 20 (D.C. Cir. 2019) (citing Kisor v. Wilkie, 139 S. Ct. 2400, 2414–15 (2019)).

[126] *E.g.*, 15 U.S.C. § 80b-11(h)(2) (emphasis added).

"Under the canon of *noscitur a sociis*, a word is generally known by the company it keeps."[127] So those three phrases—"sales practices, conflicts of interest, and compensation schemes"—have to be read in keeping with each other. They are also a closed set. There is no broader, more generalized action or practice included in that list of three. And each of those three pertains to an *action taken by a broker, dealer, or investment adviser*, directed at a client.

THE HISTORY OF THE TERM "SALES PRACTICE" CLARIFIES THE NEED FOR AN OVERT ACT DIRECTED AT AN INVESTOR.

Congress knew what it was doing when it used the phrase "sales practices"; it has a decades-long familiarity with the meaning of that phrase. The rule Congress considered as the predominant model for purposes of extending sales practice rules to government securities was the NASD (now FINRA) suitability rule, which requires a firm, *when making a recommendation* of a security or an investment strategy, to have a reasonable basis to believe the recommended investment or strategy is suitable for the customer, based on relevant facts and information about the customer.[128] Indeed, suitability was one of the first sales practices rules adopted by the NASD as part of its original mandate as a national securities association;[129] the suitability rule was codified in the original Rules of Fair Practice in 1939. [130]

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[127] Agnew v. Gov't of the District of Columbia, 920 F.3d 49, 56 (D.C. Cir. 2019).

[128] *See* Government Securities Act Amendments of 1993, Report of the Committee on Banking, Housing, and Urban Affairs, S. REP. 103-109, at 11–14 (1993) [hereinafter GSAA Report]. The GSAA Report cited to reports and testimony that highlighted a need for a suitability rule in the government securities market. *Id*. at 4 and 10–13. At the time, the NASD's suitability rule was codified in Article III, section 2 of the NASD's Rules of Fair Practice, and the NASD proposed to extend its sales practice suitability rule to government securities broker-dealers by interpretation of its Board of Governors. *See* Notice to Members 94-62 (Aug. 1994). The NASD subsequently proposed to integrate all of its government securities rules—the proposed suitability interpretation and back-office rules—into its Rules of Fair Practice. *See* Notice to Members 95-21 (April 1, 1995). The GSAA also directed the banking regulators to adopt sales practice rules similar to the NASD's to apply to banks engaged in the government securities business, and the banking regulators (the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation), collectively, proposed a sales practice rule for *recommended* transactions which imposed suitability obligations similar to the NASD's suitability rule. Government Securities Sales Practices, 61 Fed. Reg. 18,470 (proposed Apr. 25, 1996) (to be codified at 12 C.F.R. pts. 13, 208, 211, 368). Other sales practice rules substantively considered by the NASD and/or banking regulators were fair mark-ups and general fair dealing. The Commission granted an order to, among other things, adopt the NASD's suitability interpretation as a sales practices rule applicable to government securities recommendations in Exchange Act Release No. 37,588, 61 Fed. Reg. 44,100 (Aug. 27, 1996) [hereinafter SEC Order]. *See also* Government Securities Sales Practices, 62 Fed. Reg. 13,276 (Mar. 19, 1997) (to be codified at 12 C.F.R. pts. 13, 208, 211, 368).

[129] Act of June 23, 1938, ch. 677, Section 1, 52 Stat. 1070 (1938).

[130] *See* NASD, Certificate of Incorporation and By-Laws, Rules of Fair Practice and Code of Procedure for Handling Trade Practice Complaints 39 (1939).

In 1963, the Commission submitted a comprehensive, six-part study to Congress that addressed, in part, "selling practices" of broker-dealers and their salesmen.[131] The Special Study devoted nearly a hundred pages to "selling practices," which the Commission identified as advertising, sales promotion, and point-of-contact selling, all forms, according to the Commission, of "merchandising securities." [132] According to the Special Study, "the NASD rule on suitability has the most far-reaching potential for dealing with improper selling practices, and for the most part the NASD has interpreted the rule in ways which strengthen its impact." [133]

In 1993, Congress expressly granted authority for the NASD's sales practice rules to extend to government securities brokers and dealers. The Government Securities Act Amendments of 1993 ("GSAA")[134] subjected government securities broker-dealers to sales practice duties that, other than as previously provided by general anti-fraud proscriptions, had not previously been applied to firms exclusively conducting a government securities business. The focus of the GSAA was to apply sales practice rules to *recommended* transactions, where high pressure sales tactics and inappropriate investments were directed at investors.[135]

The GSAA's focus on suitability was derived, in part, from the sales practice considerations of the General Accounting Office ("GAO"), as described in a GAO report recommending a system of sales practice regulation for the government securities market.[136] The GAO looked at the sales practices of churning, fair mark-ups, and suitability of recommended transactions as relevant NASD sales practice rules to be extended to the government securities market.[137] According to the GAO, suitability means that a firm "cannot *excessively trade* a customer's account, *recommend* a purchase beyond the customer's ability, or *recommend* speculative securities inappropriate for the investor's objectives."[138] All of these sales practices are premised on an overt action directed at a customer.

FINRA's options rules regulate sales practices around options transactions substantially similarly. There are two relevant parts of FINRA's options rule: an account-opening/"know-your-customer" due diligence part (Rule 2360(b)(16)); and a suitability part (Rule 2360(b)(19)). According to the Commission, the proposed Sales Practice Rules are just like FINRA's options rules. But that is *not* correct.

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[131] *See* SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS 244 (Apr. 3, 1963) [hereinafter Special Study].

[132] *Id.*

[133] *Id*. at 311.

[134] GSAA Report, *supra* note 128.

[135] *Id.*

[136] *Id.* at 4.

[137] U.S. GOVERNMENT SECURITIES: MORE TRANSACTION INFORMATION AND INVESTOR PROTECTION MEASURES ARE NEEDED, GAO REPORT TO CONGRESSIONAL COMMITTEES 46 (Sept. 1990).

[138] *Id*. at 55 (emphasis added).

Under FINRA's options rule, broker-dealers are only required to do due diligence before opening a customer's account and accepting self-directed orders from the customer. They are not required to make a suitability determination unless or until they *recommend* an options transaction to the customer.[139] Rule 2360(b)(19) requires a broker-dealer (or "firm"), when *making a recommendation*, to have "a reasonable basis for believing . . . that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks . . . and is financially able to bear the risks of the recommended position . . . "[140] The Sales Practice Rules meld these two separate requirements into one. As a result, under the Sales Practice Rules, broker-dealers would be required to conduct due diligence on a customer *and* make a suitability determination, all before allowing the customer to open an account and conduct self-directed trades in leveraged/inverse investment vehicles.

Proposed Rule 15*l*-2 thus strips out the critical limiting feature of FINRA's option rule, namely, the need for a recommendation to trigger the need for a suitability determination. Although the Commission repeatedly describes the Sales Practice Rules as merely imposing a "due diligence requirement,"[141] they actually do much more than that. They require intermediaries to exercise due diligence *and make a suitability determination* about the appropriateness of leveraged/inverse investment vehicles for an investor at the time of account opening. Given this key difference between the options rules and the Sales Practice Rules, they cannot reasonably be compared.

THE SEC'S AND FINRA'S OWN PAST STATEMENTS CONFIRM THAT SALES PRACTICES INVOLVE OVERT ACTS DIRECTED AT INVESTORS.

Congress is not the only body to have interpreted "sales practice" rules as governing sales practices. The SEC itself and NASD (now FINRA) previously have interpreted the phrase, too.

In 1967, the Commission adopted its own suitability rule, Rule 15b10-3 under the Exchange Act, to apply to SEC-only ("SECO") registered broker-dealers when they *recommend* securities transactions.[142] (The Commission has since withdrawn this rule in light of the termination of the SECO program.) In 1978, the Commission observed "that a securities *recommendation* must not be unsuitable for a customer . . . [that suitability] is a key element in a broker-dealer's obligation to deal fairly with its customers."[143] Then again in 1996, the Commission concluded that the concepts of suitability "lay the foundation for good and sound business practices by broker-dealers and help avoid potential abusive sales practices regarding

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[139] FINRA Rule 2360(b)(19)(A)-(B).

[140] FINRA Rule 2360(b)(19)(B).

[141] *See e.g.*, Proposing Release, *supra* note 1, at 4511, 4522–23.

[142] Exchange Act Release No. 7984 at 3 (Oct. 25, 1966).

[143] REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS TO THE SECURITIES AND EXCHANGE COMMISSION 338 (Dec. 22, 1978) [hereinafter Options Study] (emphasis added).

customers."[144] Following suit, FINRA has stated that it "is axiomatic that the suitability rule applies *only* to *recommended* transactions."[145]

The Commission has also explained what suitability requirements do *not* attach to—namely, self-directed transactions. In this regard, the Commission has explained that an evaluation of an investor's financial situation and suitability "would not apply to situations where a broker-dealer functions solely as an order taker and executes transactions for persons who on their own initiative decide to purchase a [security] absent a recommendation from the broker-dealer."[146]

In this same vein, FINRA (when NASD) has explained that a firm acting as a mere "order taker," in the absence of a recommendation, does not have suitability obligations.[147] Indeed, the President of FINRA (when NASD) testified before Congress that the application of sales practice regulation requires a "'careful balancing process [to ensure] investor protection without—and I emphasize—without making the securities industry insurers [of] the performance of the investment itself.'"[148]

At least one federal court has come to the same conclusion. The United States Court of Appeals for the Seventh Circuit explained over 25 years ago, in *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, that "customer-directed transactions fall outside the 'suitability' requirement."[149] In *Associated Randall Bank*, the Seventh Circuit considered and rejected a plaintiff's argument that its securities broker should have recognized that a pool of high-risk instruments was unsuitable for the plaintiff, and stopped the transaction. As the court explained, "[f]ederal securities law . . . requires brokers and dealers acting as agents to procure

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[144] SEC Order, *supra* note 128, at 44,111.

[145] FINRA Regulatory Notice 11-02, Know Your Customer and Suitability at n.26 (January 2011).

[146] Exchange Act Release No. 26,529, 54 Fed. Reg. 6693, 6697 (proposed Feb. 14, 1989) (proposing Rule 15c2-6). *See also* Exchange Act Release No. 27,160), 54 Fed. Reg. 35,468, 35,476–77 (Aug. 28, 1989) (in adopting Rule 15c2-6, the Commission noted that the rule regulated "sales practices of broker-dealers active in the market for low-priced, non-NASDAQ over-the-counter . . . securities," affirming that this sales practice rule did not apply to customer-directed trades, only those that were recommended consistent with longstanding suitability principles). Ultimately, Rule 15c2-6 became part of the sales practice rules authorized by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101-429, 104 Stat. 931 (Oct. 15, 1990) (the "Penny Stock Act"). *Infra* notes 163–70 and surrounding text. Rule 15c2-6 ultimately became Rule 15g-9 (codified at 17 C.F.R. §15g-9). Notably, and like its predecessor, Rule 15c2-6, the customer information and suitability requirements of Rule 15g-9 apply solely to *recommended* transactions. *Id.*

[147] NASD Notice to Members 01-23 (April 2001). *See also* NASD Notice to Members 96-60 (Sept. 1996) ("A member's suitability obligation . . . applies only to securities that have been recommended by the member. It would not apply, therefore, to situations in which the member acts solely as an order-taker for persons who, on their own initiative, effect transactions without a recommendation from the member").

[148] GSAA Report, *supra* note 128, at 13–14. *See also* Options Study, *supra* note 143, at 338 (Commission stating that: "[t]he suitability requirement does not attempt to make a registered representative, or the brokerage firm for which he works, an insurer of favorable investment performance").

[149] *Associated Randall Bank*, 3 F.3d at 212.

'suitable' securities," "but federal law requires this *only when the agents exercise discretion* over the accounts."[150] In addition, the plaintiff in *Associated Randall Bank* "demanded, and exercised, the final say, rejecting at least 15% of [the defendant broker's] recommendations."[151] Federal securities law "therefore did not require [the defendant broker] to recommend only securities 'suitable' to the [plaintiff's] portfolio; the [plaintiff] could decide for itself which instruments were appropriate."[152] The court said that this would be "especially" true, where an intermediary "provides the customer with a prospectus or comparable information" – as is the case with all purchases of leveraged/inverse funds.[153]

THE SALES PRACTICE RULES FLY IN THE FACE OF THE LEGISLATIVE HISTORY OF THE STATUTE.

The legislative history of the Dodd-Frank Act further supports interpreting sales practices to require an overt act by an intermediary toward an investor for two reasons. First, the underlying sales practice concerns targeted by its Section 913 and expressly recognized by Congress were "not to allow brokers to *push* higher commission products that may be inappropriate for a particular client."[154] Individual investors' self-directed trades are not the result of a broker-dealer "pushing" any products on investors. The business model of self-directed, execution-only, and clearing firms is to act upon the direction of the customer, which their low-price structure reflects. Because of their limited interaction with customers—and particularly the lack of recommendations or advice—certain of these firms provide investment platforms to the public with *zero* commission costs or, if commissions are assessed at all, at steeply discounted rates. And whatever the form of compensation system, it applies neutrally to all investments across the platform. Thus, conflicts of interest from a broker-dealer's "compensation schemes" are minimal to non-existent. Indeed, precisely because they engage in no sales practices, they have no incentive to recommend one type of product over another. The choice is entirely the customer's.

Second, as Senator Barney Frank explained in considering the bills that ultimately became the Dodd-Frank Act, "[Dodd-Frank] doesn't ban products or ration products."[155] Yet proposed Rule 15*l*-2 functionally may do precisely that. By establishing a new and unprecedented suitability rule in the absence of any sales practice, proposed Rule 15*l*-2 may effectively ban or ration access to leveraged/inverse investment vehicles, contrary to the statute's clear intent. Self-directed, execution-only, and clearing firms will be required under the rule to correctly identify securities of every "leveraged/inverse investment vehicle" and conduct a detailed suitability analysis for all individual investors that seek to trade them, *even for existing self-directed accounts*. This customer information is not currently required by any other

[150] *Id.* (emphasis added).

[151] *Id.*

[152] *Id.*

[153] *See supra* at 8–12.

[154] 156 CONG. REC. S4070 (daily ed. May 20, 2010) (statement of Sen. Patrick Leahy) (emphasis added).

[155] 156 CONG. REC. H5255 (daily ed. June 30, 2010) (statement of Rep. Barney Frank).

Commission rule for any other registered security. This will require these firms to invest a significant amount of time and money to develop and update their systems to comply with the Sales Practice Rules. And all of this may open firms up to lawsuits from customers arguing that they should not have been determined to be "capable of evaluating the risks associated with these products,"[156] and therefore should be compensated for any losses.

In sum, the real effect of proposed Rule 15*l*-2 will likely be to "ban" these funds. Firms will exit altogether the business of executing and clearing customer-directed transactions in leveraged/inverse investment vehicles in order to avoid being forced by regulation to screen, and bear the losses incurred by, customers in connection with their own investment decisions. This contravenes the directives of the Congress that adopted the statute and clear statements from the Commission itself that this is not how suitability should work.[157]

THE COMMISSION LACKS A CONGRESSIONAL DIRECTIVE TO REGULATE LEVERAGED/INVERSE INVESTMENT VEHICLES.

The Commission has never before targeted a specific investment product in the absence of a congressional mandate. Indeed, it has rarely exercised its limited authority to adopt sales practice rules at all. Instead, the Commission typically, and appropriately, leaves sales practice regulation to FINRA and the other SROs.[158]

In the rare circumstances where the Commission has adopted sales practice rules targeted at a specific product and/or market, the rulemaking was the result of an explicit mandate from Congress.[159] For instance, in 1990, Congress adopted the Penny Stock Act,[160] which amended the Exchange Act to give the Commission express rulemaking authority over the penny stock market and its participants.[161] Prior to Congress formalizing the Commission's authority in this area under the Penny Stock Act, the Commission had adopted a sales practice rule under its

[156] Proposing Release, *supra* note 1, at 4493. *See infra* at 68-69.

[157] *See* Options Study, *supra* note 143, at 338 (where the Commission stated that "[t]he suitability requirement does not attempt to make a registered representative, or the brokerage firm for which he works, an insurer of favorable investment performance").

[158] *See* 15 U.S.C. §78o-3(b)(6) (rulemaking authority of FINRA). FINRA's rulemaking authority explains many of the aspects of FINRA's options rules, which are discussed at length below. Many aspects of those rules pertain to a broker-dealer's "back office" functions, such as operations and recordkeeping, in addition to "front-office" functions, such as sales. Importantly, however, not all broker-dealer firms need to comply with all FINRA rules. For example, firms that do not have a "front-office" (*i.e.*, sales) function and do not engage in sales do not need to comply with FINRA's sales practice rules.

[159] In 1975, the Commission did invoke its general antifraud authority to regulate offers, sales, and inducements in so-called equity-funded contracts, which essentially involved offers of credit in connection with a type of insurance at the time. *See* 17 C.F.R. § 240.15c2-5. There, however, the Commission targeted its regulation to unscrupulous sales practices directed at customers through inducements of credit financing. In short, Rule 15c2-5 was the Commission's version of "Truth in Lending" to reach firm inducements to clients to enter into equity funding contracts.

[160] *See supra* note 146.

[161] *See, e.g.*, 15 U.S.C. § 78o(g).

general antifraud rulemaking authority, Rule 15c2-6,[162] to address the high-pressure sales tactics plaguing the penny stock industry.

Rule 15c2-6 ultimately became Rule 15g-9 under the Exchange Act and is part of the Commission's comprehensive penny stock regulatory regime. Rule 15g-9 requires broker-dealers effecting transactions in penny stocks, (1) as a condition to approving the customer's account, to obtain financial information from the customer, the customer's investment experience, and investment objectives; and (2) based on that information "reasonably determine . . . that the transactions in [penny stocks] are suitable for the person, and that the person (or the person's independent adviser in these transactions) has sufficient knowledge and experience in financial matters that the person . . . reasonably may be expected to be capable of evaluating the risks of transactions in [penny stocks]."[163] The text of Rule 15g-9 thus is remarkably similar to proposed Rule 15*l*-2.

What is materially different, however, is that Rule 15g-9 applies—again, just like FINRA's options rule—solely to *recommended* transactions where a sales practice actually occurs.[164]

Also, in stark contrast to the record presented by the Commission in the Proposing Release for the Sales Practice Rules, the record supporting regulation of penny stocks was robust and specific. The Penny Stock Report described "rampant fraud and manipulation" in the penny stock market and reported that "[p]enny stock swindles are now the No. 1 threat of fraud and abuse facing small investors in the United States."[165] The Penny Stock Report estimated that penny stock fraud cost investors over $2 billion annually,[166] noted that the Commission established a special task force focused on penny stock fraud,[167] and conducted a coordinated sweep with state regulators of 130 main offices and 30 branch offices of penny stock firms, which at the time was the largest coordinated nationwide effort undertaken by securities regulators.[168] Additionally, in the two years prior to the adoption of the Penny Stock Act, the Commission reported that it had initiated 25 enforcement actions for fraud and abuse in the penny stock market and, at the time of adopting Rule 15c2-6, one of its regional offices alone had initiated more than 30 penny stock enforcement actions,[169] with more than 40 additional pending actions.[170]

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[162] *See supra* note 146.

[163] 17 C.F.R § 240.15g-9(b)(1)-(2).

[164] *Id.* at § 240.15g-9(c)(1).

[165] H. REP. NO. 101-617, 101st Cong., 2d Sess., at 8 (1990) ("Penny Stock Report").

[166] *Id.* at 10.

[167] *Id.* at 16.

[168] *Id.* at 17.

[169] Exchange Act Release No. 27,160, 54 Fed. Reg. 35,468, 35,470 (Aug. 28, 1989).

[170] *Id*.

The Commission has no such mandate from Congress here. Further, as we discuss below, it has established no record of fraud and abuse of investors in leveraged/inverse investment vehicles, particularly self-directed investors, which supports the extreme action of targeting leveraged/inverse investment vehicles as the Sales Practice Rules do.

THE SALES PRACTICE RULES ARE ARBITRARY AND CAPRICIOUS

Even if the Commission had the statutory authority to use "sales practice" rules to require broker-dealers to judge investors' suitability to buy and sell securities *by and for themselves*, and even if the Commission had sufficient evidence to support its proposal, the Commission's promulgation of the proposed rules would still be unlawful.

THE COMMISSION LACKS THE EVIDENTIARY RECORD NECESSARY TO SUPPORT THE SALES PRACTICE RULES.

The APA requires that an agency show a "rational connection between the facts found and the choice made,"[171] and act consistently with "the congressional mandate from which it derives authority."[172] The Commission fails to clear this bar. Section 913(*l*) requires the Commission to "examine" sales practices, conflicts of interest, and compensation schemes as a condition precedent to embarking on any rulemaking initiatives pursuant to Section 913(*l*). The Commission omitted this phrase when it expressly cited its authority for proposing Rule 15*l*-2.[173] And the omission is telling: the "examination" in support of proposed Rule 15*l*-2 is completely inadequate.

Compare the record built by the Commission to support the proposed rules to previous records built by the Commission when promulgating similar new rules. The record for its penny stock sales-practice rules was robust, as noted above. Indeed, 20 years before adopting its penny stock rules, the Commission took up the question of promulgating specific rules tailored to options.[174] Although the Commission sought to act quickly, it delayed rulemaking in the area to engage in an extensive study (the "Options Study") of the options market and options sales practices.[175] As part of the Options Study, SEC staff reviewed over 150 options examinations of broker-dealers, reviewed the options complaint files of the SEC, SROs and brokerage firms of all sizes, interviewed compliance and sales personnel at brokerage firms, and reviewed surveys completed by options investors. Based on the information obtained during the Options Study, the SEC reported that "significant problems related to options selling practices were found.

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[171] Burlington Truck Lines, Inc. v. United States, 371 U.S. 156, 168 (1962).

[172] Farmers Union Cent. Exch. Inc. v. FERC, 734 F.2d 1486, 1500 (D.C. Cir. 1984).

[173] Proposing Release, *supra* note 1, at 4493 n.319.

[174] The Commission previously proposed Rule 9b-2 under the Exchange Act (*see* Exchange Act Release No. 9994, 38 Fed. Reg. 4884 (proposed Feb. 23, 1973)), a suitability rule, which it later revised (Exchange Act Release No. 10,550, 38 Fed. Reg. 35,334 (proposed Dec. 27, 1973)), and ultimately withdrew (Exchange Act Release No. 18,558 (March 11, 1982), 47 Fed. Reg. 11,704 (proposed Mar. 18, 1982)).

[175] Options Study, *supra* note 143.

These problems included *solicitation* of options transactions unsuited to the customer . . . inadequately trained registered representatives and supervisors, [and] deceptive advertising and sales literature."[176] The Commission's study, which culminated in a 1,084-page report to Congress, covered extensive details of the options market, including options sales practices.

By contrast, here, the Commissions presents little to no empirical evidence of widespread abuse of investors in leveraged/inverse investment vehicles or widespread misunderstanding by investors of leveraged/inverse investment vehicles. Indeed, taking the Proposing Release at face value, it appears the Commission conducted no examination of the leveraged/inverse investment industry whatsoever in connection with the proposed rules.

The record reveals nine enforcement actions over the last eight years involving classic sales practice abuses,[177] including *recommending* unsuitable transactions in leveraged/inverse investment vehicles.

- Six of the actions involved a firm's failure to maintain a supervisory system, including written supervisory procedures ("WSPs"), reasonably designed to achieve compliance with applicable NASD and/or FINRA rules in connection with solicited transactions (*i.e.,* recommendations) of leveraged/inverse investment vehicles. In those cases, NASD and/or FINRA found such WSPs to be faulty because they did not include different requirements for supervising transactions in leveraged/inverse investment vehicles and traditional ETFs, and regulators found that the registered representatives who solicited the transactions did not have an adequate understanding of the products to make a suitability determination for their customers.[178]
- Two of the actions were brought against firms, Oppenheimer and Morgan Stanley, largely for adopting WSPs tailored to leveraged/inverse investment vehicles, then failing to implement them.[179] *Oppenheimer* was the lone action

[176] *Id*. at 289–90.

[177] Proposing Release, *supra* note 1, at 4492 n.315–16 and at 4494 n.331.

[178] *See* Morgan Stanley & Co. LLC, FINRA Letter of Acceptance, Waiver and Consent ("AWC") No. 20090181611 (May 1, 2012); Wells Fargo Advisors, LLC, et al., FINRA Letter of AWC No. 20090191139 (May 1, 2012); UBS Financial Services Inc., FINRA Letter of AWC No. 20090182292 (May 1, 2012); Citigroup Global Markets Inc., FINRA Letter of AWC No. 20090191134 (May 1, 2012); Stifel, Nicolaus & Company, Incorporated and Century Securities Associates, Inc., FINRA Letter of AWC Nos. 2012034576901 & 2011025493401 (Jan. 9, 2014); ProEquities, Inc., FINRA Letter of AWC No. 2014039418801 (Aug. 8, 2016). Subsequent to the issuance of the Proposing Release, the SEC brought an action against Wells Fargo Clearing Services, LLC, and Wells Fargo Advisors Financial Network, LLC (together, "Wells Fargo"), alleging that Wells Fargo registered representatives made unsuitable recommendations to advisory clients and brokerage customers to buy and hold certain leveraged/inverse funds, including as a result of Wells Fargo having inadequate compliance policies and procedures and not properly training personnel. *See* In the Matter of Wells Fargo Clearing Services, LLC, and Wells Fargo Advisors Financial Network, LLC, Investment Advisers Act Release No. 5451 (Feb. 27, 2020).

[179] *See* Oppenheimer & Co. Inc., FINRA Letter of AWC No. 2013038180801 (June 7, 2016) ("*Oppenheimer*"); In the Matter of Morgan Stanley Smith Barney, LLC, Advisers Act Rel. No. 4649

among the nine cited by Commission involving unsolicited transactions, and FINRA's principal complaint with respect to such accounts was that the firm had adopted WSPs to allow such transactions in leveraged/inverse funds only by pre-qualified investors, then failed to pre-qualify all customers who traded them.

- The final action, *Hallas*, involved such extreme abusive practices that it lead to a criminal conviction of the registered representative for grand larceny.[180] In that case, a registered representative purchased and sold leveraged/inverse investment vehicles for customer accounts knowingly or in recklessly disregard of the fact that these products were unsuitable for them. In addition, he misappropriated $170,750 from a customer and used it for personal expenditures.

The very fact that the abuses at issue in these actions resulted in enforcement provides evidence that a *robust regulatory regime and remedies already exist for such abuses*. Further, these enforcement actions do not justify in any way subjecting *customer-directed* trades to any kind of suitability standard.

The Commission also cites a ten-year-old paper discussing disclosure relevant to leveraged/inverse investment vehicles and the potential for investors to misunderstand how they will perform if held for an extended period of time.[181] The bulk of leveraged/inverse funds being targeted by the Sales Practice Rules, of course, did not even exist until 2006, and the Direxion ETFs did not launch until 2008. As a result, the market was not as familiar in 2008 with leveraged/inverse strategies as they are today, after 12 years of experience, education and heightened disclosure. Accordingly, the validity today of this 2008 paper is questionable.

The Commission thus cites to an academic paper about investor awareness as support for its contention that investors do not understand the funds.[182] According to the Commission, this paper is part of "a body of academic literature providing empirical evidence that retail investors may not fully understand the risks inherent in their investment decisions and not fully understand the effects of compounding returns over time."[183] However, in the very next sentence the Commission concedes that this paper does not actually analyze in any empirical way investor understanding of leveraged/inverse investment vehicles:

(Feb. 14, 2017) ("*Morgan Stanley*"). In each of these cases, the Commission also alleged that the firms' WSPs were deficient because they did not require monitoring of investors' holding periods of leveraged/inverse investment vehicles. Based on the way this allegation is framed in the *Oppenheimer* order, it is unclear whether it applied to solicited or unsolicited transactions, or both. In the case of the *Morgan Stanley* order, it clearly applied only to solicited transactions as only solicited transactions were addressed in the order.

[180] *See* SEC v. Hallas, No 1:17-cv-2999 (S.D.N.Y. Sept. 27, 2017) (default judgement); In the Matter of Demetrios Hallas, SEC Release No. 1358 (Feb. 22, 2019) (initial decision), Exchange Act Release No. 85,926 (May 23, 2019) (final decision) (collectively, "*Hallas"*).

[181] *Id.* at 4492 n.312. *See infra* at 63-64 (for detailed critique of the SLCG Paper (as defined therein)).

[182] *Id.* at 4522.

[183] *Id.* at 4522 n.535 and accompanying text (citing Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 52 J. OF ECON. LITERATURE 5 (2014)).

> [It] does not address retail investor's inattention to investment risk or the unique dynamics of compounding of daily returns in the context of leveraged/inverse ETFs or other leveraged/inverse investment vehicles specifically, *but studies investor inattention to financial products more generally*."[184]

The Commission then cites two comment letters it received in connection with its 2015 proposal of then-proposed Rule 18f-4, which provide the commenters' *anecdotal* opinions on holding periods of leveraged/inverse investment vehicles generally.[185] The Commission invokes one of the comment letters to support its proposition that "some segment of investors *may* hold leveraged/inverse funds for long periods of time."[186] Even in the aggregate, the record put forward is weak.

THE COMMISSION HAS NOT EXPLAINED ITS DEPARTURE FROM THE FINDINGS IT MADE IN DIREXION'S EXEMPTIVE ORDERS.

The APA requires that, whenever an agency decides to adopt a new policy, the agency must provide "a reasoned explanation . . . for disregarding facts and circumstances that underlay or were engendered by the prior policy."[187] The agency "need not always provide a more detailed justification than what would suffice for a new policy created on a blank slate."[188] But the agency must at least "display awareness that it *is* changing position" and "show that there are good reasons for the new policy."[189]

As discussed above, in 2008 and 2009, the Commission issued exemptive orders to Direxion to operate the Direxion ETFs, finding that the exemptions were "necessary or appropriate in the public interest and consistent with the protection investors and the purposes fairly intended by the policy and provisions" of the 1940 Act. When the Commission granted the Exemptive Orders, it fully understood how the funds would operate. The 2008 application described in excruciating detail how the Direxion ETFs would operate, and the Commission's notice of the application recited many of these details at length. The application for the 2008 Order was 96 pages long and the application for the 2009 Order, to amend the 2008 Order, was 19 pages long.[190]

Since the issuance of the Exemptive Orders, the Direxion ETFs have operated as described in the applications. The Commission itself does not contend otherwise.

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[184] *Id*. (emphasis added).

[185] *Id.* at 4492 n.314.

[186] *Id.* at 4492.

[187] FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009).

[188] *Id*.

[189] *Id.*; *see also* Encino Motorcars, LLC v. Navarro, 136 S.Ct. 2117, 2126 (2016) ("[A]n 'unexplained inconsistency' in agency policy is 'a reason for holding an interpretation to be an arbitrary and capricious change from agency practice.'" (*quoting* Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 981 (2005))).

[190] The 2008 and 2009 applications are attached hereto as Appendix B.

Yet, now, relying largely upon precisely the same statutory authority under which the Exemptive Orders were granted, the Commission arbitrarily proposes, in essence, to rewrite the terms and conditions of the Exemptive Orders with the Derivatives Rules. The Commission takes this action without adequately justifying this departure from its prior position, as established by the Exemptive Orders. The SEC "does not justify this exception by reference to any change in the nature" of the Direxion ETFs,[191] or any evidence that, as the agency contends, investors do not understand the ETFs. Absent such a justification, the agency's choice "appears completely arbitrary, contrary to the dictates of the APA."[192]

ADOPTING A MORE ONEROUS REGULATORY REGIME FOR LEVERAGED/INVERSE INVESTMENT VEHICLES THAN FOR OPTIONS WOULD BE IRRATIONAL GIVEN THEIR COMPARATIVE RISKS.

The APA requires agencies to rest their decisions on grounds that "justify the result it reached."[193] The Commission has failed to comply with that requirement here. The Commission's stated intention with respect to the Sales Practice Rules is to impose an options-like regulatory regime on leveraged/inverse investment vehicles, but the proposed regime is, in fact, more onerous than the actual options regime on which it was modeled. In addition, there are many obvious dissimilarities between options and leveraged/inverse investment vehicles—and those dissimilarities suggest that options are, in fact, *riskier* than leveraged/inverse funds, making the adoption of more onerous rules for leveraged/inverse funds irrational.

To analogize leveraged/inverse investment vehicles to options, the Commission makes two contentions. First, it contends that, like options, the returns of leveraged funds can be "replicated by trading dynamically." Of course, the returns of almost any instrument can be broadly replicated by trading a variety of correlated instruments dynamically; it just depends on how much historical information you have on the correlated instrument, how much tracking error is acceptable and how you define dynamic.[194]

Second, the Commission contends that their returns "over longer holding periods share certain features with the returns of holding options,"[195] and points to a white paper produced by the Commission's Division of Economic and Risk Analysis ("DERA") as statistical evidence of this contention. However, the DERA paper is flawed in several ways.

One, for purposes of its paper, DERA analyzed options trading strategies that either do not exist or are sparsely employed but can be shown to exhibit "skewness" levels similar to those

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[191] Goldstein v. SEC, 451 F.3d 873, 883 (D.C. Cir. 2006)

[192] *See id*.; *see also FCC v. Fox*, 556 U.S. at 515.

[193] MCI Telecomms. Corp. v. FCC, 10 F.3d 842, 846 (D.C. Cir. 1993).

[194] *See* Chester Spatt, Ph.D., *Proposed Rules 15*l-*2 and 211(h)-1 Regarding Sales Practices for Certain Leveraged/Inverse Investment Vehicles* at ⁋32 (Mar. 24, 2020) [hereinafter Spatt Economic Analysis]. *Cf.* Proposing Release, *supra* note 1, at 4513 n.473 (explaining that options returns require dynamic intraday trading whereas leveraged/inverse investment vehicle returns require only once-per-day dynamic trading).

[195] Proposing Release, *supra* note 1, at 4512.

of leveraged/inverse funds.[196] Specifically, DERA did not address the significant number of options that expire out-of-the-money and worthless each day;[197] as a result, DERA did not consider the higher likelihood of loss incurred in connection with trading options. In addition, DERA focused its study on deep in-the-money options. Such options are not a significant part of the options market, however, because they have very limited optionality and perform much more like the reference asset than options that are more commonly traded, *e.g.*, those that are at-the-money or out-of-the-money. As a result of this approach, DERA derived statistics for its graphs that make the returns of leveraged/inverse investment vehicles seem more like returns on options than they actually are, especially when presented graphically.[198]

Two, for its analysis, DERA assumed that investors hold leveraged/inverse investment vehicles for six months. Neither DERA nor the Commission, however, produces any evidence of a material cohort of investors, particularly self-directed investors, who hold leveraged/inverse investment vehicles for six months.[199] And let's be clear: if such evidence existed, the Commission could have gotten it given its broad examination authority of intermediaries and its subpoena power.[200] The Commission does not present such data, however, and as the Commission knows, all data available to Direxion suggests that investors generally hold Direxion funds for days, not months,[201] consistent with the funds' robust disclosures.[202] Under these circumstances, it is unreasonable for DERA and the Commission to assume that investors act unreasonably.

Three, DERA assumed that leveraged/inverse investment vehicles could provide up to 400% positive or negative leverage. In fact, no vehicle that would fall within the defined term "leveraged/inverse investment vehicle" provides 400% positive or negative leverage. Ironically,

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[196] Skewness is a measure of asymmetry in return distributions. *See* Spatt Economic Analysis, *supra* note 194, at ⁋6 and n.5. An investment that produces positive returns as often as negative returns would show symmetrical distributions, *i.e.*, no skewness. All other investments have some degree of skewness.

[197] *Id*. at ⁋⁋34–39.

[198] *Id*. at ⁋⁋45–47.

[199] To the extent that the Commission cites the administrative enforcement cases discussed above (*supra* at notes 178-80 and surrounding text), those investors held their investments pursuant to their intermediaries' recommendations. As is obvious from the ensuing enforcement actions, there are remedies for such unsuitable or improper recommendations. As to self-directed investors, the Commission has no material evidence of harm or abuse.

[200] *See* 15 U.S.C. §§ 78q(b)(1) and 78u(b) (authority to examine and subpoena broker-dealers, respectively), 15 U.S.C. §§ 80b-4(a) and 80b-9(b) (authority to examine and subpoena investment advisers, respectively).

[201] *See* Appendix C (attached hereto).

[202] The Commission dismisses this data as reliable evidence of holding periods because it does not capture "shareholder-level trading activity." Proposing Release, *supra* note 1, at 4492 n.314. Yet, notwithstanding the Commission's undisputed access to such data through its oversight and regulation of intermediaries, the Commission in the Proposing Release also produced no data regarding "shareholder-level trading activity." The Commission did not even produce any real data on the number of broker-dealers with retail clients who invest in leveraged/inverse investment vehicles. *See id*. at 4523 n.546.

only ETNs—which the Commission proposes for the Sales Practice Rules *not* to cover—provide 400% positive or negative leverage. Thus, any conclusion reached by DERA seems to have been based on an invalid data set because, as DERA itself wrote, "as leverage increases," return "distributions" shift.[203]

In fact, options are riskier than leveraged/inverse investment vehicles in a variety of ways. When trading options, an investor can lose far more than the amount invested. For example, if a stock is trading at $100, an investor might sell an uncovered call option with a strike price of $110 and collect a $12 premium for doing so. If the price of the stock declines between the time the investor sells the uncovered call option and the expiration date of the option (the "term"), the investor keeps the $12 as profits from the transaction. However, if the price of the stock increases above $110 during the term, the investor's profit of $12 is reduced by the amount of the increase above the strike price. And, if the stock price doubles during the term to $200, the investor would lose $78 in the transaction (*i.e.*, $200 less the strike price and premium received). In this and similar options transactions, investors take on significant risk in exchange for minimal profit potential. Further, because an increase in the market price of the reference asset is unlimited, an option investor's potential losses are also unlimited. By contrast, when investing in leveraged/inverse investment vehicles, an investor's loss is limited to the amount invested.

Further, unlike with leveraged/inverse investment vehicles, many options investors experience a complete loss (of premium paid) when purchasing out-of-the-money options as a significant number of such options expire worthless.[204] For example, in excess of 75% of S&P 500 Index options expire worthless each day. And in a volatile market, investors routinely experience such losses within one day. Stated differently, options investors may lose their entire investment—and quickly. By contrast, although the Direxion funds are risky, no investor in any Direxion fund has ever experienced a complete loss in one day.

Finally, options are not subject to the prospectus delivery and disclosure requirements of the federal securities laws. As a result, options listers may not be held strictly liable for material omissions or misstatements in a prospectus or similar document the way that leveraged/inverse investment vehicles are. Similarly, whereas options do not impose on any party, including the lister, a fiduciary duty to options investors, advisers like RAM are subject to fiduciary duties owed to the leveraged/inverse funds that they manage.

In short, although the Commission seeks to have modeled the Sales Practice Rules on the regulatory regime for options, they did not succeed in doing so. Rather, it proposed Sales Practice Rules that are, in fact, more onerous than the options rules, including because they would be applied to self-directed investors, even though the risks of investing in options are much greater than the risks of investing in leveraged/inverse investment vehicles.

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[203] Division of Economic Analysis of the Securities and Exchange Commission, *Economics Note: The Distribution of Leveraged ETF Returns* at n.3 (Nov. 2019) [hereinafter DERA Paper].

[204] *Id*. at ¶¶40–49.

THE SALES PRACTICE RULES ARE INCONSISTENT WITH THE COMMISSION'S RECENT EFFORT TO FACILITATE RETAIL INVESTMENTS IN *UNREGISTERED* SECURITIES.

The APA requires administrative agencies to offer good reasons for treating similar situations differently.[205] The Commission has failed to comply with this requirement here because its effort to make leveraged/inverse investment vehicles unavailable to retail investors, notwithstanding their compliance with the full panoply of federal securities laws (including registration), is difficult to understand in light of its nearly simultaneous effort to make *unregistered funds* more available to this same group of investors.[206] The Commission has proposed to take such steps by expanding the definition of "accredited investor" in Regulation D under the Securities Act.[207] Yet the Commission has failed to explain why retail investors are perfectly capable of understanding the risks of private funds and other private offerings, but are incapable of understanding leveraged/inverse investment vehicles despite their fulsome disclosures.

This position is hard to reconcile, given that private funds may provide exactly the same strategies as leveraged/inverse investment vehicles or otherwise be highly leveraged. When it issued the 2015 proposal, the Commission itself cited private fund leverage as an example of the type of leverage that is inappropriate for individual investors. Specifically, the Commission called out as inappropriate leverage for individual investors "a private fund with approximately $10.2 billion of net assets lost $4.9 billion in natural gas futures positions in a period of a few weeks in August and September 2006 and was forced to liquidate its entire portfolio and close."[208]

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[205] *See* Muwekma Ohlone Tribe v. Salazar, 708 F.3d 209, 216 (D.C. Cir. 2013) ("Agency action is arbitrary and capricious if 'the agency offers insufficient reasons for treating similar situations differently.'") (quoting Cty. Of Los Angeles v. Shalala, 192 F.3d 1005, 1022 (D.C. Cir. 1999); *see also e.g.,* Westar Energy, Inc. v. FERC, 473 F.3d 1239, 1241 (D.C. Cir. 2007) ("If [an] agency makes an exception in one case, then it must either make an exception in a similar case or point to a relevant distinction between the two cases.").

[206] *See* Chairman Jay Clayton, *Remarks to the Economic Club of New York*, SEC (Sept. 9, 2019) (discussing the importance of expanding investor access to the private securities markets) [hereinafter Clayton Remarks].

[207] Regulation D under the Securities Act provides issuers with an exemption from the registration requirements applicable to a public offering, provided that the offering is only made to "accredited investors." Pursuant to the amendments proposed by the Commission to such definition, certain retail investors would automatically qualify as "accredited investors." As importantly, the net worth ($1 million) and annual income thresholds ($200,000), which were embedded in the regulation in 1982 to qualify natural persons as "accredited investors," would remain unchanged, even though in today's dollars a person would need to have net worth of approximately $2.5 million and annual income of approximately $740,000 to reflect the original thresholds. *See* Amending the "Accredited Investor" Definition, Securities Act Release No. 10,734, 85 Fed. Reg. 2574 (proposed Jan. 15, 2020) (to be codified at 17 C.F.R. pts. 230 and 240). As a result of this action and lack of action by the Commission, more retail investors will qualify as "accredited investors," precisely as the Commission intends. *See* Clayton Remarks, *supra* note 206.

[208] 2015 Proposing Release, *supra* note 81, at 80,896.

Further, as Commissioners Peirce and Roisman have observed, investors in private funds "may not have the benefit of particular disclosures required by the federal securities laws and SEC rules,"[209] as private funds are largely exempt from such laws and rules.

Against this backdrop, the Commission should have explained why it is appropriate to make private funds more available to retail investors, even though they are less regulated and may be even more highly leveraged than leveraged/inverse investment vehicles, at the same time that it is limiting the leverage of registered funds, particularly given their compliance with the registration requirements of the full panoply of federal securities laws.

THE SALES PRACTICE RULES ARBITRARILY DISTINGUISH BETWEEN SUBSTANTIALLY SIMILAR INVESTMENT PRODUCTS AND WILL LEAD TO REGULATORY ARBITRAGE.

The Commission fails to explain why the Sales Practice Rules would subject leveraged/inverse investment vehicles to additional burdensome regulation, but would not subject substantially similar investment alternatives to the same regulation.[210] For example, the Commission in the Proposing Release cites the LJM Preservation and Growth Fund ("LJM Fund") as an example of a registered fund that incurred significant losses from derivatives and thus "illustrat[ive]" of the need for registered funds generally to be subject to leverage limits.[211] The Commission notes the following about the LJM Fund:

> [L]ast year the LJM Preservation and Growth Fund liquidated after sustaining considerable losses (with its net asset value declining approximately 80% in two days) when market volatility spiked. . . . The fund closed to new investments on February 7, 2018 and announced on February 27, 2018 that it would liquidate its assets and dissolve on March 29, 2018. The losses suffered by this fund . . . [we]re extreme.

However, the LJM Fund would have *passed* the absolute VaR test proposed in the Derivatives Rules if such test had existed at the time. Stated differently, even if adopted as proposed, the Derivatives Rules will do absolutely nothing to prevent a recurrence of the meltdown experienced by LJM Fund investors. Nevertheless, the Sales Practice Rules would not apply to the LJM Fund.

Of further concern, under the Derivatives Rules retail investors will continue to have access to the very same strategies as are provided by leveraged/inverse investment vehicles in other investment structures. For example, if the Derivatives Rules are adopted as proposed, these strategies will continue to be available to retail investors as ETNs. In fact, ETNs exist today that provide the same strategies as the Commission targets in the Sales Practice Rules.

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[209] Peirce/Roisman Statement, *supra* note 38.

[210] *See Muwekma Ohlone Tribe,* 708 F.3d at 216 ("Agency action is arbitrary and capricious if 'the agency offers insufficient reasons for treating similar situations differently.'") (quoting *Cty. Of Los Angeles*, 192 F.3d at 1022).

[211] Proposing Release, *supra* note 1, at 4449.

The Commission asks whether the Sales Practice Rules should apply to ETNs.[212] In our view, they should. Most importantly, failing to include ETNs within the definition of "leveraged/inverse investment vehicle" will likely lead to irrational regulatory arbitrage. Product sponsors will simply "move across the street" and offer their strategies as ETNs instead of commodity pools or ETFs, and in the transition investors will lose important protections.[213]

Unlike leveraged/inverse funds, ETNs do not offer investors the protections of the 1940 Act. To give but one example of the protections investors would lose, the 1940 Act requires ETFs to have a board of directors that exercises oversight over the investment adviser and represents the interests of shareholders. The SEC Staff has described the board as "the shareholders' watchdog," particularly with respect to its review of the adviser's contract and related fees.[214] The Commission's Director of Enforcement has further stated that the board is "the first line of defense in protecting . . . fund shareholders."[215] However, no board oversees or monitors the operations of ETNs. But retail investors may not appreciate the loss of these protections because they may not distinguish between ETFs and ETNs as a result of both trading on an exchange and being available in the secondary market.[216]

Further, investors in ETNs, unlike investors in ETFs, do not directly or indirectly own any underlying assets. They simply have an unsecured promise by the ETN sponsor to pay a return, and they have the same risk that any unsecured creditor of the ETN sponsor has. This increases the risks for investors because it exposes them to credit risk from a single issuer. Indeed, when Lehman Brothers filed for bankruptcy, investors in Lehman ETNs were reported to

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[212] Proposing Release, *supra* note 1, at 4494 (responding to Request for Comment #173).

[213] Indeed, the Commission seems to endorse such regulatory arbitrage and counts it as a potential competitive benefit for ETNs. *Id*. at 4528 n.597 (noting competitive benefit for ETNs). *See also id*. at 4519 (noting that, due to the proposed rules, "investors may instead invest in alternative investment vehicles, exchange-traded notes, or structured products, which can provide leveraged market exposure but would not be subject to the VaR-based limit on fund leverage risk of rule 18f-4").

[214] Statement of Julie M. Riewe, in *SEC Charges Investment Adviser and Mutual Fund Board Members with Failures in Advisory Contract Approval Process*, SEC (June 17, 2015), https://www.sec.gov/news/pressrelease/2015-124.html. Section 15(c) of the 1940 Act requires the independent directors of the board to evaluate all such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes to serve as an investment adviser of the fund.

[215] Statement of Andrew Ceresney, in *SEC Charges Investment Adviser and Mutual Fund Board Members with Failures in Advisory Contract Approval Process*, SEC (June 17, 2015), https://www.sec.gov/news/pressrelease/2015-124.html.

[216] Retail investors will also continue to have access to such strategies in bank structured products, even though they have precipitated the same type of administrative enforcement actions as the Commission cites to justify the Sales Practice Rules for leveraged/inverse investment vehicles. *See, e.g.,* In the Matter of UBS Financial Services Inc., Exchange Act Release No. 78,958 (Sept. 28, 2016) (regarding transactions in reverse convertible notes that functioned as short positions on individual securities issuers by retail investors pursuant to brokers' recommended transactions).

have lost billions of dollars because they had assumed the credit risk on Lehman Brothers.[217] Thus, assuming that the proposed rules, if adopted, would cause a migration of these strategies to ETN structures, their paradoxical impact would be to migrate leveraged/inverse funds from a more-regulated environment (covered by the Securities Act, Exchange Act and 1940 Act) to a less-regulated environment (covered only by the Securities Act and Exchange Act).

Finally, there is a lengthy list of complicated accounting concepts that investors need to understand in order to make an informed decision as to whether to invest in the securities of individual issuers.[218] For some such issuers, investors need to understand complicated concepts of asset depreciation. For other issuers, they need to understand amortization. And for all issuers, they arguably need to understand price-to-equity ratios and the concept of leveraged balance sheets. DERA even acknowledged in its white paper that "some unlevered investments in equity or debt markets, such as distressed firm debt or unprofitable growth stocks, can also exhibit payoff distributions that are similar to out-of-the-money options."[219] Nevertheless, the Commission does not explain why investors should have unfettered access to these types of investments, but not leveraged/inverse investment vehicles. This is another reason the Commission's proposal falls short of standards articulated by the APA.

THE SALES PRACTICE RULES ARBITRARILY DISTINGUISH BETWEEN LEVERAGED/INVERSE FUNDS AND OTHER FUNDS THAT COMPLY WITH RULE 18F-4'S RELATIVE VAR TEST.

As discussed above, the APA requires that agencies offer good reasons for treating similar situations differently. Here, the Commission fails to explain why it is appropriate to distinguish between registered funds that pursue leveraged/inverse strategies in compliance with the relative VaR test of proposed Rule 18f-4 and other registered funds that comply with the same relative VaR test. The Proposing Release describes proposed Rule 18f-4(c)(4) as an "alternative approach" for leveraged/inverse funds. There, the Commission says,

> The proposed rule would . . . provide an exception from the VaR-based limit on fund leverage risk for certain leveraged/inverse funds in light of the requirements under the proposed sales practices rules that broker-dealers and investment advisers exercise due diligence in approving the accounts of retail investors to invest in these funds, and other conditions for these funds that proposed rule 18f-4 includes. This would allow these funds, which generally could not currently

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[217] *See ETN Credit Risk Rears its Ugly Head*, MORNINGSTAR (Sept. 18, 2008), http://investors.morningstar.com/news/cmsAcontent.html?t=OAKIX&src=Morningstar&date=04-08-2015&nav=no&region=USA&culture=en-US&ProductCode=mle&resourceId=253614.

[218] Mark J. Flannery, Ph.D., Bank of America Eminent Scholar in Finance, Warrington Collect of Business Administration, University of Florida, *Proposed Sales Practice Rules for Certain Leveraged/Inverse Investment Vehicles* at ¶¶ 33, 44–46 (Mar. 24, 2020) [hereinafter Flannery Economic Analysis].

[219] DERA Paper, *supra* note 203, at n.13.

satisfy the proposed VaR-based limit on fund leverage risk, to continue offering their current strategies.[220]

What the Commission fails to address is that leveraged/inverse funds actually would be required to comply with the Sales Practice Rules, even if they did not need an exception from proposed Rule 18f-4's 150% relative VaR (or 15% absolute VaR) limit.

Stated differently, leveraged/inverse funds do not have an opportunity to address the Commission's "investor protection concerns" related to leverage by complying with the 150% relative VaR test in proposed Rule 18f-4(c)(2). Uniquely, even leveraged/inverse funds that comply with the proposed 150% relative VaR test would still be subject to the Sales Practice Rules due to the absence of carve out in the definition of "leveraged/inverse investment vehicle" for leveraged/inverse funds that comply with proposed Rule 18f-4(c)(2). The Commission does not explain why this is the case—meaning why, even when a leveraged/inverse fund operates in line with the same leverage limits as all other funds relying on the rule, it alone must continue to be subject to the Sales Practice Rules.

The Commission should allow leveraged/inverse funds that comply with 150% relative VaR test to operate like all other funds complying with the 150% relative VaR test, *i.e.*, outside of the Sales Practice Rules. In certain respects, this seems to be the intent of the Commission, insofar as the Proposing Release characterizes proposed Rule 18f-4(c)(4) as an "alternative" to the 150% relative VaR test. However, this is not the way that the Sales Practice Rules are currently written. Under these circumstances, the Commission should re-propose the Derivatives Rules with greater clarity on whether proposed Rule 18f-4(c)(4) is, in fact, an "alternative," or a mandate, and seek further comment.

THE SALES PRACTICE RULES CANNOT BE JUSTIFIED AS A MEANS TO MAINTAIN FAIR, ORDERLY AND EFFICIENT MARKETS

The Commission raises concerns in the Proposing Release that the rebalancing activity of leveraged/inverse funds may affect the price and volatility of their portfolio holdings or the indexes that they track.[221] In doing, the Commission cites a handful of academic studies whose conclusions contradict each other.[222] For example, the Commission says that one paper finds a "positive association" between the rebalancing activity of leveraged/inverse funds and the price and volatility of component stocks. "Conversely," the Commission acknowledges, another paper presents evidence that suggests that the effect of such funds' rebalancing activities on underlying asset prices is "attenuate[d]." As a result, the Commission concedes that the academic literature is "inconclusive" as to the effect of leveraged funds' rebalancing activity on the securities in

[220] Proposing Release, *supra* note 1, at 4511.

[221] Any concerns that the Commission might have about the effect of rebalancing trades must be limited to leveraged/inverse funds, as a subset of leveraged/inverse investment vehicles, because only leveraged/inverse funds' rebalancing trades occur in the securities markets. Other leveraged/inverse investment vehicles normally invest in commodities or currencies. Accordingly, their rebalancing trades occur in non-securities markets, which are outside the jurisdiction of the SEC.

[222] *See* Proposing Release, *supra* note 1, at 4528 n.591–92 and 4531 n.615.

their portfolio,[223] begging the question—yet again—what problem precisely the Commission is trying to "fix" with the Derivatives Rules.

The Proposing Release defines "leveraged/inverse funds" as leveraged/inverse investment vehicles that are registered investment companies.[224] As of December 31, 2019, total assets under management in such products had grown to approximately $51 billion. During the same time, the total capitalization of the U.S. equity market had grown to approximately $33.8 trillion. As a result, in the aggregate, leveraged/inverse funds represented less than one-quarter of one percent of U.S. equity market capitalization and less than one-tenth of one percent of global equity market capitalization. Assuming these trends continue, and there is no reason to think that they will not, leveraged/inverse funds will represent a smaller and smaller portion of the U.S. equity market. As a result, their rebalancing trades will become increasingly irrelevant.

Even now, the rebalancing trades of the Direxion ETFs represent a miniscule percentage of average daily trading activity. On more than 80% of trading days over the last seven calendar years, the Direxion ETFs' rebalancing trades represented less than 0.20% of the day's overall market trading volume. And on the most active trading days,[225] the Direxion ETFs' rebalancing trades represented less than 0.60% of the day's overall market trading volume. At these levels, it's hard to see how their trading would have any material impact on the price or volatility of the portfolio holdings being traded.

As a practical matter, the Sales Practice Rules impose on intermediaries a due diligence requirement and potential liability in connection with their performance of such due diligence. The primary means by which they could address the Commission's concern (that leveraged/inverse funds rebalancing activities adversely impact the fairness, orderliness and efficiency of the markets) is by reducing the number of investors trading them—either because (as the Commission presumably envisions) investors who currently trade them fail to qualify under the new regime to do so, or because intermediaries cease making them available in order to avoid the cost of implementing the due diligence requirements and the potential for associated liability. Even assuming the Commission came forth with data substantiating its market-based concerns, such a roundabout approach to addressing the problem would be indefensible as a matter of law, particularly in light of the fact that multiple reasonable alternatives would be available, such as pursuing new listing standards for products.

[223] *See also id.* at 4528 (describing the academic literature on point as "not definitive").

[224] *Id*. at 4491.

[225] For this purpose, Direxion considered trading days in the top one percent of all trading days based on market volume.

THE SALES PRACTICE RULES REPRESENT THE NANNY STATE AT ITS WORST.[226]

The APA requires courts to invalidate rules where the agency has made a decision that "is so implausible that it could not be ascribed to a difference in view or agency expertise."[227] For example, where, as here, the Commission claims that the Sales Practice Rules are "designed to help ensure that retail investors in leveraged/inverse investment vehicles are limited to those who are capable of evaluating the risks these products pose,"[228] its proposed rules should advance this purpose. However, the investor characteristics about which intermediaries would be required to seek information pursuant to the Sales Practice Rules belie this purpose.

As noted above, intermediaries would be required to seek information regarding a customer's investment objectives and time horizon; the customer's employment status (including the name of employer and whether the investor is self-employed or retired); the customer's estimated annual income, net worth, and liquid net worth; the percentage of the customer's estimated liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and the customer's "investment experience and knowledge (*e.g.*, number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities, and other financial instruments."

Only one of these characteristics—the last—potentially speaks to a person's ability to understand leveraged/inverse investment vehicles. At least five of the characteristics are irrelevant to such an inquiry. Can an unemployed person with a Ph.D. in chemistry understand leveraged/inverse funds? Can a middle-school math teacher? Can the surprised beneficiary of a large estate? And, in any case, how is the percent of assets that any person intends to invest in leveraged/inverse investment vehicles relevant to his or her ability to understand them?

Further, under the Sales Practice Rules, nearly conclusive evidence that a person *does* understand leveraged/inverse investment vehicles would not be considered. Specifically, the Sales Practice Rules would not exempt intermediaries from making a suitability determination for individual investors who have previously traded them—even though there is likely no better evidence that a person understands them.[229]

The incongruity between the personal characteristics that intermediaries would be required to scrutinize under the Sales Practice Rules and a person's actual ability to understand leveraged/inverse funds makes us concerned that the goal of the Sales Practice Rules is, in fact, to make leveraged/inverse funds unavailable to investors because this Commission has decided that they are "bad." Yet the Commission's own website acknowledges the impropriety of the SEC regulating the merits of investment companies' investment strategies. In this regard, the SEC website says:

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[226] *See* Proposing Release, *supra* note 1, at 4496 (responding to Request for Comment #176) (asking whether the Sales Practice Rules should apply to transactions "that are directed by a retail investor without any recommendation or advice" from an intermediary).

[227] *State Farm*, 463 U.S. at 43.

[228] Proposing Release, *supra* note 1, at 4492.

[229] *See id*. at 4497 (responding to Request for Comment #191).

> It is important to remember that the [1940] Act does not permit the SEC to directly supervise the investment decisions or activities of these companies or judge the merits of their investments.[230]

Yet that is precisely what the Commission does in the Derivatives Rules, and the Sales Practice Rules in particular: pass judgment on the merits of products and single them out for unprecedented regulation without a congressional mandate to do so and without presenting data or other evidence of their harm. The Commission's assertion of rulemaking authority here conjures up the axiom of "the government knows better" and is therefore justified in interfering with the public's own choices. That may well be what caused two sitting Commissioners to describe the Derivatives Rules as "overly paternalistic" and the Sales Practice Rules an instance of "micromanage[ment]."[231]

For all of these reasons, the proposed Sales Practice Rules are unlawful.

THE ECONOMIC ANALYSIS UNDERLYING THE DERIVATIVES RULES IS FLAWED.

Section 2(c) of the 1940 Act and Section 3(f) of the Exchange Act require the Commission, when engaged in rulemaking, to consider whether a proposed rule is necessary or appropriate in the public interest and whether it will promote efficiency, competition and capital formation, in addition to the protection of investors.[232] And under Section 23(a)(2) of the Exchange Act, the Commission "shall not adopt any [rule] which would impose a burden on competition not necessary or appropriate in furtherance of the purposes" of the Exchange Act. As relevant here, Section 2 of the Exchange Act describes its purposes as "insur[ing] the maintenance of fair and honest markets."[233] The Commission has not met its burden under the Exchange Act because the Commission has failed to establish that the Sales Practice Rules only impose a burden on competition that is necessary or appropriate to ensure fair and honest markets.

THE COMMISSION FAILED TO ESTABLISH MATERIAL BENEFITS FROM THE DERIVATIVES RULES.

Implicit in the Commission's proposal of the Derivatives Rules is a contention that, at a minimum, they are necessary for "investor protection." And the Commission asserts multiple

[230] *See Laws and Rules*, SEC, https://www.sec.gov/investment/laws-and-rules (last visited Mar. 22, 2020).

[231] Peirce/Roisman Statement, *supra* note 38, at II.A and II.B. Other commenters similarly describe the rules as, among other things, an instance of "paternalistic merit review." Letter from Tim Chapman, Executive Director, Heritage Action for America, *et al.* to Vanessa Countryman, Secretary, U.S. Securities and Exchange Commission (Feb. 7, 2020), https://s3.amazonaws.com/hafa/Coalition-Letter-to-SEC-Re_-Leveraged_Inverse-Funds.pdf [hereinafter Coalition Letter].

[232] 15 U.S.C. § 78c(f); 15 U.S.C. § 80a-2(c).

[233] 15 U.S.C. § 78b.

times throughout the Proposing Release that they "address investor protection" concerns. The data—or really, the absence of data—indicates otherwise.

Take proposed Rule 18f-4. The Commission asserts that in the absence of rules that "address the current broad range of funds' derivatives use, inconsistent industry practices have developed," and "certain of these practices may not address investor protection concerns that underlie section 18's limitation on funds' issuance of senior securities." The Commission's own economic analysis, however, shows otherwise. There, in defending the proposed VaR tests that would be codified in proposed Rule 18f-4, the Commission says,

> [W]e estimate that there would only be a very small number of funds, *if any*, that would have to adjust their portfolios in order to comply with the VaR-based limit on fund leverage risk.[234]

In short, proposed Rule 18f-4 will require changes for very few, *if any*, funds—which necessarily means that it will result in very few, if any, incremental investor protections.

Then consider the Sales Practice Rules. The Proposing Release describes the primary benefit of the rules as "address[ing] potential investor protection concerns" by ensuring that investors who invest in leveraged/inverse investment vehicles "are limited to those who are capable of evaluating the characteristics and unique risks" of such products. Inexplicably, however, the Proposing Release sets forth no "hard empirical data" that a material number of individual investors who trade them do not understand them—notwithstanding various Commissioners' apparent commitment to proceeding only on the basis of such data.[235] And we agree that the need for "hard empirical data," which substantiates that a significant number of real-life investors are harmed by leveraged/inverse funds, is critical here, particularly given that the Sales Practice Rules are estimated—and underestimated at that—to cost over $2 billion in the first year alone. As the Commission knows, it may not rely on hypothetical scenarios or "mere speculation."[236] It has a statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure."[237]

Here, the Commission has been gaining experience with leveraged/inverse funds since 1997 and, thus, has had over 20 years to gather data in support of its proposition that leveraged/inverse funds harm investors. During this time, the Commission could have used one or more of the vast array of tools in its toolbox to obtain such data. Notably, the Commission has a unique ability to get such data from intermediaries as all intermediaries are SEC registrants that are subject to books and records maintenance requirements and examination by the SEC.[238]

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[234] Proposing Release, *supra* note 1, at 4519 (emphasis added).

[235] Jackson Statement, *supra* note 4. (emphasis supplied).

[236] *Cf. Business Roundtable v. SEC*, 647 F.3d 1144, 1150–51 (D.C. Cir. 2011).

[237] *Chamber of Commerce*, 412 F.3d at 143 (quoting *Nat'l Ass'n of Mfrs.*, 748 F.3d at 369).

[238] *See* 15 U.S.C. §§ 78q(a) and 78q(b)(1) (books and records maintenance and examination obligations of broker-dealers, respectively), 15 U.S.C. §§ 80b-4(a)-(b) and 80b-4(a) (books and records maintenance and examination obligations of investment advisers, respectively).

Further, the SEC has authority to subpoena such data from intermediaries.[239] Yet, here, the SEC apparently has not done so. It "has not performed any analysis" to determine if the Sales Practice Rules would, in fact, benefit investors.[240]

The Commission operates a Tips, Complaints and Referrals service.[241] Investors may use the service to report, as the name implies, tips (on potential illegal activity), complaints about products and/or intermediaries and to make referrals to the SEC Division of Enforcement. The Proposing Release provides no indication that the Commission routinely receives tips, complaints or referrals about leveraged/inverse investment vehicles—much less a sufficient number to support a "hard empirical evidence"-driven conclusion that investors do not understand leveraged/inverse funds.

The Proposing Release also does not cite any complaints, much less a significant number of complaints, routinely received by FINRA about such products. FINRA maintains a complaint list, which should reflect any complaints received by FINRA about leveraged/inverse investment vehicles. While this complaint list is non-public, the Commission would surely have been able to access it given FINRA's operation as a Commission-approved SRO. Nonetheless, the SEC either did not seek the list, or did but did not find evidence therein that supports the need for the Sales Practice Rules, particularly with respect to self-directed investors.

As another commenter has observed, "the proposing release makes an entirely underwhelming qualitative case for the benefits of the proposed rules."[242] In fact, based on the Commission's requests for comments in the Proposing Release, the Commission does not even know and did not obtain data on how many individual investors—the purported focus of the proposed regulatory protections—trade leveraged/inverse funds. Instead, it asks the industry for data in this regard.[243]

The Proposing Release cites a paper by the Securities Litigation Consulting Group ("SLCG") seemingly as support for the proposition that investors with an intermediate to long-term time horizon "*may* experience large and unexpected losses or otherwise experience returns that are different from what they anticipated," when investing in leveraged/inverse funds.[244] Notably the Commission does not, and cannot, make the statement necessary to support the rule—namely, that investors *do* experience unexpected losses or unanticipated returns—because the SLGC Paper cannot support that proposition for several reasons.

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[239] *See* 15 U.S.C. § 78u(b) (authority to subpoena broker-dealers), 15 U.S.C. § 80b-9(b) (authority to subpoena investment advisers).

[240] Flannery Economic Analysis, *supra* note 218, at ¶60.

[241] *See Tip, Complaint, or Referral*, SEC, https://www.sec.gov/about/forms/formtcr.html (linking the form to be completed to make a tip, complaint or referral).

[242] *See* Coalition Letter, *supra* note 231, at 2

[243] Proposing Release, *supra* note 1, at 4496 (responding to Request for Comment #188).

[244] *Id*. at 4492 n.312 (emphasis added) (citing Securities Litigation and Consulting Group, *Leveraged ETFs, Holding Periods and Investment Shortfalls* 13 (2010) [hereinafter SLCG Paper]).

To begin, as explained above, the SLCG Paper was published in 2010 and is based on 2008 data.[245] The bulk of leveraged/inverse funds being targeted by the Sales Practice Rules, of course, did not even exist until 2006, and the Direxion ETFs did not launch until 2008. As a result, the market was not as familiar in 2008 with leveraged/inverse strategies as they are today, after 12 years of experience, education and heightened disclosure. Accordingly, the SLCG Paper tells us little about current investors and their understanding of leveraged/inverse funds.

Even if the data in the SLCG Paper were not stale, it would not support the contention that some investors must not understand leveraged/inverse funds because they hold them longer term. First, the statistical model used by SLCG *assumes* that there are two groups of investors in the relevant market: one group that trades and one group that holds. Stated differently, the SLCG model assumes what it purports to conclude, *i.e.*, that some investors hold leveraged/inverse funds longer term.[246] Thus, SLCG's "estimate" that a number of investors hold products for more than a month is meaningless. And the Proposing Release's citation to a comment letter that relies on the SLCG Paper to reach the same conclusions as the paper itself does nothing to buttress the Commission's unsubstantiated position.[247]

Second, SLCG extrapolates from its "conclusion" (that some investors hold leveraged/inverse investment vehicles longer term) that such investors do not understand leveraged/inverse funds. In short, it infers that if investors hold the funds, they must not understand them.

In fact, investors may *both* understand leveraged/inverse funds *and* reasonably determine to hold them longer term. For example, as shown in the Flannery Economic Analysis, over 21-day holding periods, leveraged funds outperform unleveraged funds tracking the same index in trending markets (meaning, markets that are materially moving up or moving down). In addition, the returns of leveraged/inverse funds over 21-day periods almost always directionally correlate with the returns that the SEC seems to think investors would expect, *i.e.*, three times the return of the index over the 21-day period (the "naïve return").[248] The Commission cannot reasonably dismiss this data and the other data presented in the Flannery Economic Analysis, which suggests that holding periods of longer than one day (i) are not *per se* irrational and (ii) do not establish that investors do not understand leveraged/inverse strategies—particularly since the Commission presents no evidence that investors do not understand such strategies.

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[245] *See supra* at note 181 and surrounding text.

[246] Flannery Economic Analysis, *supra* note 218, at ¶41. Due to this and other flaws in the statistical model used by SLCG, courts have found the model to be not reliable. *Id.* at n.46 (citing court case where model was rejected).

[247] Proposing Release, *supra* note 1, at 4492 n.312. Note, however, that the relevant footnote in the Proposing Release confusingly and, it seems mistakenly, cites to a comment letter submitted by the CFA Institute, which is an association of chartered financial analysts, in connection with the SEC's proposal of Rule 6c-11 under the 1940 Act, when we believe that the Commission intended to cite to a letter submitted by the Consumer Federation of America in connection with the SEC's 2015 proposal of Rule 18f-4. *See id.* (citing Exchange-Traded Funds, Investment Company Act Release No. 33,646, 84 Fed. Reg. 57,162 (Oct. 24, 2019)).

[248] Flannery Economic Analysis, *supra* note 218, at ¶21.

THE COMMISSION FAILED TO CONSIDER THE EXTENT TO WHICH ANY BENEFIT WILL BE DIMINISHED AS A RESULT OF RECENTLY ADOPTED REGULATIONS.[249]

The Commission, in passing, "acknowledge[s] that the[] benefits [of the Sales Practice Rules] may be reduced, to the extent that they overlap with the effects of investment advisers' or broker-dealers' existing requirements or practices related to a retail investors' [sic] suitability for investments." The Commission nowhere seriously analyzes the extent of the overlap, however, including specific benefits generated by the overlap and costs incurred from the overlap. In addition, the Commission fails to seriously analyze how the overlap will be impacted by the Fiduciary Interpretation, as recently issued, and the effectiveness of Regulation Best Interest in June 2020. In our view, the overlap is so significant as to make the Sales Practice Rules unjustifiable as a matter of costs and benefits.

APPLICATION OF THE SALES PRACTICE RULES TO INVESTMENT ADVISERS WOULD BE REDUNDANT.

As discussed above,[250] an adviser's fiduciary duty applies to the totality of a client relationship, whether discretionary, non-discretionary, or even in the unusual case where a client would direct his or her adviser to make an investment. This view of an investment adviser's broad obligations to its clients was affirmed by the Commission less than six months ago in an interpretation,[251] which stated that an "investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship." The interpretation further reviewed the duty of care and duty of loyalty obligations owed by investment advisers to their clients, including the obligation at all times to act in clients' best interest. Given this broad obligation owed by advisers to their clients, we are hard-pressed to understand what is left to be regulated by proposed Rule 211(h)-1.

Further, the Commission's proposal to apply the requirements of the Sales Practice Rules to investment advisers evidences a fundamental misunderstanding by the Commission of investment adviser's business of providing advice as a fiduciary.[252] Most curious is the Commission's apparent assumption (or assertion) that a client may hire an investment adviser only to then direct the adviser to make investments or to make only recommended investments that the client fully understands. As for investment recommendations, a key reason that some investors hire investment advisers is because they do not understand investments and potentially have no interest in spending the time to become sufficiently familiar with them. Yet the

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[249] Proposing Release, *supra* note 1, at 4495 (responding to Request for Comment #175) (asking whether the Sales Practice Rules should apply to transactions otherwise subject to an adviser's fiduciary duties or a broker-dealer's Regulation Best Interest obligations).

[250] *See supra* at 12-13.

[251] Fiduciary Interpretation, *supra* note 24.

[252] *See Am. Equity Inv. Life Ins. Co.,* 613 F.3d at 179 (where the D.C. Circuit found that the SEC acted in an arbitrary and capricious manner when it concluded that a rule subjecting fixed index annuities to federal law would enable investors to make more informed investment decisions by "fail[ing] to determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions and sellers to make suitable recommendations to investors").

Commission does not explain why a client who does not understand leveraged/inverse funds would necessarily not benefit from their account investing in them, where the investment adviser finds it appropriate. Advisers' clients may, in fact, benefit from their portfolios being invested in such products, as long as their advisers understand them.[253]

Further still, application of the Sales Practice Rule requirements to investment advisers would directly contradict the Commission's own pronouncements in the Fiduciary Interpretation. There, less than six months ago, this very same Commission lauded the value of principles-based regulation regarding an adviser's fiduciary duty. Yet without explanation of this abrupt about-face, proposed Rule 211(h)-1 would return the Commission to a code-oriented approach to adviser regulation.[254]

The SEC's failure here to review the economic baseline is directly analogous to its failure in the rulemaking that precipitated *American Equity Inv. Life Insurance Co. v. SEC.*[255] Pursuant to that rulemaking, the SEC sought to subject fixed indexed annuities to regulation as securities, notwithstanding existing state regulation of those same entities. In the rule release, the SEC acknowledged "recent and ongoing efforts by state insurance regulators" and mentioned particularly relevant state laws, but proceeded to adopt its rules.[256] Not surprisingly, the D.C. Circuit found the SEC's economic analysis inadequate. Specifically, the court said that the SEC had failed to "assess the baseline" of existing regulation, and found its analysis "incomplete because it fails to determine whether, under the existing regime, sufficient protections existed to enable investors to make informed investment decisions."[257] As true as that was in *American Equity*, it is even more true here, where the existing regulatory regime has received no meaningful analysis.

APPLICATION OF THE SALES PRACTICE RULES TO *RECOMMENDED* TRANSACTIONS WOULD BE SUPERFLUOUS.

As discussed above, a broker-dealer who recommends a security transaction to a client is subject to Regulation Best Interest. According to the Commission and as reiterated by the Chairman in congressional testimony, Regulation Best Interest imposes on broker-dealers, precisely as its name suggests, an obligation for broker-dealers to act in clients' best interest. As specifically confirmed by the Commission and reiterated by the Chairman in congressional testimony, this best interest obligation is an obligation broader than suitability.[258] Further, with

[253] Flannery Economic Analysis, *supra* note 218, at ¶¶34, 54.

[254] Peirce/Roisman Statement, *supra* note 38.

[255] American Equity Inv. Life Insurance Co. v. SEC, 613 F.3d 166, (D.C. Cir. 2010).

[256] *See* Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release No. 8996, 74 Fed. Reg. 3138, 3148 (Jan. 16, 2009).

[257] 613 F.3d at 178, 179. *See also id.* ("[t]he SEC's failure to analyze the efficiency of the existing state law regime renders arbitrary and capricious the SEC's judgment that applying federal securities law would increase efficiency").

[258] *See* Testimony of Chairman Jay Clayton before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *Oversight of the Securities and Exchange Commission* (Dec. 10, 2019) ("[u]nder

respect to recommended transactions by broker-dealers, this best interest obligation only adds to already-heightened suitability obligations related to transactions in leveraged/inverse investment vehicles.[259] Nevertheless, according to the Proposing Release, the Sales Practice Rules should now pile on top of these.[260]

The Commission does not explain how a broker-dealer could recommend transacting in products without believing such investment was in the client's best interest and suitable or address why investors could not benefit from working with a broker who recommends the products when in the investor's best interest and suitable.[261] Further, in the case of Regulation Best Interest, the Commission has not even allowed time for broker-dealers to implement the regulation and evaluated the need for additional regulation before proposing the Sales Practice Rules. Indeed, Regulation Best Interest is not even effective until June 2020.

The Commission's proposed imposition of additional regulations on recommended broker-dealer transactions in this case is very similar to the Commission's rulemaking that prompted court review in *Business Roundtable v. SEC*.[262] There, the court considered an SEC regulation that applied broadly to public companies, including investment companies. Investment companies challenged the application of the rule to them, arguing that the SEC "failed adequately to address whether the regulatory requirements of the [1940] Act reduce the need for, and hence the benefit to be had from," the rule.[263] The D.C. Circuit agreed with the investment companies. The agency, the court found, had failed to explain why certain asserted benefits of the rule were not already provided by existing regulation of investment companies; for example, although the rule was intended to give shareholders greater control over the board, the agency had failed to "consider that the ICA already requires shareholder approval of advisory contracts."[264] Similarly, here, the Sales Practice Rules would be redundant regulation of broker-dealers with respect to recommended transactions.

Regulation Best Interest, broker-dealers are required to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer").

[259] *See supra* at 11–13.

[260] *See* Proposing Release, *supra* note 1, at 4493 (confirming that "compliance with the [Sales Practice Rules] would not supplant or by itself satisfy" intermediaries' obligations under Regulation Best Interest).

[261] Flannery Economic Analysis, *supra* note 218, at ¶¶34, 54.

[262] *Business Roundtable*, 647 F.3d at 1155.

[263] *Id.* at 1154.

[264] *Id.* at 1154–55; *compare Inv. Co. Institute v. CFTC*, 720 F.3d 370, 378 (D.C. Cir. 2013) (crediting CFTC for considering existing regulatory regime and evaluating whether additional regulation was needed).

THE ENFORCEMENT CASES CITED BY THE COMMISSION DO NOT JUSTIFY THE SALES PRACTICE RULES.

To justify the Sales Practice Rules, the Commission points in part to nine administrative enforcement actions involving leveraged/inverse investment vehicles. But the Proposing Release fails to explain why the investors harmed in those cases would have been better protected by the Sales Practice Rules, given that they were "made whole" by available remedies in those cases.[265] As we explained above, most of those cases involved unsuitable recommendations by broker-dealers to their customers; and, except for the case that resulted in a criminal conviction of an adviser representative for theft of client assets, the rest involved an intermediary's failure to implement its compliance program.[266] Further, the very fact that regulators were able to pursue the recommendations as unsuitable establishes exactly the opposite point implied by the proposal of the Sales Practice Rules (*i.e.*, that additional regulation is necessary to protect investors). In fact, the existence of the cases shows that the current regulatory regime is sufficient and that regulators have the tools that are necessary to protect investors.

The Proposing Release also fails to explain why the adoption of Regulation Best Interest will not be just the regulation needed to address the harms identified in the enforcement actions, to the extent any are un-remedied at all. As noted above, Regulation Best Interest is not even effective until June 2020; accordingly, to the extent additional regulation is required, it is unclear why Regulation Best Interest is not precisely the additional regulation needed.[267]

The one additional protection that investors would likely get from the Sales Practice Rules is that they could potentially sue their intermediary if even their *self-directed* trading of leveraged/inverse investment vehicles resulted in losses. The Sales Practice Rules, and the obligations they place on intermediaries to vet investors as "capable of understanding" these products, would give them a basis to argue that they should not have been approved to trade them in the first place. In this way, the Sales Practice Rules would convert intermediaries into insurers of their clients' trading decisions with respect to leveraged/inverse investment vehicles. Imposing that substantial burden on intermediaries blatantly disregards the previously recognized need for sales practice rules to reflect a "careful balance" and flies in the face of the Supreme Court's admonishment that the securities laws are not intended to "provide investors with broad insurance against market losses."[268]

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[265] Flannery Economic Analysis, *supra* note 218, at ⁋57.

[266] *See* Proposing Release, *supra* note 1, at 4494 n.331 (citing Cadaret Grant, et al., Exchange Act Release No. 84,074 (Sept. 11, 2018)).

[267] *See Business Roundtable,* 647 F.3d at 1154.

[268] Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 345 (2005). *See also* Basic Inc., v. Levinson, 485 U.S. 224 (1988) ("allowing recovery in the face of affirmative evidence of nonreliance—would effectively convert Rule 10b–5 into a scheme of investor's insurance. There is no support in the Securities Exchange Act, the Rule, or our cases for such a result" (internal quotation marks and citations omitted)).

THE SEC UNDERESTIMATED THE COST OF THE SALES PRACTICE RULES.

As aptly summarized by another commenter, while the "benefits of the rule are unclear and potentially non-existent," the "costs of the proposed rule are very high and defined."[269]

The Commission estimates the cost of the Sales Practice Rules *in the first year alone* at $2,377,503,800.[270] Still, the Commission's estimate likely understates the total cost of the Sales Practice Rules.

THE COMMISSION'S COST ESTIMATE FAILS TO FULLY ACCOUNT FOR INVESTORS' INCREASED COSTS FROM THE SALES PRACTICE RULES.

Most importantly, the Sales Practice Rules will result in substantially higher costs for investors who seek to employ leveraged/inverse strategies. Although not analyzed by the SEC in the Proposing Release, many intermediaries may simply abandon leveraged/inverse investment vehicles—meaning, they may simply stop making them available to their clients.[271] They would take such steps in light of the high implementation costs imposed by the Sales Practice Rules and the requirement that they, basically, act as an insurer of their clients' trades of such vehicles, as discussed above. Under such circumstances, individual investors who still want to effectuate leveraged/inverse strategies will be forced to find another means to do so.

As suggested by the SLCG Paper, some investors may turn to margin accounts for this purpose.[272] By using a margin account, an investor may borrow a percentage of the value of such account and use it to purchase additional securities or obtain exposure to such securities. Brokerage firms that offer margin accounts require investors to pay interest on the amount borrowed. Based on research done by RAM in the summer of 2019, the interest rate on margin accounts ranged between 8.38% and 10% at four of the largest broker-dealers surveyed, resulting in an average interest rate of approximately 9%. As a result of such interest rates, when using a margin account to execute leveraged/inverse strategies, investors are likely to incur significantly higher costs than they do at present to obtain the strategies through leveraged/inverse funds, which typically have net expense ratios of less than 1% and borrowing costs well below margin account rates.

Investors who do not or cannot trade through a margin account to execute leveraged/inverse strategies may simply lose access to such strategies altogether. The Proposing Release nowhere considers the cost of this loss of investor choice.[273] In addition, the Proposing Release fails to address the fairness, from a cost perspective, of *either* making leveraged/inverse

[269] *See* Coalition Letter, *supra* note 231.

[270] Proposing Release, *supra* note 1, at 4523.

[271] Flannery Economic Analysis, *supra* note 218, at ⁋57.

[272] SLCG Paper, *supra* note 244, at 13 (comparing gross-of-fee returns over various periods using a margin account to obtain leveraged/inverse performance during such periods (without compounding) to leveraged/inverse fund returns over the same periods (with compounding)).

[273] Flannery Economic Analysis, *supra* note 218, at ⁋59.

funds unavailable to investors who do understand them and are trading them appropriately *or* making them available at significantly increased costs in order to protect an unidentified and potentially imaginary group of investors—namely, those who are haphazardly wandering into them, notwithstanding the cautionary disclosures provided by them. In the absence of such an analysis, Direxion fails to see how the Commission can appropriately justify this cost transference on to investors who have taken the time to read such funds' disclosures, to understand them and to trade them appropriately.

INTERMEDIARIES' COSTS WILL LIKELY BE EVEN HIGHER THAN ESTIMATED.

There are critical differences between the Sales Practice Rules and the existing options rules, which are not accounted for in the Commission's cost-benefit analysis. There, the Commission says, "as the proposed requirements are generally modeled after the options account requirements, broker-dealers that already have compliance procedures in place for approving options accounts would likely have reduced compliance costs."[274] If the Commission understood that the Sales Practice Rules will impose a front-office compliance requirement on a broker-dealer's back office operations, *as has never been done before*, it could not reasonably estimate that such firms' existing options-related compliance practices will result in reduced compliance implementation costs.

Indeed, in nearly the same breath that the Commission notes the need to train "customer-facing personnel" on the Sales Practice Rules, it provides a cost analysis that does not include any customer-facing personnel time. Yet many self-directed investors do not interact with customer-facing personnel when placing self-directed trades. Personnel to interact with them likely do not even exist; so intermediaries will incur costs hiring such personnel, and there will be additional time and costs training them—none of which appear to be reflected in the Commission's estimates.[275]

Further, broker-dealers will need to collect data that they do not currently collect on customers who seek to open self-directed brokerage accounts. Such customers may not know what types of securities they want to trade when they open an account; so they may misinform the firm. What happens then?

The Proposing Release also does not indicate what intermediaries' updating responsibility is with respect to the information on which they had approved an account opening under the Sales Practice Rules. It is entirely unclear what this timing obligation is for them and, in order to mitigate the risk of liability, they would likely do it more—rather than less—frequently. Indeed, assuming that they are advised to mimic their approach to options trading, they would be required to do it "as soon as aware" of a change in the information provided, creating a constant obligation on intermediaries to patrol their customers.

Further, firms would need to develop software systems to prevent accounts that had not been approved for product trading from such trading. They would not currently have such a

[274] Proposing Release, *supra* note 1, at 4522.

[275] *Compare id*. at 4523 *with id*. at 4523 n.538.

system because their current system for options accounts would be triggered based on their attempting to place a trade on an options exchange. As leveraged/inverse funds are traded on securities exchanges, entirely new systems would need to be developed.

Once developed and deployed, these new software systems would need to be updated daily to include the CUSIPs and tickers of products listed the previous day as the system would need to be CUSIP/ticker specific. The Commission's cost-benefit analysis does not seem to account for the continuous and on-going dedication of personnel resources to these updates. In sum, the costs of the Sales Practice Rules would likely be even higher than estimated by the Commission.

As the Commission must realize, intermediaries are unlikely to make the necessary revisions to their compliance and related procedures to implement the Sales Practice Rules. This is not only Direxion's view, but that of other commenters, as well.[276] The direct consequence, of course, will be that assets in leveraged/inverse investment vehicles will likely decline precipitously, making it impossible for sponsors like Direxion to run such strategies cost-effectively. Nevertheless, the Commission estimates *no costs* to the industry in this regard.[277] Instead, the Commission says that because no existing leveraged/inverse fund could not comply with the 300% limit on leverage in proposed Rule 18f-4, it "do[es] not expect any costs associated with existing funds having to alter their investment strategies or business practices."[278] Thus, the Commission does not consider for purposes of its cost-benefit analysis, the full cost of its proposed rules.[279]

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[276] Coalition Letter, *supra* note 231, at 1 ("[m]any broker-dealers will deny investors the ability to invest in these instruments simply because of the regulatory risk that allowing such investment entails"). *See also*, Flannery Economic Analysis, *supra* note 218, at ¶¶62–65

[277] Proposing Release, *supra* note 1, at 4524.

[278] *Id.*

[279] The Commission's analysis of the proposed rules' effects on efficiency, competition and capital formation are similarly Pollyannaish. For example, the Commission says,

> The proposed sales practices rules could . . . reduce investments in leveraged/inverse investment vehicles, to the extent that some retail investors would not be approved by their broker-dealer or investment adviser to transact in leveraged/inverse investment vehicles or to the extent that some retail investors would be deterred by the time costs and delay introduced by the account-opening procedures. The proposed amendments to rule 6c-11, however, would likely outweigh these effects in the case of leveraged/inverse ETFs and lead to an overall increase in the number and assets under management for these types of funds.

Proposing Release, *supra* note 1, at 4528.

Again, the Commission has not considered the possibility of intermediary abandonment. Intermediary abandonment will result in reduced investments in leveraged/inverse investment vehicles, and intermediary abandonment will make it impossible for new market entrants to take advantage of Rule 6c-11 to offer competing leveraged/inverse funds. Thus, while Direxion supports expanding Rule 6c-11 to allow all registrants to launch future leveraged/inverse ETFs,

THE COMMISSION FAILED TO CONSIDER REASONABLE ALTERNATIVES.

THE COMMISSION COULD ACHIEVE ITS GOALS BY CODIFYING CURRENT ASSET SEGREGATION PRACTICES.

The Commission and Staff have continuously endorsed asset segregation as an appropriate means of addressing the risks purportedly giving rise to proposed Rule 18f-4 since at least 1979.[280] In an asset segregation regime, funds segregate assets to cover outstanding liabilities in order to address concerns about asset sufficiency. Segregating assets, however, necessarily limits the amount of leverage a fund can obtain; accordingly, limitations on leverage are a natural by-product of asset segregation.

The Commission now says that asset segregation does not impose a "practical limit" on funds' use of derivatives,[281] suggesting the additional measure of proposed Rule 18f-4 is necessary. The Commission partially explains its concern about there being a "practical limit" on leverage by observing that a fund segregating only the mark-to-market value (*i.e.,* the out-of-the-money value) of a derivative could lose more than the amount segregated.[282] What the Commission fails to acknowledge is that this is also true with bank borrowings, which are explicitly permitted by Section 18(f). There is no requirement anywhere in the 1940 Act that a fund, which borrows $50 on a $100 of total assets, only invest in instruments that may result in losses of $50 or less. As this is not the standard embodied in Section 18(f) itself, it is entirely arbitrary for the Commission to adopt it as the appropriate standard for derivatives, which it contends are functionally equivalent to bank borrowings.

Further, as noted above, the Commission estimates that "a very small number of funds, *if any,* would have to adjust their portfolios in order to comply with the VaR-based limit" proposed.[283] In plain English: funds' current asset segregation practices are working. And not only are they working, they are achieving basically the same result that proposed Rule 18f-4 will achieve. Investors' protection from "leverage risk" will be largely unchanged after proposed Rule 18f-4, and the Commission could achieve this result *at virtually no cost* by simply codifying current market practices.

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we are concerned that the Commission has failed to confront the full costs and benefits of the Derivatives Rules.

[280] *See* Release 10666, *supra* note 55.

[281] Proposing Release, *supra* note 1, at 4512.

[282] *Id*.

[283] *Id*. at 4519 (emphasis added).

THE COMMISSION COULD—AND SHOULD—SEEK TO ACHIEVE ITS INVESTOR PROTECTION GOALS THROUGH DISCLOSURE.[284]

We do not believe that the Commission should turn its back on disclosure, and various provisions in proposed Rule 18f-4 suggest that the Commission, too, continues to believe in the value of clear disclosure. For example, under proposed Rule 18f-4, funds complying with the relative VaR test would be required to disclose their designated reference index for calculating VaR. The Commission explains this disclosure requirement as being appropriate because "[r]equiring a fund to select a designated reference index that it publicly discloses would promote the fund's selection of an appropriate index that reflects the fund's portfolio risks and its investor expectations."[285] Simply put, investors will develop expectations based on the disclosure. And, by the way, they will develop expectations based on this disclosure even though it will be buried in a fund's annual report. Yet implicit in the Sales Practice Rules is the notion that investors do not develop similar reasonable expectations about leveraged/inverse fund performance based on the **boldface cover page** *and* point of sale disclosures that they receive.

The illogic of the Commission's position is only heightened by other provisions of proposed Rule 18f-4. Specifically, the "alternative provision for leveraged/inverse funds" in proposed Rule 18f-4 would require that such funds disclose in their prospectus that they are "not subject to the condition of [Rule 18f-4] limiting fund leverage risk."[286] This proposed disclosure requirement is perplexing. On the one hand, the Commission seems to have concluded that disclosure does not work for leveraged/inverse funds, and therefore, the intermediary babysitting regime embodied by the Sales Practice Rules is necessary. On the other hand, it is proposing additional disclosure for such funds that only investors who are familiar with proposed Rule 18f-4 will understand. Together, this proposed disclosure requirement and the Sales Practice Rules are wholly incongruous, and further highlight the Commission's failure to explain why disclosure is sufficient for every other security type, but not leveraged/inverse funds.

Direxion has always advocated, and continues to advocate, for robust disclosure by leveraged/inverse funds in order to ensure that investors have the information that they need to understand their characteristics and risks when deciding whether to include them in their portfolios. And Congress has given the Commission broad authority to prescribe disclosure requirements. As part of the Dodd-Frank Act, Congress added Section 15(n) to the Exchange Act. Section 15(n) is entitled "Disclosures to Retail Investors" and provides:

> Notwithstanding any other provision of the securities laws, the Commission may issue rules designating documents or information that shall be provided by a

[284] *Id*. at 4496 (responding to Request for Comment #187) (asking whether the Sales Practice Rules "should . . . require a firm to incorporate and distill into a short disclosure the specific risk factors associated with products (such as the risks related to compounding . . . ")). *See also*, *id*. at 4498 (responding to Request for Comment #198) (asking if additional restrictions on advertising and marketing would address the Commission's investor protection concerns)).

[285] *Id*. at 4472.

[286] *Id*. at 4496.

broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor.

Congress directed that in implementing rules under its Section 15(n) authority, "the Commission shall consider whether the rules will promote investor protection, efficiency, competition, and capital formation." Accordingly, under Section 15(n), the Commission appears to be empowered to impose reasonable disclosure requirements on leveraged/inverse investment vehicles, and Direxion supports sensible additional disclosure requirements.[287]

More specifically, Direxion supports the codification of various current market practices that it believes, in fact, enhance investors' understanding—and investors' opportunity to understand—leveraged/inverse funds before they trade them. For example, Direxion supports imposing a uniform naming convention on leveraged/inverse funds, requiring the name to include an indication of the level of leverage obtained by a fund and the compounding rate (*e.g.*, daily, monthly). In addition, Direxion believes that the boldface cover page and similar disclosures that are currently prominently featured on leveraged/inverse fund prospectuses are valuable in alerting investors to the characteristics and risks of such funds. Accordingly, Direxion supports making these disclosures mandatory. Further, Direxion supports requiring broker-dealers to obtain annual affirmations from self-directed clients, who have traded leveraged/inverse funds, that they understand such funds' strategies. Moreover, Direxion supports requiring broker-dealers to provide point-of-sale disclosure to self-directed investors regarding the characteristics and risks of such funds.

Direxion does not support such requirements for recommended or discretionary transactions already subject to suitability and Regulation Best Interest requirements or for transactions subject to an investment adviser's fiduciary duties. Any additional disclosure requirements in those circumstances would impose costs without benefits for all of the reasons explained above.

* * *

In conclusion, for the reasons explained herein, Direxion strongly opposes promulgation of the proposed Derivatives Rules.

[287] Other commenters, too, recommend that the Commission focus on a disclosure-based regime. *E.g.*, Letter of CFA Institute to Brent J. Fields, Secretary, Securities and Exchange Commission, at 3 (Nov. 15, 2018) (in the context of commenting on then-proposed Rule 6c-11, stating that its members "support requiring marketing materials for [leveraged/inverse funds] to contain language to put retail investors on notice of the particular risks of investing in these instruments").

APPENDIX A

The detailed disclosure provided by the most highly daily leveraged Direxion ETFs ("Bull ETFs") provides: [1]

> ***Effects of Compounding and Market Volatility Risk*** - The Fund has a daily leveraged investment objective and the Fund's performance for periods greater than a trading day will be the result of each day's returns compounded over the period, which is very likely to differ from 300% of the Index's performance, before fees and expenses. Compounding affects all investments, but has a more significant impact on funds that are leveraged and that rebalance daily. Particularly during periods of higher Index volatility, compounding will cause results for periods longer than a trading day to vary from 300% of the performance of the Index. The effect of compounding becomes more pronounced as Index volatility and the holding period increase. The impact of compounding will impact each shareholder differently depending on the period of time an investment in the Fund is held and the volatility of the Index during shareholder's holding period of an investment in the Fund. If adverse daily performance of the Index reduces the amount of a shareholder's investment, any further adverse daily performance will lead to a smaller dollar loss because the shareholder's investment had already been reduced by the prior adverse performance. Equally, however, if favorable daily performance of the Index increases the amount of a shareholder's investment, the dollar amount lost due to future adverse performance will increase because the shareholder's investment has increased.
>
> The chart below provides examples of how Index volatility could affect the Fund's performance. Fund performance for periods greater than one single day can be estimated given any set of assumptions for the following factors: a) Index volatility; b) Index performance; c) period of time; d) financing rates associated with leveraged exposure; e) other Fund expenses; and f) dividends or interest paid with respect to securities in the Index. The chart below illustrates the impact of two principal factors – Index volatility and Index performance – on Fund performance. The chart shows estimated Fund returns for a number of combinations of Index volatility and Index performance over a one-year period. Performance shown in the chart assumes that: (i) no dividends were paid with respect to the securities included in the Index; (ii) there were no Fund expenses; and (iii) borrowing/lending rates (to obtain leveraged exposure) of 0%. If Fund expenses and/or actual borrowing/lending rates were reflected, the estimated returns would be different than those shown.
>
> As shown in the chart below, the Fund would be expected to lose 17.1% if the Index provided no return over a one year period during which the Index experienced annualized volatility of 25%. At higher ranges of volatility, there is a chance of a

[1] This discussion uses disclosure from a Direxion ETF. The Direxion Funds' disclosure is similar but reflects the monthly nature of their investment objectives and their lower leverage points.

near complete loss of value in the Fund, even if the Index's return is flat. For instance, if the Index's annualized volatility is 100%, the Fund would be expected to lose 95% of its value, even if the cumulative Index return for the year was 0%. Areas shaded red (or dark gray) represent those scenarios where the Fund can be expected to return less than 300% of the performance of the Index and those shaded green (or light gray) represent those scenarios where the Fund can be expected to return more than 300% of the performance of the Index. The table below is intended to isolate the effect of Index volatility and performance on the Fund's performance. The Fund's actual returns may be significantly better or worse than the returns shown below as a result of any of the factors discussed above or in "Daily Index Correlation/Tracking Risk" below.

One Year Index Return	300% One Year Index Return	Volatility Rate 10%	25%	50%	75%	100%
-60%	-180%	-93.8%	-94.7%	-97.0%	-98.8%	-99.7%
-50%	-150%	-87.9%	-89.6%	-94.1%	-97.7%	-99.4%
-40%	-120%	-79.0%	-82.1%	-89.8%	-96.0%	-98.9%
-30%	-90%	-66.7%	-71.6%	-83.8%	-93.7%	-98.3%
-20%	-60%	-50.3%	-57.6%	-75.8%	-90.5%	-97.5%
-10%	-30%	-29.3%	-39.6%	-65.6%	-86.5%	-96.4%
0%	0%	-3.0%	-17.1%	-52.8%	-81.5%	-95.0%
10%	30%	29.2%	10.3%	-37.1%	-75.4%	-93.4%
20%	60%	67.7%	43.3%	-18.4%	-68.0%	-91.4%
30%	90%	113.2%	82.1%	3.8%	-59.4%	-89.1%
40%	120%	166.3%	127.5%	29.6%	-49.2%	-86.3%
50%	150%	227.5%	179.8%	59.4%	-37.6%	-83.2%
60%	180%	297.5%	239.6%	93.5%	-24.2%	-79.6%

* * *

For information regarding the effects of volatility and Index performance on the long-term performance of the Fund, see "Additional Information Regarding Investment Techniques and Policies" in the Fund's statutory prospectus, and "Special Note Regarding the Correlation Risks of the Funds" in the Fund's Statement of Additional Information.

These same risks are disclosed in even greater detail in the Direxion funds' statutory prospectuses and SAIs. Under the heading "Additional Information Regarding Investment Techniques and Policies" in the statutory prospectus, the Funds disclose the following:

Rafferty uses a number of investment techniques in an effort to achieve the stated investment objective for each Fund. Each Fund seeks 300% or -300% of the return of its underlying index on a given day.

For the Bull Funds, Rafferty attempts to provide three times the returns of its underlying index for a one-day period. Each Bear Fund is managed to provide three times the inverse (or opposite) of the return of its underlying index for a one-day period. To do this, Rafferty creates net “long” positions for the Bull Funds and net “short” positions for the Bear Funds. (Rafferty may create short positions in the Bull Funds and long positions in the Bear Funds even though the net exposure in the Bull Funds will be long and the net exposure in the Bear Funds will be short.) Long positions move in the same direction as its underlying index, advancing when the underlying index advances and declining when the underlying index declines. Short positions move in the opposite direction of the underlying index, advancing when the underlying index declines and declining when the underlying index advances. Additionally, none of the Funds seek income that is exempt from federal, state or local income taxes.

In seeking to achieve each Fund’s investment objective, Rafferty uses statistical and quantitative analysis to determine the investments each Fund makes and the techniques it employs. Rafferty relies upon a pre-determined model to generate orders that result in repositioning each Fund’s investments in accordance with its daily leveraged investment objective. Using this approach, Rafferty determines the type, quantity and mix of investment positions that it believes in combination should produce daily returns consistent with a Fund’s investment objective. In general, if a Fund is performing as designed, the return of the underlying index will dictate the return for that Fund. Rafferty does not invest the assets of a Fund in securities, derivatives or other investments based on Rafferty’s view of the investment merit of a particular security, instrument or company, nor does it conduct conventional investment research or analysis or forecast market movements or trends. Each Fund generally pursues its investment objective regardless of the market conditions and does not take defensive positions.

Each Fund has a clearly articulated daily leveraged investment objective which requires the Fund to seek economic exposure in excess of its net assets (i.e., economic leverage). To meet its objectives, each Fund invests in some combination of financial instruments so that it generates economic exposure consistent with the Fund’s investment objective.

The Bull Funds generally may hold a representative sample of the securities in the underlying index. The sampling of securities that is held by a Bull Fund is intended to maintain high correlation with, and similar aggregate characteristics (e.g., market capitalization and industry weightings) to, the underlying index. A Bull Fund also may invest in securities that are not included in its underlying index or may overweight or underweight certain components of the underlying index. Certain Funds’ assets may be concentrated in an industry or group of industries to the extent that a Fund's underlying index concentrates in a particular industry or group of industries. In addition, each Fund offered in this Prospectus is non-diversified, which means that it may invest in the securities of a limited number of issuers.

At the close of the markets each trading day, each Fund will position its portfolio to ensure that the Fund's exposure to its underlying index is consistent with the Fund's stated investment objective. The impact of market movements during the day determines whether a portfolio needs to be repositioned. If the underlying index has risen on a given day, a Bull Fund's net assets should rise, meaning its exposure will typically need to be increased. Conversely, if the underlying index has fallen on a given day, a Bull Fund's net assets should fall, meaning its exposure will typically need to be reduced. If the underlying index has risen on a given day, a Bear Fund's net assets should fall, meaning its exposure will typically need to be reduced. If the underlying index has fallen on a given day, a Bear Fund's net assets should rise, meaning its exposure will typically need to be increased. Any of the Funds' portfolios may also need to be changed to reflect changes in the composition of its underlying index. A Fund may have difficulty in achieving its daily leveraged investment objective due to fees, expenses, transaction costs, income items, accounting standards, significant purchase and redemption activity by Fund shareholders and/or disruptions or a temporary lack of liquidity in the markets for the securities held by the Fund. Additionally, if a Fund's underlying index includes foreign securities or tracks a foreign market index where the foreign market closes before or after the New York Stock Exchange ("NYSE") closes (generally at 4 p.m. Eastern Time), the performance of the underlying index may differ from the expected daily leveraged performance. As such, correlation to an underlying index for Funds that track an underlying index that includes foreign securities will generally be measured by comparing the daily change in a Fund's NAV per share to the performance of one or more U.S. ETFs that tracks the same underlying index. An exchange or market may close or issue trading halts on specific securities, or the ability to buy or sell certain securities or financial instruments may be restricted, which may result in a Fund being unable to buy or sell certain securities or financial instruments. In such circumstances, a Fund may be unable to rebalance its portfolio, may be unable to accurately price its investments and/or may incur substantial trading losses.

If a Fund is unable to obtain sufficient leveraged or leveraged inverse exposure to its underlying index due to the limited availability of necessary investments or financial instruments, a Fund could, among other things, limit or suspend creation units until the Adviser determines that the requisite exposure to its underlying index is obtainable. During the period that creation units are suspended, a Fund could trade at a significant premium or discount to its NAV and could experience substantial redemptions.

A Cautionary Note to Investors Regarding Dramatic Index Movement. A Bull Fund seeks daily exposure to its underlying index equal to 300% of its net assets while a Bear Fund seeks daily exposure to its underlying index equal to -300% of its net assets. As a consequence, a Fund could lose an amount greater than its net assets in the event of a movement of its underlying index in excess of 33% in a direction adverse to the Fund (meaning a decline in the value of the underlying index of a Bull Fund and a gain in the value of the underlying index for a Bear Fund). Rafferty will attempt to position each Fund's portfolio to ensure that a Fund does not gain or lose more than 90% of its NAV on a given day. If Rafferty successfully positions a Fund's portfolio to provide such limits, a Fund's portfolio and NAV will not be responsive to movements in its underlying index beyond 30% in a given day, whether that movement is favorable or adverse to the Fund. For example, if a Bull Fund's underlying index were to gain 35%, the Bull Fund would be limited to a daily gain of 90%, which corresponds to 300% of an underlying index gain of 30%, rather than 105%, which is 300% of the underlying index gain of 35%. It may not be possible to limit a Fund's losses, and shareholders should not expect such protection. The risk of total loss exists.

If the underlying index of a Fund has a dramatic adverse move that causes a material decline in a Fund's net assets, the terms of a Fund's swap agreements may permit the counterparty to immediately close out the swap transaction. In that event, a Fund may be unable to enter into another swap agreement or invest in other derivatives to achieve exposure consistent with a Fund's investment objective. This may prevent a Fund from achieving its leveraged or inverse leveraged investment objective, even if the underlying index later reverses all or a portion the move.

Examples of the Impact of Daily Compounding. Seeking daily leveraged investment results provides potential for greater gains and losses for the Funds relative to its underlying index's performance. For a period longer than one day, the pursuit of a daily investment objective will result in daily leveraged compounding for the Funds. This means that the return of an underlying index over a period of time greater than one day multiplied by a Fund's daily leveraged investment objective (e.g., 300% or -300%) generally will not equal a Fund's performance over that same period. As a consequence, investors should not plan to hold the Funds unmonitored for periods longer than a single trading day. Further, the return for investors that invest for periods less than a full trading day or for a period different than a trading day will not be the product of the return of a Fund's stated daily leveraged investment objective and the performance of the underlying index for the full trading day. The Funds are not suitable for all investors.

Consider the following examples:

> Mary is considering investments in two Funds, Funds A, and B. Fund A is a traditional index ETF which seeks (before fees and expenses) to match the performance of the XYZ index. Fund B is a leveraged ETF and seeks daily leveraged investment results (before fees and expenses) that correspond to 300% of the daily performance of the XYZ index.
>
> On Day 1, the XYZ index increases in value from $100 to $105, a gain of 5%. On Day 2, the XYZ index declines from $105 back to $100, a loss of 4.76%. In the aggregate, the XYZ index has not moved.

An investment in Fund A would be expected to gain 5% on Day 1 and lose 4.76% on Day 2 to return to its original value. The following example assumes a $100 investment in Fund A when the index is also valued at $100:

Day	Index Value	Index Performance	Value of Investment
	$100.00		$100.00
1	$105.00	5.00%	$105.00
2	$100.00	-4.76%	$100.00

The same $100 investment in Fund B, however, would be expected to gain in value on Day 1 but decline in value on Day 2.

The $100 investment in Fund B would be expected to gain 15% on Day 1 (300% of 5%) but decline 14.28% on Day 2.

Day	Index Performance	300% of Index Performance	Value of Investment
			$100.00
1	5.00%	15.0%	$115.00
2	-4.76%	-14.28%	$98.57

Although the percentage decline in Fund B is smaller on Day 2 than the percentage gain on Day 1, the loss is applied to a higher principal amount, so the investment in Fund B experiences a loss even when the aggregate index value for the two-day period has not declined. (These calculations do not include the charges for expense ratio and financing charges.)

As you can see, an investment in Fund B has additional risks due to the effects of leverage and compounding. The Funds are very different from most mutual funds and ETFs. Each Fund pursues a daily leveraged or daily inverse leveraged investment objective, which means that the Funds are riskier than alternatives that do not use leverage because the Funds magnify the performance or the inverse of the performance of the underlying index. Additionally, each Bear Fund seeks to provide returns that are a multiple of the inverse of the performance of its underlying index (-300%), a result opposite of most mutual funds and ETFs. An investor who purchases shares of a Fund intra-day will generally receive more, or less, than 300% exposure to the underlying index from that point until the end of the trading day. The actual exposure will be largely a function of the performance of the underlying index from the end of the prior trading day. If a Fund's shares are held for a period longer than a single trading day, the Fund's performance is likely to deviate from 300% or -300% of the return of the underlying index's performance for the longer period. This deviation will increase with higher underlying index volatility and longer holding periods.

For periods longer than a trading day, volatility in the performance of the underlying index from day to day is the primary cause of any disparity between a Fund's actual returns and the returns of the underlying index for such period. Volatility causes such disparity because it exacerbates the effects of compounding on a Fund's returns. In addition, the effects of volatility are magnified in the Funds due to leverage. For example, consider the following three examples that demonstrate the effect of volatility on a hypothetical fund:

Example 1 – Underlying Index Experiences Low Volatility

Mary invests $10.00 in a hypothetical Bull Fund at the close of trading on Day 1. During Day 2, the Fund's underlying index rises from 100 to 102, a 2% gain. Mary's investment rises 6% to $10.60. Mary holds her investment through the close of trading on Day 3, during which the Fund's underlying index rises from 102 to 104, a gain of 1.96%. Mary's investment rises to $11.22, a gain during Day 3 of 5.88%. For the two day period since Mary invested in the Fund, the underlying index gained 4% although Mary's investment increased by 12.2%. Because the underlying index continued to trend upwards with low volatility, Mary's return closely correlates to the 300% return of the return of the underlying index for the period.

John invests $10.00 in a hypothetical Bear Fund at the close of trading on Day 1. During Day 2, the Fund's underlying index gains 2%, and John's investment falls by 6% to $9.40. On Day 3, the underlying index rises by 1.96%, and John's Fund falls by 5.88% to $8.85. For the two day period the underlying index returned 4% while the Fund lost 11.5%. John's return still correlates to -300% return of the underlying index, but not as closely as Mary's investment in a Bull Fund.

Example 2 – Underlying Index Experiences High Volatility

Mary invests $10.00 in a hypothetical Bull Fund after the close of trading on Day 1. During Day 2, the Fund's underlying index rises from 100 to 102, a 2%gain, and Mary's investment rises 6%to $10.60. Mary continues to hold her investment through the end of Day 3, during which the Fund's underlying index declines from 102 to 98, a loss of 3.92%. Mary's investment declines by 11.76%, from $10.60 to $9.35. For the two day period since Mary invested in the Fund, the Fund's underlying index lost2%while Mary's investment decreased from $10 to $9.35, a 6.47% loss. The volatility of the underlying index affected the correlation between the underlying index's return for the two day period and Mary's return. In this situation, Mary lost more than three times the return of the underlying index.

Conversely, John invests $10.00 in a hypothetical Bear Fund after the close of trading on Day 1. During Day 2, the Fund's underlying index rises from 100 to 102, a 2% gain, and John's investment falls 6% to $9.40. John continues to hold his investment through the end of Day 3, during which the Fund's underlying index declines from 102 to 98, a loss of 3.92%. John's investment rises by 11.76%, from $9.40 to $10.51. For the two day period since John invested in the Fund, the Fund's underlying index lost 2% while John's investment increased from $10 to $10.51, a 5.06% gain. The volatility of the underlying index affected the correlation between the underlying index's return for the two day period and John's return. In this situation, John gained less than three times the return of the underlying index.

<u>Example 3 – Intra-day Investment with Volatility</u>

The examples above assumed that Mary purchased the hypothetical Bull Fund at the close of trading on Day 1 and sold her investment at the close of trading on a subsequent day. However, if she made an investment intra-day, she would have received a beta determined by the performance of the underlying index from the end of the prior trading day until her time of purchase on the next trading day. Consider the following example.

Mary invests $10.00 in a hypothetical Bull Fund at 11 a.m. on Day 2. From the close of trading on Day 1 until 11 a.m. on Day 2, the underlying index moved from 100 to 102, a 2%gain. In light of that gain, the Fund beta at the point at which Mary invests is 289%. During the remainder of Day 2, the Fund's underlying index rises from 102 to 110, a gain of 7.84%, and Mary's investment rises 22.7% (which is the underlying index gain of 7.84% multiplied by the 289% beta that she received) to $12.27. Mary continues to hold her investment through the close of trading on Day 2, during which the

Fund's underlying index declines from 110 to 90, a loss of 18.18%. Mary's investment declines by 54.5%, from $12.27 to $5.58. For the period of Mary's investment, the Fund's underlying index declined from 102 to 90, a loss of 11.76%, while Mary's investment decreased from $10.00 to $5.58, a 44% loss. The volatility of the underlying index affected the correlation between the underlying index's return for period and Mary's return. In this situation, Mary lost more than three times the return of the underlying index. Mary was also hurt because she missed the first 2% move of the underlying index and had a beta of 289% for the remainder of Day 2.

The Funds are designed to be utilized only by sophisticated investors, such as traders and active investors employing dynamic strategies. Such investors are expected to monitor and manage their portfolios frequently. Investors in the Funds should: (a) understand the risks associated with the use of leverage, (b) understand the consequences of seeking daily leveraged investment results, (c) For each Bear

Fund, understand the risk of shorting, and (d) intend to actively monitor and manage their investments. Investors who do not understand the Funds, or do not intend to actively manage their funds and monitor their investments, should not buy the Funds. There is no assurance that any of the Funds offered in this Prospectus will achieve their investment objectives and an investment in any Fund could lose money. No single Fund is a complete investment program.

Market Volatility. Each Fund seeks to provide a return which is a multiple of the daily performance of its underlying index. No Fund attempts to, and no Fund should be expected to, provide returns which are a multiple of the return of the underlying index for periods other than a single day. Each Fund rebalances its portfolio on a daily basis, increasing exposure in response to that day's gains or reducing exposure in response to that day's losses.

Daily rebalancing will impair a Fund's performance if the underlying index experiences volatility. For instance, a Bull Fund would be expected to lose 11% (as shown in Table 1 below) if its underlying index provided no return over a one year period and experienced annualized volatility of 20%. A Bear Fund would be expected to lose 21% (as shown in Table 1 below) if its underlying index provided no return over a one year period and experienced annualized volatility of 20%. If the underlying index's annualized volatility were to rise to 40%, the hypothetical loss for a one year period for a Bull Fund widens to approximately 38% while the loss for a Bear Fund rises to 62%.

At higher volatility levels, there is a chance of a complete loss of Fund assets even if the underlying index is flat. For instance, if annualized volatility of an underlying index were 90%, both Bull and Bear Funds based on that underlying index would be expected to lose more than 90% of their value, even if the underlying index returned 0% for the year. An index's volatility rate is a statistical measure of the magnitude of fluctuations in the returns of an index.

Table 1

Volatility Range	Bull Fund Loss	Bear Fund Loss
10%	-3%	-6%
20%	-11%	-21%
30%	-24%	-42%
40%	-38%	-62%
50%	-53%	-78%
60%	-67%	-89%
70%	-78%	-95%
80%	-87%	-98%
90%	-92%	-99%
100%	-96%	-99%

Table 2 shows the average volatility rate for the Funds' underlying indices over the five year period ended December 31, 2019. If an index has been in existence for less than 5 years, its inception date is noted next to its name in Table 2. The underlying indices have annualized historical volatility rates over that period ranging from 5.20% to 40.06%. Since market volatility has negative implications for Funds which rebalance daily, investors should be sure to monitor and manage their investments in the Funds particularly in volatile markets. The negative implications of volatility in Table 1 can be combined with the recent volatility ranges of various indices in Table 2 to give investors some sense of the risks of holding the Funds for longer periods over the past five years. Given the historically low levels of volatility during the past five years, historical index volatility and performance are not likely indicative of future volatility and performance.

Table 2 – Historic Volatility of each Fund's Benchmark Index

Index	5-Year Historical Volatility Rate
Consumer Discretionary Select Sector Index	14.85%
* * *	* * *

The Projected Return of a Bull Fund for a Single Trading Day. Each Bull Fund seeks to provide a daily return that is 300% of the daily return of an underlying index. Doing so requires the use of leveraged investment techniques, which necessarily incur financing charges. In light of the financing charges and a Bull Fund's operating expenses, the expected return of a Bull Fund over one trading day is equal to the gross expected return, which is the daily underlying index return multiplied by a Bull Fund's daily leveraged investment objective, minus (i) financing charges incurred by the portfolio and (ii) daily operating expenses. For instance, if the S&P 500® Index returns 2%on a given day, the gross expected return of the Direxion Daily S&P 500® Bull 3X Shares would be 6%, but the net expected return, which factors in the cost of financing the portfolio and the impact of operating expenses, would be lower. Each Bull Fund will reposition its portfolio at the end of every trading day. Therefore, if an investor purchases Fund shares at close of the markets on a given trading day, the investor's exposure to the underlying index of a Bull Fund would reflect 300% of the performance of the underlying index during the following trading day, subject to the charges and expenses noted above.

The Projected Return of a Bear Fund for a Single Trading Day. Each Bear Fund seeks to provide a daily return which is 300% of the inverse (or opposite) of the daily return of an underlying index. To create the necessary exposure, a Bear Fund may engage in short selling — borrowing and selling securities it does not own. The money that a Bear Fund receives from short sales — the short sale proceeds — is an asset of the Bear Fund that can generate income to help offset the Bear Fund's operating expenses. However, the costs of creating short exposure, which may require the Bear Fund's counterparties to borrow and sell certain securities, may offset or outweigh such income. As the holder of a short position, a Bear Fund also is responsible for paying the dividends and interest accruing on the short position, which is an expense to the Bear Fund that could cause the Fund to lose money on the short sale and may adversely affect its performance. Each Bear Fund will reposition its portfolio at the end of every trading day. Therefore, if an investor purchases Bear Fund shares at close of the markets on a given trading day, the investor's exposure to the underlying index of a Bear Fund would reflect 300% of the inverse performance of the underlying index during the following trading day, subject to the charges and expenses noted above.

The Projected Returns of Funds for Intra-Day Purchases. Because the Funds rebalance their portfolios once daily, an investor who purchases shares during a day will likely have more, or less, than 300% leveraged investment exposure to the underlying index. The exposure to the underlying index received by an investor who purchases a Fund intra-day will differ from the Fund's stated daily leveraged investment objective (e.g., 300% or -300%) by an amount determined by the movement of the underlying index from its value at the end of the prior day. If the underlying index moves in a direction favorable to the Fund between the close of the market on one trading day through the time on the next trading day when the investor purchases Fund shares, the investor will receive less exposure to the underlying index than the stated fund daily leveraged investment objective (e.g., 300% or -300%). Conversely, if the underlying index moves in a direction adverse to the Fund, the investor will receive more exposure to the underlying index than the stated fund daily leveraged investment objective (e.g., 300% or -300%).

Table 3 below indicates the exposure to the underlying index that an intra-day purchase of a Bull Fund would be expected to provide based upon the movement in the value of a Bull Fund's underlying index from the close of the market on the prior trading day. Such exposure holds until a subsequent sale on that same trading day or until the close of the market on that trading day. For instance, if the underlying index of a Bull Fund has moved 2% in a direction favorable to a Bull Fund, the investor would receive exposure to the performance of the underlying index from that point until the investor sells later that day or the end of the day equal to approximately 289% of the investor's investment.

Conversely, if the underlying index has moved 2% in a direction unfavorable to a Bull Fund, an investor at that point would receive exposure to the performance of the underlying index from that point until the investor sells later that day or the end of the day equal to approximately 313% of the investor's investment.

The table includes a range of underlying index moves from 5%to -5% for a Bull Fund. Movement of the underlying index beyond the range noted below will result in exposure further from the Fund's daily leveraged investment objective.

Table 3

Index Move	Resulting Exposure for Bull Fund
-5%	335%
-4%	327%
-3%	320%
-2%	313%
-1%	306%
0%	300%
1%	294%
2%	289%
3%	283%
4%	279%
5%	274%

Table 4 below indicates the exposure to the underlying index that an intra-day purchase of a Bear Fund would be expected to provide based upon the movement in the value of the Bear Fund's underlying index from the close of the market on the prior trading day. Such exposure holds until a subsequent sale on that same trading day or until the close of the market on that trading day. Table 4 indicates that, if the underlying index of a Bear Fund has moved 2% in a direction favorable to the Bear Fund, the investor would receive exposure to the performance of the underlying index from that point until the investor sells later that day or the end of the day equal to approximately -277% of the investor's investment. Conversely, if the underlying index has moved 2% in a direction unfavorable to a Bear Fund, an investor would receive exposure to the performance of the underlying index from that point until the investor sells later that day or the end of the day equal to approximately 326% of the investor's investment.

The table includes a range of underlying index moves from 5% to -5% for the Bear Fund. Movement of the underlying index beyond the range noted below will result in exposure further from the Fund's daily leveraged investment objective.

Table 4

Index Move	Resulting Exposure for Bear Fund
-5%	248%
-4%	-257%
-3%	-267%
-2%	-277%
-1%	-288%
0%	-300%
1%	-312%
2%	-326%

3%	-340%
4%	-355%
5%	-371%

The Projected Returns of the Funds for Periods Other Than a Single Trading Day. The Funds seek leveraged investment results on a daily basis — from the close of regular trading on one trading day to the close on the next trading day — which should not be equated with seeking a leveraged investment objective for any other period. For instance, if the S&P 500® Index gains 10% for a week, the Direxion Daily S&P 500® Bull 3X Shares should not be expected to provide a return of 30% for the week even if it meets its daily leveraged investment objective throughout the week. This is true because of the financing charges noted above but also because the pursuit of daily goals may result in daily leveraged compounding, which means that the return of an underlying index over a period of time greater than one day multiplied by a Fund's daily leveraged investment objective or inverse daily leveraged investment objective (e.g., 300% or -300%) will not generally equal a Fund's performance over that same period. In addition, the effects of compounding become greater the longer Shares are held beyond a single trading day.

The following charts set out a range of hypothetical daily performances during a given 10 trading days of the hypothetical underlying index and demonstrate how changes in the hypothetical underlying index impact the hypothetical Funds' performance for one trading day and cumulatively up to, and including, the entire 10 trading day period. The charts are based on a hypothetical $100 investment in the hypothetical Funds over a 10 trading day period and do not reflect expenses of any kind.

Table 5 – The Index Lacks a Clear Trend

Index				Bull Fund			Bear Fund		
	Value	Daily Performance	Cumulative Performance	NAV	Daily Performance	Cumulative Performance	NAV	Daily Performance	Cumulative Performance
	100			$100.00			$100.00		
Day 1	105	5.00%	5.00%	$115.00	15.00%	15.00%	$ 85.00	-15.00%	-15.00%
Day 2	110	4.76%	10.00%	$131.43	14.29%	31.43%	$ 72.86	-14.29%	-27.14%
Day 3	100	-9.09%	0.00%	$ 95.58	-27.27%	-4.42%	$ 92.73	27.27%	-7.27%
Day 4	90	-10.00%	-10.00%	$ 66.91	-30.00%	-33.09%	$120.55	30.00%	20.55%
Day 5	85	-5.56%	-15.00%	$ 55.76	-16.67%	-44.24%	$140.64	16.67%	40.64%
Day 6	100	17.65%	0.00%	$ 85.28	52.94%	-14.72%	$ 66.18	-52.94%	-33.82%
Day 7	95	-5.00%	-5.00%	$ 72.48	-15.00%	-27.52%	$ 76.11	15.00%	-23.89%
Day 8	100	5.26%	0.00%	$ 83.93	15.79%	-16.07%	$ 64.09	-15.79%	-35.91%
Day 9	105	5.00%	5.00%	$ 96.52	15.00%	-3.48%	$ 54.48	-15.00%	-45.52%
Day 10	100	-4.76%	0.00%	$ 82.73	-14.29%	-17.27%	$ 62.26	14.29%	-37.74%

The cumulative performance of the hypothetical underlying index in Table 5 is 0% for 10 trading days. The return of the hypothetical Bull Fund for the 10 trading day period is 17.27%, while the return of the hypothetical Bear Fund is -37.74%. The volatility of the hypothetical underlying index's performance and lack of a clear trend results in performance for each hypothetical Fund for the period which bears little relationship to the performance of the hypothetical underlying index for the 10 trading day period.

Table 6 – The Index Rises in a Clear Trend

Index				Bull Fund			Bear Fund		
	Value	Daily Performance	Cumulative Performance	NAV	Daily Performance	Cumulative Performance	NAV	Daily Performance	Cumulative Performance
	100			$100.00			$100.00		
Day 1	102	2.00%	2.00%	$106.00	6.00%	6.00%	$ 94.00	-6.00%	-6.00%
Day 2	104	1.96%	4.00%	$112.24	5.88%	12.24%	$ 88.47	-5.88%	-11.53%
Day 3	106	1.92%	6.00%	$118.71	5.77%	18.71%	$ 83.37	-5.77%	-16.63%
Day 4	108	1.89%	8.00%	$125.43	5.66%	25.43%	$ 78.65	-5.66%	-21.35%
Day 5	110	1.85%	10.00%	$132.40	5.56%	32.40%	$ 74.28	-5.56%	-25.72%
Day 6	112	1.82%	12.00%	$139.62	5.45%	39.62%	$ 70.23	-5.45%	-29.77%
Day 7	114	1.79%	14.00%	$147.10	5.36%	47.10%	$ 66.46	-5.36%	-33.54%
Day 8	116	1.75%	16.00%	$154.84	5.26%	54.84%	$ 62.97	-5.26%	-37.03%
Day 9	118	1.72%	18.00%	$162.85	5.17%	62.85%	$ 59.71	-5.17%	-40.29%
Day 10	120	1.69%	20.00%	$171.13	5.08%	71.13%	$ 56.67	-5.08%	-43.33%

The cumulative performance of the hypothetical underlying index in Table 6 is 20% for 10 trading days. The return of the hypothetical Bull Fund for the 10 trading day period is 71.13%, while the return of the hypothetical Bear Fund is -43.33%. In this case, because of the positive hypothetical underlying index trend, the hypothetical Bull Fund gain is greater than 300% of the hypothetical underlying index gain and the hypothetical Bear Fund's decline is less than -300% of the hypothetical underlying index gain for the 10 trading day period.

Table 7 – The Index Declines in a Clear Trend

Index				Bull Fund			Bear Fund		
	Value	Daily Performance	Cumulative Performance	NAV	Daily Performance	Cumulative Performance	NAV	Daily Performance	Cumulative Performance
	100			$100.00			$100.00		
Day 1	98	-2.00%	-2.00%	$ 94.00	-6.00%	-6.00%	$106.00	6.00%	6.00%
Day 2	96	-2.04%	-4.00%	$ 88.24	-6.12%	-11.76%	$112.49	6.12%	12.49%
Day 3	94	-2.08%	-6.00%	$ 82.73	-6.25%	-11.76%	$119.52	6.25%	19.52%
Day 4	92	-2.13%	-8.00%	$ 77.45	-6.38%	-22.55%	$127.15	6.38%	27.15%
Day 5	90	-2.17%	-10.00%	$ 72.40	-6.52%	-27.60%	$135.44	6.52%	35.44%

Day 6	88	-2.22%	-12.00%	$ 67.57	-6.67%	-32.43%	$144.47	6.67%	44.47%
Day 7	86	-2.27%	-14.00%	$ 62.96	-6.82%	-37.04%	$154.32	6.82%	54.32%
Day 8	84	-2.33%	-16.00%	$ 58.57	-6.98%	-41.43%	$165.09	6.98%	65.09%
Day 9	82	-2.38%	-18.00%	$ 54.39	-7.14%	-45.61%	$176.88	7.14%	76.88%
Day 10	80	-2.44%	-20.00%	$ 50.41	-7.32%	-49.59%	$189.82	7.32%	89.82%

The cumulative performance of the hypothetical underlying index in Table 7 is -20% for 10 trading days. The return of the hypothetical Bull Fund for the 10 trading day period is 49.59%, while the return of the hypothetical Bear Fund is 89.82%. In this case, because of the negative hypothetical underlying index trend, the hypothetical Bull Fund's decline is less than 300% of the hypothetical underlying index decline and the hypothetical Bear Fund's gain is greater than 300% of the hypothetical underlying index decline for the 10 trading day period.

Under the heading "Special Note Regarding the Correlation Risks of the Funds" in the SAI, the Funds disclose the following:

Special Note Regarding the Correlation Risks of the Funds. As discussed in the Prospectus, each Fund is "leveraged" in the sense that it has an investment objective to match 300% or -300% of the performance of its underlying index on a given day. Each Fund is subject to all of the correlation risks described in the Prospectus. In addition, there is a special form of correlation risk that derives from each Fund's use of leverage, which is that for periods greater than one day, the use of leverage tends to cause the performance of a Fund to be either greater than, or less than, 300% or -300% of the performance of its underlying index.

A Fund's return for periods longer than one day is primarily a function of the following:

a) underlying index performance;

b) underlying index volatility;

c) financing rates associated with leverage;

d) other fund expenses;

e) dividends paid by companies in the underlying index; and

f) period of time.

The fund performance for a Fund can be estimated given any set of assumptions for the factors described above. Illustrated below is the impact of two factors, underlying index volatility and underlying index performance, on a Fund. Underlying index volatility is a statistical measure of the magnitude of fluctuations in the returns of an index and is calculated as the standard deviation of the natural logarithms of one plus the index return (calculated daily), multiplied by the square root of the number of trading days per year (assumed to be 252). The illustration estimates Fund returns for a number of combinations of underlying index performance and underlying index volatility over a one year period and assumes: a) no dividends paid by the companies included in the underlying index; b) no fund expenses; and c) borrowing/lending rates (to obtain leverage) of zero percent. If fund expenses were included, a Fund’s performance would be lower than shown.

As shown below, a Bull Fund would be expected to lose 17.1% and a Bear Fund would be expected to lose 31.3% if the underlying index provided no return over a one year period during which the underlying index experienced annualized volatility of 25%. If the underlying index’s annualized volatility were to rise to 75%, the hypothetical loss for a one year period widens to approximately 81.5% for a Bull Fund and 96.6% for a Bear Fund. At higher ranges of volatility, there is a chance of a near complete loss of value even if the underlying index is flat. For instance, if the underlying index’s annualized volatility is 100%, it is likely that a Bull Fund would lose 95% of its value, and a Bear Fund would lose approximately 100% of its value, even if the underlying index’s cumulative return for the year was only 0%. The volatility of ETFs or instruments that reflect the value of the underlying index such as swaps, may differ from the volatility of a Fund's underlying index.

In the tables below, areas shaded green represent those scenarios where a Fund with the investment objective described will outperform (i.e., return more than) the underlying index’s performance times the stated multiple in the Fund’s investment objective; conversely areas shaded red represent those scenarios where the Fund will underperform (i.e., return less than) the underlying index’s performance times the stated multiple in the Fund’s investment objective.

The tables below are intended to underscore the fact that the Funds are designed as short-term trading vehicles for investors who intend to actively monitor and manage their portfolios. They are not intended to be used by, and are not appropriate for, investors who do not intend to actively monitor and manage their portfolios. For additional information regarding correlation and volatility risk for the Funds, see “Effects of Compounding and Market Volatility Risk” in the Prospectus.

Bull Fund

One Year Index	300% One Year Index	Volatility Rate				
Return	Return	10%	25%	50%	75%	100%
-60%	-180%	-93.8%	-94.7%	-97.0%	-98.8%	-99.7%
-50%	-150%	-87.9%	-89.6%	-94.1%	-97.7%	-99.4%
-40%	-120%	-79.0%	-82.1%	-89.8%	-96.0%	-98.9%
-30%	-90%	-66.7%	-71.6%	-83.8%	-93.7%	-98.3%
-20%	-60%	-50.3%	-57.6%	-75.8%	-90.5%	-97.5%
-10%	-30%	-29.3%	-39.6%	-65.6%	-86.5%	-96.4%
0%	0%	-3.0%	-17.1%	-52.8%	-81.5%	-95.0%
10%	30%	29.2%	10.3%	-37.1%	-75.4%	-93.4%
20%	60%	67.7%	43.3%	-18.4%	-68.0%	-91.4%
30%	90%	113.2%	82.1%	3.8%	-59.4%	-89.1%
40%	120%	166.3%	127.5%	29.6%	-49.2%	-86.3%
50%	150%	227.5%	179.8%	59.4%	-37.6%	-83.2%
60%	180%	297.5%	239.6%	93.5%	-24.2%	-79.6%

Bear Fund

One Year Index	-300% One Year Index	Volatility Rate				
Return	Return	10%	25%	50%	75%	100%
-60%	180%	1371.5%	973.9%	248.6%	-46.5%	-96.1%
-50%	150%	653.4%	449.8%	78.5%	-72.6%	-98.0%
-40%	120%	336.0%	218.2%	3.3%	-84.2%	-98.9%
-30%	90%	174.6%	100.4%	-34.9%	-90.0%	-99.3%
-20%	60%	83.9%	34.2%	-56.4%	-93.3%	-99.5%
-10%	30%	29.2%	-5.7%	-69.4%	-95.3%	-99.7%
0%	0%	-5.8%	-31.3%	-77.7%	-96.6%	-99.8%
10%	-30%	-29.2%	-48.4%	-83.2%	-97.4%	-99.8%
20%	-60%	-45.5%	-60.2%	-87.1%	-98.0%	-99.9%
30%	-90%	-57.1%	-68.7%	-89.8%	-98.4%	-99.9%
40%	-120%	-65.7%	-75.0%	-91.9%	-98.8%	-99.9%
50%	-150%	-72.1%	-79.6%	-93.4%	-99.0%	-99.9%
60%	-180%	-77.0%	-83.2%	-94.6%	-99.2%	-99.9%

The foregoing tables are intended to isolate the effect of underlying index volatility and underlying index performance on the return of a Fund. A Fund's actual returns may be significantly greater or less than the returns shown above as a result of any of factors discussed above or under "Effects of Compounding and Market Volatility Risk" in the Prospectus.

Appendix B

As filed with the Securities and Exchange Commission on September 12, 2008

UNITED STATES OF AMERICA

BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

THIRD AMENDED AND RESTATED APPLICATION FOR AN ORDER UNDER SECTION 6(c) OF THE INVESTMENT COMPANY ACT OF 1940 FOR AN EXEMPTION FROM SECTIONS 2(a)(32), 5(a)(1), 22(d), 22(e) AND 24(d) OF THE ACT AND RULE 22c-1 UNDER THE ACT, AND UNDER SECTIONS 6(c) AND 17(b) OF THE ACT FOR AN EXEMPTION FROM SECTIONS 17(a)(1) AND 17(a)(2) OF THE ACT

In the Matter of

Rafferty Asset Management, LLC
Direxion Shares ETF Trust

File No. 812- 13483

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In the Matter of Rafferty Asset Management, LLC Direxion Shares ETF Trust 33 Whitehall Street, 10th Floor New York, NY 10004 File No. 812- 13483	APPLICATION FOR AN ORDER UNDER SECTION 6(c) OF THE INVESTMENT COMPANY ACT OF 1940 FOR AN EXEMPTION FROM SECTIONS 2(a)(32), 5(a)(1), 22(d) 22(e) AND 24(d) OF THE ACT AND RULE 22c-1 UNDER THE ACT, AND UNDER SECTIONS 6(c) AND 17(b) OF THE ACT FOR AN EXEMPTION FROM SECTIONS 17(a)(1) AND 17(a)(2) OF THE ACT

I. SUMMARY OF APPLICATION

A. Request for Order

In this application ("**Application**"), the undersigned applicants ("**Applicants**") apply for and request an order under section 6(c) of the Investment Company Act of 1940 ("**Act**") for an exemption from sections 2(a)(32), 5(a)(1), 22(d), 22(e) and 24(d) of the Act and rule 22c-1 under the Act and under sections 6(c) and 17(b) of the Act for an exemption from sections 17(a)(1) and 17(a)(2) of the Act ("**Order**").[1] The requested Order would permit, among other things,

- open-end management investment company shares to trade on a national securities exchange, as defined in section 2(a)(26) of the Act (each, an "**Exchange**") such as the American Stock Exchange LLC ("**Amex**"), the Nasdaq Stock Market, Inc. ("**Nasdaq**") the New York Stock Exchange ("**NYSE**"), including NYSE Arca, at negotiated market prices rather than at net asset value ("**NAV**");
- the investment company's exchange-traded shares ("**ETS**") to be redeemable in large aggregations only;

[1] All existing entities that intend to rely on the requested Order have been named as applicants.

- dealers to sell the investment company's ETS to purchasers in the secondary market unaccompanied by a statutory prospectus, when prospectus delivery is not required by the Securities Act of 1933 ("**Securities Act**");
- certain Funds (as defined below) based on foreign equity securities indices to pay redemption proceeds more than seven days after ETS are tendered for redemption; and
- certain affiliated persons of the investment company to buy securities from, and sell securities to, the investment company, in connection with the in-kind purchase and redemption of the investment company's ETS.

More generally, the Order would permit Applicants to operate certain exchange-traded funds ("**ETFs**").

Applicants believe that (i) with respect to the relief requested pursuant to section 6(c), the requested exemption for the proposed transactions is appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act, and (ii) with respect to the relief requested pursuant to section 17(b), the proposed transactions are reasonable and fair and do not involve overreaching on the part of any person concerned; the proposed transactions are consistent with the policy of each Fund (as defined below); and the proposed transactions are consistent with the general purposes of the Act. No form having been specifically prescribed for this Application, Applicants proceed under rule 0-2 of the General Rules and Regulations of the Securities and Exchange Commission ("**SEC**" or "**Commission**").

B. Comparability of Relief Sought to Prior Relief Granted by the Securities and Exchange Commission

The relief requested in this Application is substantially identical to the relief granted by the Commission to open-end management companies (collectively, the "**Prior ETFs**") pursuant to their respective applications for exemptive relief.[2] The term "**Prior Orders**" is used herein when referring to orders granting such exemptive relief.

II. BACKGROUND

A. Brief Overview of Direxion Shares ETF Trust

Applicants have undertaken the development of an index-based market-basket investment product intended for both institutional and retail investors. Direxion Shares ETF Trust (the "**Trust**") is organized as a Delaware statutory trust and registered under the Act as an open-end management investment company that is authorized to offer an unlimited number of series (each, a "**Fund**").

Each Fund will have a distinct investment objective. Each Fund, on a daily basis, will seek to achieve the performance or inverse performance, or a specified multiple of the performance or inverse performance, of a particular foreign equity, domestic equity or fixed income securities index (respectively, an "Underlying Foreign Index," "Underlying Domestic Index," or "Underlying Fixed Income Index," and together, the "**Underlying Indices**"). Funds based on Underlying Foreign Indices are "Foreign Funds." Funds based on Underlying Domestic Indices are "Domestic Funds." Funds based on Underlying Fixed Income Indices are

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[2] See In the Matter of ProShares Trust, et al., ICA Rel. Nos. 27323 (May 18, 2006) (notice) and 27394 (June 13, 2006) (order); In the Matter of NETS Trust, et al., ICA Rel. 28166 (Feb. 25, 2008) (notice) and 28195 (Mar. 17, 2008) (order); In the Matter of Van Eck Associates Corporation, et al., ICA Rel. Nos. 28007 (Sept. 28, 2007) (notice) and 28021 (Oct.24, 2007) (order).

“Fixed Income Funds.” Exhibit C identifies the Underlying Indices of the Initial Funds (as defined below), as well as the licensor of each such Underlying Index.

B. Applicants’ Proposal

Each Fund will issue, on a continuous offering basis, its shares (i.e., the ETS) to be listed and traded on an Exchange. The Trust will issue, with respect to each Fund on a continuous offering basis, large blocks of ETS (“**Creation Units**”) of approximately 25,000 to 100,000 ETS, as will be stated in the relevant Fund’s prospectus (“**Prospectus”**), as contained in its registration statement on Form N-1A (“**Registration Statement**”). The size of such Creation Unit will be determined by the Adviser (as defined below), in part on the estimated initial trading price per ETS of the Fund, its Underlying Index and anticipated audience. Applicants expect that the initial offering price of a Creation Unit will be a minimum of $1 million.[3] The initial trading price per ETS of each Fund will fall in the range of $50 to $250. Individual ETS will be listed and traded on an Exchange, but they will not be individually redeemable; only ETS combined into Creation Units will be redeemable. Creation Units will not be listed or traded on an Exchange. Applicants intend that the initial NAV of the ETS be established at a level convenient for trading purposes.[4] Purchases and redemptions of Creation Units of the Funds, with the exception of the Inverse Funds (as described below), will generally be made by means of an in-kind tender (“**In-Kind Payment**”) of specified securities, with any cash portion of the purchase price and redemption proceeds (“**Balancing Amount**”) to be kept to a minimum, all in the

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[3] The Creation Unit size stated in a Prospectus may be changed, from time to time, if the individual ETS price of such Fund increases or decreases to such an extent that the Creation Unit price becomes unappealing to investors and arbitrageurs seeking to create or redeem.

[4] Applicants believe that a convenient trading range will be between $50 and $250 per ETS, and the Trust reserves the right to declare a stock split, or a reverse stock split, if the trading price over time deviates significantly from such price range. Each shareholder will have one vote per ETS.

manner described herein. This "in-kind" approach will minimize, to the extent possible, each Fund's need to liquidate portfolio securities to meet redemptions and to use cash to acquire portfolio securities in connection with purchases of ETS. It should therefore permit closer correlation with, and tracking of, (the multiple or inverse of) the relevant Underlying Index.

Applicants believe that the ETS must be available on an "open-end" basis (i.e., continuously offered) and provide ready redeemability for investors presenting the specified Creation Units for redemption. Applicants believe that this structure will permit efficiencies in pricing, respond to market needs and provide reductions in certain costs experienced by the Trust, including overhead costs such as custodial, transaction and fund accounting costs.

C. <u>The Trust</u>

As discussed above, the Trust is a Delaware statutory trust, registered under the Act as an open-end management investment company. The Trust is authorized to offer an unlimited number of series (i.e., Funds) and shares (i.e., ETS).

The Trust will offer and sell ETS pursuant to its Registration Statement. The following Funds, which are discussed in greater detail in the Registration Statement, will be those offered by the Trust initially ("**Initial Funds**"):

Fund	Index or Benchmark	Daily Target
Total Market Bull 3X Shares	Russell 3000® Index	300%
Total Market Bear 3X Shares		-300%
Large Cap Bull 3X Shares	Russell 1000® Index	300%
Large Cap Bear 3X Shares		-300%
Small Cap Bull 3X Shares	Russell 2000® Index	300%
Small Cap Bear 3X Shares		-300%
Mid Cap Bull 3X Shares	Russell Midcap® Index	300%
Mid Cap Bear 3X Shares		-300%
Developed Markets Bull 3X Shares	MSCI EAFE® Index	300%
Developed Markets Bear 3X Shares		-300%

Fund	Index or Benchmark	Daily Target
Emerging Markets Bull 3X Shares	MSCI Emerging Markets Index℠	300%
Emerging Markets Bear 3X Shares		-300%
BRIC Bull 3X Shares	BNY BRIC Select ADR Index℠	300%
BRIC Bear 3X Shares		-300%
China Bull 3X Shares	BNY China Select ADR Index℠	300%
China Bear 3X Shares		-300%
India Bull 3X Shares	Indus India Index	300%
India Bear 3X Shares		-300%
Latin America Bull 3X Shares	S&P Latin America 40 Index	300%
Latin America Bear 3X Shares		-300%
Clean Energy Bull 3X Shares	S&P Global Clean Energy Index™	300%
Clean Energy Bear 3X Shares		-300%
Energy Bull 3X Shares	Russell 1000® Energy Index	300%
Energy Bear 3X Shares		-300%
Financial Bull 3X Shares	Russell 1000® Financial Services Index	300%
Financial Bear 3X Shares		-300%
Technology Bull 3X Shares	Russell 1000® Technology Index	300%
Technology Bear 3X Shares		-300%
Real Estate Bull 3X Shares	Dow Jones Wilshire REIT Index	300%
Real Estate Bear 3X Shares		-300%
Homebuilders Bull 3X Shares	S&P Homebuilding Select Industry Index	300%
Homebuilders Bear 3X Shares		-300%

Each Initial Fund seeks to provide daily investment results, before fees and expenses, that correspond to 300% of the daily performance, or 300% of the inverse (opposite) daily performance, of its Underlying Index. Each Initial Fund that seeks to provide daily investment results, before fees and expenses, that correspond to 300% of the daily performance of its Underlying Index may be referred to as a "Bull" Fund. Each Initial Fund that seeks to provide daily investment results, before fees and expenses, that correspond to 300% of the inverse of the daily performance of its Underlying Index may be referred to as a "Bear" Fund. Initial Funds based on Underlying Foreign Indices, Underlying Domestic Indices and Underlying

Fixed Income Indices are, respectively, the “Initial Foreign Funds,” “Initial Domestic Funds” and “Initial Fixed Income Funds.” All Initial Funds are included in the defined term “Funds.”

Applicants may offer, and seek relief herein to offer, additional Funds in the future (“**Future Funds**,” included in the defined term “**Funds**”). Any Future Fund that relies on the requested Order will comply with the terms and conditions of the Application.

D. <u>The Adviser</u>

Rafferty Asset Management, LLC (the “**Adviser**”) is a New York limited liability company, with its principal office in New York, NY. Each Initial Fund will be advised by the Adviser. The Adviser will also serve as the investment adviser to any Future Fund. The Adviser is registered as an “investment adviser” under section 203 of the Investment Advisers Act of 1940 (“**Advisers Act**”). The Adviser may enter into sub-advisory agreements with additional investment advisers to act as sub-advisers with respect to the Trust and any of the Funds, if warranted. The Adviser is not affiliated (within the meaning of section 2(a)(3) of the 1940 Act) with the Exchange on which ETS will be listed. Any sub-adviser to the Trust or a Fund will be registered under the Advisers Act and will not be affiliated (within the meaning of section 2(a)(3) of the Act) with the Fund’s listing Exchange.

E. <u>The Distributor</u>

A broker-dealer registered under the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”), will act as the distributor and principal underwriter of the Creation Units of ETS (the “**Distributor**”). The Distributor will distribute ETS on an agency basis. The Distributor will not be affiliated with any Fund’s listing Exchange. The Distributor will be identified as such in the Prospectus.

F. Administrator/Custodian/Transfer Agent/Index Receipt Agent/ Securities Lending Agent/Fund Accounting Agent

The Trust may appoint the Adviser or other service providers to act as administrator (the "**Administrator**"), custodian (the "**Custodian**"), transfer agent ("**Transfer Agent**"), index receipt agent ("**Index Receipt Agent**"), securities lending agent ("**Securities Lending Agent**") and fund accounting agent ("**Fund Accounting Agent**"). The Index Receipt Agent will be responsible for transmitting the list of Deposit Securities (as defined below) to the National Securities Clearing Corporation ("**NSCC**") and for the processing, clearance and settlement of purchase and redemption orders through the facilities of the Depository Trust Company ("**DTC**") and NSCC on behalf of the Trust. The Index Receipt Agent will also be responsible for the coordination and transmission of files and purchase and redemption orders between the Distributor and NSCC.

G. The Underlying Indices

The Underlying Index for each Initial Fund is briefly described in Exhibit C. Each Underlying Domestic Index is an index comprised of equity securities issued by one or more of the following categories of issuers: (i) domestic issuers and (ii) non-domestic issuers meeting the requirements for trading in U.S. markets.[5] Each Underlying Foreign Index is

[5] Applicants have been informed that certain Underlying Domestic Indices may include securities issued by one or more non-domestic issuers, if the relevant Underlying Index Provider believes it would be appropriate. The securities issued by these non-domestic issuers will be shares registered for trading in U.S. markets, such as American Depositary Receipts ("**ADRs**") and similar depositary receipt arrangements (collectively, "**Depositary Receipts**"), ordinary shares and New York Shares. A Domestic Fund will only hold ADRs to the extent they are listed on an Exchange, including Nasdaq. A Domestic Fund will only invest in sponsored ADRs, except for certain listed ADRs that remain unsponsored. Neither the Adviser, any sub-adviser, nor any of their affiliated persons will serve as a depository bank for any Depositary Receipts held by a Fund. For a discussion of a Foreign Fund's potential investment in Depositary Receipts, see below at pages 13-16.

comprised of foreign equity securities. Each Underlying Fixed Income Index is comprised of fixed income securities.

An entity that creates, compiles, sponsors or maintains an Underlying Index (each, an "**Underlying Index Provider**") is not and will not be an "affiliated person", as defined in section 2(a)(3) of the Act, or an affiliated person of an affiliated person, of the Trust, a Fund, the Distributor, the Adviser, or any sub-adviser or promoter of any Fund. An Underlying Index Provider will not provide recommendations to a Fund regarding the purchase or sale of specific securities. In addition, an Underlying Index Provider will not provide any information relating to changes to an Underlying Index's methodology for the inclusion of component securities, the inclusion or exclusion of specific component securities, or methodology for the calculation of the return of component securities, in advance of a public announcement of such changes by the Underlying Index Provider.

The Adviser represents that any necessary licensing arrangements with the Underlying Index Provider to offer the ETS, to the extent such licensing arrangements are legally required, have already been entered into or will be in effect at the time the relevant Fund issues its first Creation Unit and secondary market trading of such ETS commences.

H. Capital Structure and Voting Rights; Book-Entry of ETS

Each Fund will have one class of shares, i.e., ETS. Each ETS-holder of the Trust ("**shareholders**") will have one vote per ETS with respect to matters regarding the Trust, or the respective Fund, for which a shareholder vote is required under the Act, the rules promulgated thereunder, or relevant state law.

ETS will be registered in book-entry form only and Funds will not issue individual share certificates. No Beneficial Owner shall have the right to receive a certificate representing such ETS. DTC, a limited purpose trust company organized under the laws of the State of New York, or its nominee will be the record or registered owner of all outstanding ETS. Beneficial ownership of ETS (owners of such beneficial interest, sometimes referred to herein as "shareholders" and "**Beneficial Owners**") will be shown on the records of DTC or DTC participants (e.g., broker-dealers, banks, trust companies, and other financial institutions) ("**DTC Participants**"). All references herein to rights of Beneficial Owners or shareholders of ETS shall reflect the rights of such persons, as they may indirectly exercise such rights through DTC and DTC Participants, except as otherwise specified. Delivery of all notices, statements, shareholder reports and other communications from any Fund to Beneficial Owners will be at such Fund's expense through the customary practices and facilities of DTC and DTC Participants.

I. Investment Objectives and Principal Investment Strategies

1. Summary

As described below, all of the Funds are index funds employing the same types of investment strategies as conventional and leveraged index funds. The Funds will operate and be administered in a manner similar to Prior ETFs. Because the Funds will be traded on an Exchange like the Prior ETFs, the Funds will offer market participants comparable arbitrage opportunities.

a. *Conventional Funds*

Although none of the Initial Funds will have an objective of matching the daily performance, before fees and expenses, of a specified index (each such Fund, a "**Conventional Fund**"), certain Future Funds may be Conventional Funds. Each Conventional Fund will be "indexed" and its portfolio will be managed based upon the same strategies as those employed by conventional index funds. This investment approach attempts to approximate the investment performance of the relevant Index through quantitative analytical procedures. The Adviser may fully replicate a Conventional Fund's relevant Underlying Index or use a "sampling" strategy to track each Conventional Fund's respective Underlying Index. A Fund which utilizes a representative sampling strategy will hold a basket of the component securities of its Underlying Index, but it may not hold all of the component securities of its Underlying Index (as compared to funds that use a replication strategy which invest in substantially all of the component securities in its index in the same approximate proportions as in the underlying index). This sampling strategy is similar to that commonly employed by certain Prior ETFs.

Conventional Funds will hold positions primarily in securities. Securities to be held by a Conventional Fund generally will be components of the relevant Underlying Index, but they may also be other securities that the Adviser believes should help the Fund's overall portfolio simulate the movement of such Underlying Index.

Conventional Domestic Funds. Conventional Funds based on Underlying Domestic Indices ("**Conventional Domestic Funds**") will invest at least 95% of their total assets in the equity securities contained in the relevant Underlying Domestic Index. The Adviser may invest up to 5% of any Conventional Domestic Fund's, and up to 20% of any Conventional Foreign Fund's or Conventional Fixed Income Fund's, total assets in other financial instruments including (i) futures contracts, (ii) options on securities, indices and futures contracts, (iii) equity caps, collars and floors, (iv) swap agreements, (v) forward contracts, and (vi) reverse repurchase agreements (collectively, "**Financial Instruments**"), and money market instruments ("**Money Market Instruments**"). For purposes of this Application, the term Money Market Instruments means short-term debt instruments that have terms-to-maturity of less than 397 days and exhibit high quality credit profiles and includes U.S. government securities and repurchase agreements.

All Money Market Instruments held by a Fund will meet the definition of "Eligible Security" in Rule 2a-7 under the Act. The Adviser may invest in such Money Market Instruments and Financial Instruments rather than in securities when it would be more efficient or less expensive for the Fund. Applicants note that this same practice is utilized by conventional index funds.

Conventional Foreign Funds. Conventional Funds based on Underlying Foreign Indices ("**Conventional Foreign Funds**") will invest at least 80% of their total assets in the equity securities contained in the relevant Underlying Foreign Index and Depositary Receipts representing such equity securities. Applicants anticipate that many, if not all of the Foreign Funds (except any Foreign Fund whose investment objective is to track the inverse of an Underlying Foreign Index) will invest a significant portion of its assets in Depositary Receipts (including ADRs, Global Depositary Receipts ("GDRs") and European Depositary Receipts ("EDRs")) representing the component securities of their respective Underlying Foreign Indices. Any Depositary Receipts held by a Foreign Fund will be negotiable securities that represent ownership of a non-U.S. company's publicly traded stock. Applicants intend that any Foreign Fund would be able to treat Depositary Receipts that represent component securities of its Underlying Foreign Index as component securities for purposes of any requirements related to the percentage of component securities held in such Foreign Fund's portfolio.

Depositary Receipts are typically issued by a financial institution (a "depositary") and evidence ownership interests in a security or a pool of securities ("Underlying Securities") that have been deposited with the depositary.[6] To the extent that a Foreign Fund invests in

[6] With respect to ADRs, the depository is typically a U.S. financial institution and the underlying securities are issued by a foreign issuer. The ADR is registered under the Securities Act on Form F-6. With respect to other Depositary Receipts, the depository may be foreign or a U.S. entity, and the underlying securities may have a foreign or a U.S. issuer.

Depositary Receipts, the Depositary Receipts will be listed on an Exchange or a foreign exchange. A Foreign Fund will not invest in any unlisted Depositary Receipts or any listed Depositary Receipts that the Advisor or the sub-adviser deems to be illiquid or for which pricing information is not readily available. A Foreign Fund will only invest in sponsored Depositary Receipts, except for certain listed ADRs that remain unsponsored.[7] Generally, a Foreign Fund would only hold Depositary Receipts in situations where the Advisor or the sub-adviser believes that holding the Depositary Receipt, rather than the actual underlying foreign Component Security, would benefit the Foreign Fund. This could occur where an investment in a Depositary Receipt offers greater liquidity or would otherwise improve the liquidity, tradability or settlement of the Foreign Fund's then current Deposit Basket. For example, in some cases, a Depositary Receipt may provide more liquidity than its corresponding underlying security simply because the demand for the Depositary Receipt is higher, creating a more active and liquid market for the Depositary Receipt. Also, in certain countries, local market regulations may place restrictions on the transfer of local securities that act to prohibit the in-kind delivery and receipt of local securities as part of the creation and redemption process. In addition, in situations where a Foreign Fund invests in securities of multiple countries, the use of Depositary Receipts, particularly ADRs, can reduce the expense and difficulty of assembling a Deposit Basket upon creation and of disposing of Redemption Securities received through redemption. In addition, since GDRs and EDRs may trade in more developed countries with more efficient custodial, clearance and settlement mechanisms than the underlying securities they represent, the use of

[7] Applicants understand that since 1984 all listed ADRs are required to be sponsored. Applicants also understand that a few listed, but unsponsored, ADRs that existed prior to the 1984 requirement have been "grandfathered." Applicants do not believe that these unsponsored listed ADRs pose any special pricing or liquidity issues. Thus, although the Applicants have no present intention for a Foreign Fund to invest in these unsponsored listed ADRs, Applicants seek to reserve the ability for a Foreign Fund to hold these unsponsored listed ADRs in those situations where the use of these ADRs would otherwise benefit the Foreign Fund.

GDRs and EDRs should, in certain instances, reduce trading, settlement and other costs experienced by a Fund. For example, it may be less expensive to trade and settle a transaction in GDRs traded in London than it would be to trade and settle the corresponding local securities in Moscow or Seoul. In each of the above scenarios, the use of Depositary Receipts potentially decreases the cost of trading and settling securities included in the Deposit Basket (as defined below) upon creation of Creation Units or distributed as Redemption Securities upon redemption of Creation Units. This should improve efficiency of the creation and redemption process and facilitate efficient arbitrage activity.

Applicants note that factors such as supply and demand and differences between the market-trading hours of the exchanges on which Depositary Receipts and underlying securities trade may cause Depositary Receipts to trade at premiums or discounts to the trading price of the underlying securities they represent. To the extent a Foreign Fund is invested in Depositary Receipts and an Underlying Foreign Index contains local securities, any premium or discount between the price of the underlying security and the corresponding Depositary Receipt creates the potential for tracking error between the Foreign Fund and its Underlying Foreign Index.[8] Applicants expect any such impact to be insignificant as the Adviser or sub-adviser will monitor each Foreign Fund's portfolio and Underlying Foreign Index on a daily basis and would take appropriate action as warranted (such as rebalancing the Foreign Fund's portfolio) to reduce potential tracking error.

Applicants do not believe the potential for premiums and discounts between the price of Depositary Receipts and corresponding underlying securities will have any material

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[8] The value of an Underlying Foreign Index will reflect the value of its component securities, rather than the value of any Depositary Receipt representing a component security.

negative impact on the efficiency of the creation/redemption process because market participants have access to both the prices of the Depositary Receipts and the prices of the corresponding underlying securities. Applicants believe the pricing transparency for listed Depositary Receipts will be substantially equivalent to the pricing transparency of the corresponding underlying securities, since both are traded and priced intra-day on securities exchanges and markets. The Foreign Funds will publish each Business Day (as defined below) a list of the current Deposit Securities (including any Depositary Receipts). The intra-day values of the Deposit Basket (as defined below) will be updated throughout the day. Authorized Participants (as defined below) that wish to create or redeem will have equal access to this information and access to the Deposit Securities (including any Depositary Receipts) in a Deposit Basket. Applicants therefore expect that Foreign Funds' investment in Depositary Receipts will not have any material negative impact on the arbitrage efficiency of the Foreign Funds. Further, Applicants believe that there would be no significant differences in the pricing and pricing transparency of Depositary Receipts held by a Foreign Fund and that of equity securities held by other ETFs that do not invest in Depositary Receipts. Finally, the Applicants do not anticipate any liquidity issues with respect to any Foreign Fund's use of Depositary Receipts. Applicants do not intend to use Depositary Receipts unless they are liquid enough to facilitate efficient creations and redemptions and the use of Depositary Receipts would otherwise benefit the Foreign Fund.

Conventional Fixed Income Funds. Conventional Funds based on Underlying Fixed Income Indices ("**Conventional Fixed Income Funds**") will also invest at least 80% of their total assets in the securities that compromise the relevant Underlying Fixed Income Index. When using a sampling strategy, the Adviser will attempt to match the risk and return characteristics of a Conventional Fixed Income Fund's portfolio to the risk and return characteristics of the Underlying Fixed Income Index.[9]

There are many benefits to the employment of sampling strategy with respect to the Conventional Fixed Income Funds. For example, the Adviser can avoid bonds that are relatively expensive (i.e. bonds that trade at perceived higher prices or lower yields due to supply demand) but have the same relative risk, value, duration and other characteristic as less expensive bonds. In addition, the use of sampling techniques permit the Adviser to exclude bonds that it believes will soon be deleted from the Index. The Adviser can also avoid holding bonds it deems less liquid than other bonds with similar characteristic which facilitates a more tradable portfolio. Lastly, the Adviser can develop a basket of component securities that is easier to construct and cheaper to trade, thereby potentially improving arbitrage opportunities.

b. *Leveraged Funds*

Certain Funds will seek daily investment results that correspond, before fees and expenses, to up to four times (400%) the daily performance of an Underlying Index ("**Leveraged Funds**"). Rather than holding positions in securities and Financial Instruments intended to create exposure to 100% of the daily performance of an Underlying Index, however, these Leveraged Funds will hold positions in securities and Financial Instruments designed to create exposure equal to up to four times (400%), before fees and expenses, of the daily performance of

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[9] Future Funds may be based on Underlying Fixed Income Indices which include component bonds (and the respective Deposit Securities, as defined below) with embedded options. However, the bonds in each Underlying Fixed Income Index should be readily tradable on the market because each Underlying Fixed Income Index will contain U.S. Treasury and agency securities and/or liquid corporate and non-corporate bonds. To the extent a particular bond is less liquid than another bond with similar characteristics, the Adviser's sampling techniques should permit the Adviser to replace the less liquid bond with a more liquid bond. For these reasons, the Applicants do not believe bonds with embedded options in the Underlying Fixed Income Indices or in Deposit Securities will have a material impact on the creation or redemption process, or the efficiency of the arbitrage mechanism for the Funds.

an Underlying Index. Leveraged Funds based on Underlying Domestic Indices and Underlying Fixed Income Indices will hold at least 80% of their total assets in the securities contained in the relevant Underlying Index. Leveraged Funds based on Underlying Foreign Indices will hold at least 80% of their total assets in the securities contained in the relevant Underlying Index or in Depositary Receipts representing those securities. The remainder of each Leveraged Fund's assets will be devoted to Financial Instruments and Money Market Instruments that are intended to create the additional exposure needed to pursue their investment objectives.

c. *Inverse Funds*

Certain Funds will seek daily investment results, before fees and expenses, of up to 400% of the inverse (or opposite) of an Underlying Index ("**Inverse Funds**"). Each such Inverse Fund will not invest in the component securities of the relevant Underlying Index, but will create short exposure to the Underlying Index utilizing only Financial and Money Market Instruments. In other words, Inverse Funds will not pursue their investment objectives by creating short positions in individual component securities of the relevant Underlying Index. Under normal circumstances, 100% of the total assets of the Inverse Funds will be devoted to Financial and Money Market Instruments.

2. <u>General</u>

The Funds will be designed to be used both by professional money managers and investors as part of asset allocation or active investment strategies, to create specified investment exposure to a particular segment of the securities market, or to hedge an existing investment portfolio. It will be the policy of each Fund to pursue its investment objective in relation to its respective Underlying Index regardless of market conditions, trends or direction and not to take defensive positions.

The Adviser will not conduct conventional stock research or analysis, or forecast stock market movement in managing the Funds' assets, or invest such assets in equity securities or Financial Instruments based on the Adviser's view of the fundamental prospects of particular companies. While the Adviser will attempt to minimize any "tracking error" between the investment results of a particular Fund and the specified multiple of the performance, or inverse performance, of its Underlying Index on any given day, certain factors may tend to cause the investment results of a Fund to vary from such specified multiple.

Correlation is a measure of the strength of the relationship between two variables over time. In this Application, correlation means the strength of the relationship between (1) the daily change in a Fund's NAV and (2) the daily change in the benchmark index over the course of a year. The statistical measure of correlation is known as the "correlation coefficient." The measure can be between –1 and +1. A correlation coefficient of +1 signifies perfect positive correlation, while a correlation coefficient of –1 signifies perfect negative correlation. A value of zero would mean that there is no correlation between the two variables. For Conventional Funds and Leveraged Funds (where the change in NAV is positive for a positive change in the Underlying Index), the correlation coefficient will have a value between 0 and +1. The closer the value is to +1, the stronger the correlation. For Inverse Funds, the correlation coefficient will assume values between 0 and –1. The closer the value is to –1, the stronger the correlation.

Applicants expect that each Conventional Fund's statistical correlation to the performance of the respective Underlying Index will be .95 or greater and that the performance of each Conventional Fund (excluding the impact of expenses and interest, if any,) will have a tracking error of less than five percent (5%) over the course of a year relative to the respective Underlying Index. In addition, Applicants expect that a Leveraged Fund's statistical correlation to the specified performance multiple of the respective Underlying Index will be .95 or greater and that the performance of each Leveraged Fund (excluding the impact of expenses and interest, if any,) will have a tracking error of less than five percent (5%) over the course of a year relative to the specified multiple of the performance of the respective Underlying Index. Similarly, Applicants expect that an Inverse Fund's statistical correlation to the specified multiple of the performance of the respective Underlying Index will be -.95 or greater and that the performance of each Inverse Fund (excluding the impact of expenses and interest, if any) will have a tracking error of less than five percent (5%) over the course of a year relative to the specified inverse multiple of the performance of the relevant Underlying Index.[10]

3. The Portfolio Investment Methodology

As discussed above, the Adviser will seek to establish investment exposure in each Leveraged and Inverse Fund corresponding to its investment objective based upon a mathematical model, which is based on well-established principles of finance that are widely used by investment practitioners, including conventional index fund managers ("**Portfolio Investment Methodology**").

The Portfolio Investment Methodology is designed to determine, for each such Fund, the portfolio investments needed to achieve its stated investment objective. The Portfolio Investment Methodology takes into account a variety of specified criteria and data (the "**Inputs**"), the most important of which are: (1) net assets (taking into account creations and redemptions) in each such Fund's portfolio at the end of each trading day, (2) the amount of

[10] Mutual funds advised by the Adviser typically have a statistical correlation to the relevant underlying index of .95 or better (-.95 or better for mutual funds that are inverse to the relevant underlying index). Correlation coefficients are calculated over the course of the year based on the daily performance data of the fund and the relevant Underlying Index. Applicants believe that the Funds may achieve comparable levels of correlation.

required exposure to the Underlying Index and (3) the positions in equity or fixed income securities, Financial Instruments and Money Market Instruments at the beginning of each trading day. The Portfolio Investment Methodology then mathematically dictates the Leveraged or Inverse Fund's end-of-day positions to establish the solution (the "**Solution**"), which may include equity or fixed income securities, Financial Instruments and Money Market Instruments. The difference between the start-of-day positions and the required end-of-day positions is the actual amount of equity or fixed income securities, Financial Instruments and/or Money Market Instruments that must be bought or sold for the day. The Solution represents the required exposure and, when necessary, is converted into an order or orders to be filled that same day ("**T**").

Generally, portfolio trades effected pursuant to the Solution on T are reflected in the NAV on the first Business Day (defined below) after the date the relevant trades are made ("**T+1**"). For example, trades pursuant to the Solution calculated on a Monday afternoon are executed on behalf of the relevant Fund on Monday; these trades will then be reflected in the NAV for that Fund that is calculated as of 4:00 p.m. on Tuesday. The clearing and settlement process for Fixed Income Funds will vary, and will be as described on pages 31-34 below.

4. <u>Description of Investment Techniques</u>

In attempting to achieve its individual investment objectives, a Foreign or Domestic Fund (or Fixed Income Fund) may invest its assets in equity (or fixed income) securities, Money Market Instruments and/or certain Financial Instruments (collectively, the "**Portfolio Investments**"). The Inverse Funds will not invest in any of the component securities of their Underlying Indices, but rather will hold only Financial Instruments and Money Market Instruments. To the extent applicable, each Fund will comply with the requirements of the

Commission and the Commission's staff regarding "cover" for Financial Instruments and thus may hold a significant portion of its assets in liquid instruments in segregated accounts. In addition, Funds may "sweep" uninvested cash on a short-term basis into repurchase agreements, Money Market Instruments, and deposit accounts.

a. *Futures Contracts*

Each Fund may engage in transactions in futures contracts on the Chicago Mercantile Exchange ("**CME**") or other exchanges where such contracts trade, and will only purchase and sell futures contracts traded on a U.S. exchange or board of trade. Each Fund intends to comply with the requirements of section 4.5 of the regulations promulgated by the Commodity Futures Trading Commission ("**CFTC**"), as it may be amended from time to time.

b. *Swap Agreements and Forward Contracts*

Each Fund may enter into swap agreements and forward contracts for purposes of attempting to gain exposure to the component securities of its Underlying Index without actually purchasing such securities. The counterparties to the swap agreements and forward contracts will primarily be major broker-dealers, but may also be banks. The creditworthiness of each counterparty candidate is assessed by the Adviser pursuant to guidelines approved by the Trust's Board of Trustees (the "**Board**" or "**Trustees**") and the evaluation of existing counterparties is reviewed periodically. The Trust expects that swap agreements will be structured as total return equity swaps or similar derivatives such as contracts for difference, but notes that such instruments (and its use of them) may change as the derivatives market continues to evolve.

The duration of each swap agreement varies with the counterparty, but is generally 1, 3, 6 or more months. "Resets" may be required upon the occurrence of certain events defined in the swap agreement; when a swap agreement is reset, one counterparty pays the other the amount that is owed under the agreement to that date. Thus, upon each reset, the counterparties place themselves in a position as though the agreement had just been entered into.

c. *Reverse Repurchase Agreements*

Each Fund may enter into reverse repurchase agreements with terms of less than one year and will only enter into such agreements with (i) members of the Federal Reserve System, (ii) primary dealers in U.S. government securities or (iii) broker-dealers.

d. *Money Market Instruments*

Each Fund may invest in Money Market Instruments in pursuit of its investment objectives, as cover for Financial Instruments, as described above, for liquidity purposes or to earn interest.

e. *Options*

Each Fund may invest in options contracts, which are agreements that grant the owner (or holder) the right, but not the obligation, to buy or sell underlying securities or commodities at fixed prices and within particular time frames in the future.

f. *Caps, Floors and Collars*

Funds may invest in caps and floors, which are financial contracts that settle at a predetermined date in the future and are valued by reference to the price of a specified index, security, commodity, interest rate, foreign exchange rate or other financial metric. A “cap”, as its name implies, pays the holder of the contract the greater of (a) the difference between the actual price or value of the reference item and a specified maximum value or cap or (b) zero. A “floor” entitles the contract holder to the greater of (a) the difference between the actual price or value of the reference item and a specified minimum value or floor or (b) zero.

Funds may also enter into a combination of a cap and a floor in an arrangement referred to as a collar. The cap and floor comprising a collar have the same settlement date and pertain to the same underlying index, security, commodity, interest rate, foreign exchange rate or other financial metric.

J. Exchange Listing of the ETS

The Trust intends to submit an application to list the ETS on an Exchange. As long as the Trust and any Fund operate in reliance on the requested Order, ETS will be listed on an Exchange. The Distributor will serve as principal underwriter only of the Creation Units of ETS. The principal secondary market for the ETS will be the Exchange on which they are primarily listed (the "**Primary Listing Exchange**"). The Distributor will not maintain a secondary market in ETS.[11] ETS traded on an Exchange will be traded in a manner similar to Prior ETFs and it is expected that one or more Exchange member firms will be designated to act as a specialist ("**Exchange Specialist**") or market maker ("**Market Maker**") and maintain a market for the ETS trading on the Exchange.

K. Sales of ETS

1. General

a. *Creation Units*

The Trust will offer, issue and sell ETS of each Fund to investors only in Creation Units through the Distributor on a continuous basis at the NAV next determined after an order in proper form is received. The NAV of each Fund is expected to be determined as of the close of the regular trading session on the NYSE ordinarily 4:00 p.m. Eastern Time ("**E.T.**"), on each day

[11] Applicants understand that none of the distributors of any of the Prior ETFs currently listed on an Exchange maintain secondary markets for those ETFs.

that the NYSE is open for business. The Trust will sell and redeem Creation Units of each Fund on any day that a Fund is required to be open under section 22(e) of the Act (each such day, a "**Business Day**"). Each Fund will always have a fixed number of ETS in a Creation Unit as specified in the Prospectus for such Fund. ETS will always be listed on an Exchange and traded individually in the secondary market in the same manner as other equity securities.

As mentioned above, in order to keep costs low and permit each Fund to be as fully invested as possible, it is expected that ETS of each Fund (with the exception of the Inverse Funds) will be purchased in Creation Units in exchange for the purchaser's deposit of an In-Kind Payment, as described below. Likewise, to keep costs low and minimize liquidity problems, it is expected that redemptions of Creation Units of ETS of each Fund (except the Inverse Funds) will be made by the Trust in In-Kind Payments, as described below.[12]

b. *Transaction Fees*

The Trust may impose transaction fees ("**Transaction Fees**") in connection with the purchase or redemption of Creation Units. The exact amount of any such Transaction Fees will be determined by the Adviser. The purpose of the Transaction Fees is to protect the continuing shareholders of the Trust against the possible dilutive transactional expenses,

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[12] The Inverse Funds will generally be purchased and redeemed entirely for cash ("**All-Cash Payments**"). The All-Cash Payment protocol for the purchase and redemption of Creation Units of the Inverse Funds is due to the limited transferability of Financial Instruments. Each Fund may accept All-Cash Payments or partial cash payments in lieu of equity or fixed income securities in connection with purchases of Creation Units if such methods would reduce such Fund's transactions costs or would enhance operating efficiency. This would likely happen only in limited circumstances (such as where, due to significant changes in the Underlying Index, cash may be more efficient than securities, or the purchaser is unable to deliver such securities). Each Fund may redeem wholly or partially in cash where the Fund determines, in its discretion that such method is warranted. This could occur, for example, when a redeeming entity is restrained by regulation or policy from transacting in certain portfolio securities of the Fund, such as the presence of such portfolio securities on a redeeming investment banking firm's restricted list. Additionally, in some circumstances or in certain countries, it may not be practicable or convenient, or permissible under the laws of certain countries or the regulations of certain foreign stock exchanges, for a Foreign Fund to operate exclusively on an "in-kind" basis.

including operational processing and brokerage costs, associated with establishing and liquidating portfolio positions in connection with the purchase and redemption of Creation Units. Where the Adviser permits an in-kind purchaser to substitute cash in lieu of depositing a portion of the requisite securities comprising the In-Kind Payment, the purchaser may be assessed a higher Transaction Fee on the cash in lieu portion of its investment to cover the cost of purchasing such securities, including operational processing and brokerage costs (including part or all of the spread between the expected bid and offer side of the market relating to such securities) associated with the recent purchases and sales of the securities, Financial Instruments and Money Market Instruments held by the Fund.

The maximum Transaction Fees, and any variations or waivers thereof, will be fully disclosed in the Prospectus. The method of determining the Transaction Fees and such variations or waivers thereof will be disclosed in the Prospectus or Statement of Additional Information ("**SAI**"). From time to time and for such periods as the Adviser in its sole discretion may determine, the Transaction Fees may be increased, decreased, or otherwise modified. Such changes and variations will be disclosed in an amendment or supplement to the relevant Prospectus and/or SAI. In all cases, Transaction Fees will comply with then-existing Commission requirements applicable to management investment companies offering redeemable securities.

c. *Section 12(d)(1) Disclosure*

ETS are shares of investment companies and, accordingly, the acquisition of any ETS by an investment company, whether acquired from the Trust or in the secondary market, are subject to the restrictions of section 12(d)(1) of the Act, except as permitted by exemptive relief that permits registered investment companies to invest in a Fund beyond the limits in section

12(d)(1), subject to certain terms and conditions, which may include that the registered investment company enter into an agreement with the Fund regarding the terms of the investment. If required, disclosure to this effect will be made in the Prospectus and Product Description, as defined below.

2. Placement of Purchase Orders

The Trust and Distributor will accept orders to purchase Creation Units received by at least three means. First, they will accept orders by U.S. mail, which is received, opened and time-stamped periodically throughout the day. Any order for Creation Units received by U.S. mail on any Business Day prior to the Order Cut-Off Time (as defined below) will be processed on the same Business Day.

Second, the Trust and Distributor will accept orders to purchase Creation Units through the electronic order system operated by the Transfer Agent ("Order System"). Any order for Creation Units made through the Order System on any Business Day prior to the Order Cut-Off Time (as defined below) will be processed on the same Business Day.

Applicants also will accept telephone and facsimile orders as a third means for submitting purchase orders with respect to ETS. Such orders to purchase Creation Units will be required to be received by the Order Cut-Off Time in order to be processed on the same Business Day (the "**Transmittal Date**").

The "**Order Cut-Off Time**" of each Fund is the time at which the Fund calculates its NAV. Each Fund currently intends to calculate its NAV at the close of regular trading on the NYSE (ordinarily 4:00 p.m. E.T.). Thus, Order Cut-Off Time of each Fund is currently generally expected to be 4:00 p.m. E.T. The Order Cut-Off Time will be disclosed to Authorized Participants in the Participant Agreement.

The Order Cut-Off Time may be truncated in the case of custom orders. Specifically, the Order Cut-Off Time may be shortened by up to two (2) hours in the case of custom orders and require custom orders to be placed no later than 2:00 p.m. E.T. In addition, on days when the Exchange or bond markets close earlier than normal, the Fixed Income Funds may require custom orders for Creation Units to be placed earlier in the day. For example, on days when the generally accepted close of the bond market occurs earlier than normal (such as the day before a holiday), the Order Cut-Off Time for custom orders is expected to be no later than 11:00 a.m. E.T. Like the standard Order Cut-Off Time, exceptions to it, including for custom orders, will be disclosed in the Participant Agreement.

All orders to purchase Creation Units must be placed on a Business Day with the Distributor by or through an "**Authorized Participant**" which is either: (1) a "**Participating Party**," i.e., a broker-dealer or other participant in the Continuous Net Settlement ("**CNS**") System of NSCC, a clearing agency registered with the Commission, or (2) a Participant in DTC, which, in either case, has signed a "**Participant Agreement**" with the Distributor. The Distributor will furnish to those placing such orders acknowledgement that the orders have been accepted, but the Distributor may reject any order which is not submitted in proper form by the Cut-Off Time.[13]

Subsequent to the acceptance of an order to purchase a Creation Unit and the receipt of proper payment therefor, the Trust will be instructed to initiate "delivery" of the appropriate number of ETS to the book-entry account specified by the entity placing the order in the manner described below. The Distributor also will be responsible for delivering the

[13] For an order to be accepted on a particular Business Day, the order must be received by the Distributor either by U.S. mail or by other permitted means on the Transmittal Date and must conform to all the terms, conditions and times established in the Participant Agreement.

Prospectus to those persons purchasing Creation Units and for maintaining records of both the orders placed with it and the acknowledgements of acceptance furnished by it. In addition, the Distributor will maintain a record of the instructions given to the Trust to implement the delivery of ETS. The Distributor may delegate certain administrative tasks to the Administrator.

3. Payment Requirements

As noted above, payments for purchases of Creation Units of ETS generally will be made by In-Kind Payments, although All-Cash Payments will be accepted in certain cases, including for Inverse Funds. In-Kind Payments will be made by a deposit with the Trust of a "**Deposit Basket**" that includes (i) Deposit Securities (defined below) and (ii) a Balancing Amount (defined below). A Deposit Basket will generally include a basket of securities ("**Deposit Securities**") consisting of some or all of the securities contained in the relevant Underlying Index or other securities selected by the Adviser to correspond to the performance of such index for each Fund. The Index Receipt Agent will make available through the NSCC on each Business Day, prior to the opening of trading on the NYSE (currently 9:30 a.m. E.T.) the list of the names and the required number of shares of each Deposit Security (based on information at the end of the previous Business Day) and the Balancing Amount (defined below) in the Deposit Basket for each Fund.[14]

[14] Applicants expect the same information to be provided prior to the opening of trading on any Exchange that is the Primary Listing Exchange for ETS. Applicants do not believe that All-Cash Payments will affect arbitrage efficiency. This is because Applicants believe it makes little difference to an arbitrageur whether Creation Units are purchased in exchange for a basket of securities or cash. The important function of the arbitrageur is to bid the market price of ETS of any Fund up or down until it converges with the NAV. Applicants note that this can occur regardless of whether the arbitrageur is allowed to create in cash or with a Deposit Basket. In either case, the arbitrageur can effectively hedge a position in a Fund in a variety of ways, including the use of market-on-close contracts to buy or sell the underlying equity securities and/or Financial Instruments.

To the extent a Conventional or Leveraged Fixed Income Fund seeks to hold mortgage-backed securities, the Trust intends to substitute a cash-in-lieu amount to replace any Deposit Security or Redemption Security that is a "to-be-announced transaction" or "**TBA Transaction**." A TBA Transaction is a method of trading mortgage-backed securities. In a TBA Transaction, the buyer and seller agree upon general trade parameters such as agency, settlement date, par amount and price. The actual pools delivered generally are determined two days prior to the settlement date. The amount of substituted cash in the case of TBA Transactions will be equivalent to the value of the TBA Transaction listed as a Deposit Security or Redemption Security.[15]

Such Deposit Basket will be applicable, subject to any adjustments as described below, in order to effect purchases of Creation Units of a given Fund until the next Deposit Basket is made available. The Deposit Securities may change frequently or infrequently, and will change from time to time to reflect rebalancing adjustments and corporate action events as well as adjustments to the weighting or composition of the component securities in the relevant Underlying Index. The "**Balancing Amount**" will be an amount equal to the differential, if any, between the total aggregate market value of the Deposit Securities, or Redemption Securities (defined below), and the NAV per Creation Unit next determined.[16] The Balancing Amount will

[15] Applicants expect that a cash-in-lieu amount would replace any TBA Transaction that is listed as a Deposit Security or Redemption Security of any applicable Future Fund.

[16] Because the Balancing Amount is designed to be an amount sufficient to make up the difference between the sum of (i) the market value of the securities in a Deposit Basket or, in the case of redemptions, the value of the list of securities tendered by the Trust to an investor as the In-Kind Payment in connection with a redemption ("**Redemption Securities**"), and the value of a Creation Unit, Applicants believe, as a general proposition, that the Balancing Amount for all Leveraged Funds will be greater than the Balancing Amount for Conventional Funds. Applicants expect that this should generally be the case because the value of the Financial Instruments held by Leveraged Funds will be included in the Balancing Amount (but not as Deposit Securities or Redemption Securities) and therefore should generally increase the relative portion of cash required to bring the value of the securities being deposited (or received) up to the value of a Creation Unit. Because the Leveraged Funds will be subject to greater fluctuation than is the case for non-Leveraged Funds, the Balancing Amount for the Leveraged Funds will likewise

be paid to or received from the Trust after such Creation Unit has been created and the next NAV has been calculated.

In the case of Inverse Funds, the purchaser will make a cash payment by 12:00 p.m. E.T. on the third Business Day following the date on which the request was accepted by the Distributor ("**T+3**"). Purchasers must satisfy certain creditworthiness criteria established by the Adviser and approved by the Board, as provided in the Participant Agreement between the Trust and Authorized Participants.

The Deposit Securities and Redemption Securities of each Fixed Income Fund will settle via free delivery through the Federal Reserve System for U.S. government securities and cash; through DTC or the CNS System[17] for U.S. corporate and non-corporate (including municipal bonds) (other than U.S. government) fixed income securities; and Euroclear, or other foreign settlement system for non-U.S. fixed income securities. The ETS will settle through DTC. The Custodian will monitor the movement of the Deposit Securities and will instruct the movement of the ETS only upon validation that the Deposit Securities have settled correctly or that required collateral is in place.

As with the settlement of domestic ETF transactions outside of the CNS System, (i) ETS of the Fixed Income Funds and U.S. corporate and non-corporate bonds (including municipal bonds) (other than U.S. government securities) will generally clear and settle through DTC, (ii) non-U.S. corporate and non-corporate bonds will clear and settle through Euroclear or

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be subject to greater fluctuation. This potential will be fully disclosed in the Prospectus. The Balancing Amount and the Transaction Fee are referred to collectively as the "**Cash Component**" in connection with creations and as the "**Cash Redemption Amount**" in connection with redemptions. Redemption Securities and the Cash Redemption Amount may be referred to collectively as the "Redemption Basket."

[17] To the extent creation/redemption transactions for ETS of the Fixed Income Funds can clear and settle through the CNS System, Creation Units may be deposited or charged to the Authorized Participants' DTC accounts through the CNS System.

another foreign clearance and settlement system, and (iii) U.S. government securities and cash will clear and settle through the Federal Reserve System. More specifically, creation transactions will generally settle as follows: on settlement date (T + 3) (as defined below) an Authorized Participant will transfer Deposit Securities that are U.S. corporate and non-corporate bonds (including municipal bonds) (other than U.S. government securities) through DTC to a DTC account maintained by the Custodian, Deposit Securities that are non-U.S. fixed income securities through Euroclear, or other foreign settlement system, to an account maintained by the Custodian or sub-custodian, and Deposit Securities that are U.S. government securities, together with any Cash Component, to the Custodian through the Federal Reserve System. Once the Custodian has verified the receipt of all the Deposit Securities (or in the case of failed delivery of one or more bonds, collateral in the amount of 105% or more of the missing Deposit Securities, which will be marked to market each day the failed delivery remains undelivered) and the receipt of any Cash Component, the Custodian will notify the Distributor and the Adviser. The Fixed Income Fund will issue Creation Units of ETS and the Custodian will deliver the ETS to the Authorized Participants through DTC. DTC will then credit the Authorized Participant's DTC account. The clearance and settlement of redemption transaction essentially reverses the process described above. After a Fixed Income Fund has received a redemption request in proper form and the Authorized Participant transfers Creation Units to the Custodian through DTC, the Fixed Income Fund will cause the Custodian to initiate procedures to transfer the requisite Redemption Securities and any Cash Redemption Amount. On T + 3, assuming the Custodian has verified receipt of the Creation Units, the Custodian will transfer Redemption Securities that are corporate and non-corporate bonds (including municipal bonds) (other than U.S. government securities) to the Authorized Participant through DTC, non-U.S. corporate and non-corporate bonds to the Authorized Participant through Euroclear or another foreign clearance and settlement system, and Fixed Income Securities that are U.S. government securities, together with any Cash Redemption Amount through the Federal Reserve System.

ETS of each Fixed Income Fund will be debited or credited by the Custodian directly to the DTC accounts of the Authorized Participants. With respect to domestic equity-based ETF's using the CNS System, Creation Units are deposited or charged to the Authorized Participants' DTC accounts through the CNS System. Since creation/redemption transaction for ETS of the Fixed Income Funds will generally not clear and settle through the CNS System, the failed delivery of one or more Deposit Securities (on a create) or one or more Redemption Securities (on a redemption) will not be facilitated by the CNS System. Therefore, Authorized Participants will be required to provide collateral to cover the failed delivery of Deposit Securities in connection with an "in-kind" creation of ETS. In case of a failed delivery of one or more Deposit Securities, the Fixed Income Funds will hold the collateral until the delivery of such Deposit Security. The Fixed Income Funds will be protected from failure to receive the Deposit Securities because the Custodian will not effect the Fixed Income Fund's side of the transaction (the issuance of ETS) until the Custodian has received confirmation of receipt of the Authorized Participant's incoming Deposit Securities (or collateral for failed Deposit Securities) and Cash Component. In the case of redemption transaction, the Fixed Income Funds will be protected from failure to receive Creation Units because the Custodian will not effect the Fixed Income Fund's side of the transaction (the delivery of Redemption Securities and the Cash Redemption Amount) until the Fixed Income Fund's transfer agent has received confirmation of receipt of the Authorized Participant's incoming Creation Units. In order to simplify the transfer agency process and align the settlement of ETS with the settlement of the Deposit Securities and

Redemption Securities, the Fixed Income Funds plan to settle transaction in U.S. government securities, corporate bonds and non-corporate bonds (other than U.S. government securities) and ETS on the same T + 3 settlement cycle.

Applicants do not believe that the clearing and settlement process will affect the arbitrage of ETS of the Fixed Income Funds.[18]

4. Placement of Creation Unit Purchase Orders

Creation Units may only be purchased by or through an Authorized Participant that has entered into a Participant Agreement. An investor does not have to be an Authorized Participant, but must place an order through, and make appropriate arrangements with, an Authorized Participant. An Authorized Participant is not required to be a member of an Exchange.

Authorized Participants making an In-Kind Payment for Creation Units of ETS must either: (1) initiate instructions pertaining to Deposit Baskets through the CNS System as such processes have been enhanced to effect purchases and redemptions of Creation Units of ETS (such process being referred to herein as the "**ETS Clearing Process**") or (2) deliver

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[18] Applicants note that ETS of the Fixed Income Funds typically will trade and settle on a trade date plus three business days ("T + 3") basis. Where this occurs, Applicants believe that ETS of each Fixed Income Fund will trade in the secondary market at prices that reflect interest and coupon payments on Portfolio Investments through the ETS' T + 3 settlement date. As with other investment companies, the Act requires the Fixed Income Funds to calculate NAV based on the current market value of portfolio investments, and does not permit the Fixed Income Funds to reflect in NAV interest and coupon payments not due and payable. Therefore, to the extent that ETS of the Fixed Income Funds may trade in the secondary market at a price that reflects interest and coupon payments due on a T + 3 settlement date, Applicants anticipate that such ETS may trade in the secondary market at a slight premium to NAV that reflects these interest and coupon payments. Applicants do not believe that this apparent premium will have any impact on arbitrage activity or the operations of the Fixed Income Funds. The Exchange Specialists and/or Market Makers (and other institutional investors) who would take advantage of arbitrage activity have full access to this information and regularly consider such information when buying an individual bond or baskets of fixed income securities.

Deposit Baskets to the Trust through the facilities of DTC (i.e., outside the ETS Clearing Process).

Authorized Participants making an All-Cash Payment must plainly state that fact in the order form. The entire required payment must be transferred directly to the Trust through the Fed-Wire system or otherwise in the manner set forth in the Participant Agreement, by the specified time on the third Business Day following the Transmittal Date.

5. Rejection of Purchase Orders for Creation Units of ETS

Upon the deposit of the Deposit Basket, or the All-Cash Payment and Transaction Fee, in payment for Creation Units, the Creation Unit(s) of ETS will be delivered to purchaser(s). As noted above, the Trust or Distributor may reject any order to purchase Creation Units that is not submitted in proper form by 4:00 p.m. E.T., as applicable, on the Transmittal Date. The Prospectus or SAI of each Fund will disclose any other grounds for rejection of purchase orders.

L. Pricing of ETS

The secondary market price of ETS trading on an Exchange will be based on a current bid/offer market. The secondary market price of ETS of any Fund, like the price of all traded securities, will be determined by supply and demand and will be affected by the current value of the Portfolio Investments held by such Fund. In addition, ETS will be available for purchase or sale on an intraday basis on an Exchange at prices that will not have a fixed relationship to the previous day's NAV or the current day's NAV. Prices on an Exchange therefore may be below, at, or above the most recently calculated NAV of such ETS.

No secondary sales will be made to brokers or dealers at a concession by the Distributor or by the Trust. Purchases and sales of ETS on an Exchange by an investor will be subject to customary brokerage fees or commissions and charges levied by the investor's broker-dealer.

Applicants believe that the existence of a continuous trading market on an Exchange for ETS, together with the publication by the Exchange of the current Indicative Intra-Day Value **("IIV")** of each Fund, will be features of the Trust particularly attractive to certain types of investors. Applicants intend to emphasize these features in the marketing of ETS.

Applicants note that the pricing of ETS by means of bids and offers on an exchange in the secondary market is no longer novel. Applicants are aware of the marketing success of the Prior ETFs, the individual securities of which are traded on an Exchange, but which also permit on a continuous basis the creation and redemption of specified aggregations of such individual securities. Shares of Prior ETFs based on indices generally have traded close to their respective NAVs since trading of such shares commenced. Applicants believe that the Funds will experience similar trading patterns. It is apparent to Applicants that an exchange-traded open-end investment company which provides a daily redemption feature affords significant possible benefits for certain types of investors.

M. Redemption

Beneficial Owners of ETS may sell their ETS in the secondary market, but must accumulate enough ETS to constitute a Creation Unit in order to redeem through the Distributor, which will act as the Trust's agent for redemption. Redemption orders must be placed by, or through, an Authorized Participant. Creation Units of each Fund will be redeemable at their NAV per ETS next determined after receipt of a request for redemption in good order. The Trust will have, pursuant to its organizational documents, the right to make redemption payments in respect of ETS of a Fund by In-Kind Payments, All-Cash Payments, or a combination of each, provided the value of each redemption payment equals the NAV per Creation Unit of ETS of such Fund. Applicants currently contemplate that Creation Units of each Fund (except the Inverse Funds) generally will be redeemed by In-Kind Payments, as discussed below. However, in certain cases, such as where it is not possible to effect delivery of all or some of the Redemption Securities, a Fund may redeem partially or wholly in cash.

Except with respect to certain Foreign Funds (as discussed below), consistent with the provisions of section 22(e) of the Act and Rule 22e-2 thereunder, the right to redeem will not be suspended, nor payment upon redemption delayed, except at the following times: (1) any period during which the NYSE is closed other than customary weekend and holiday closings; (2) any period during which trading on the NYSE is suspended or restricted; (3) any period during which an emergency exists as a result of which disposal of the Portfolio Investments is not practicable or it is not reasonably practicable fairly to determine the value of the Portfolio Investments; or (4) in such other circumstance as is permitted by the Commission.

Subject to the foregoing, Creation Units of any Fund, other than an Inverse Fund, will generally be redeemable on any Business Day in exchange for an In-Kind Payment, which will be comprised of the Redemption Securities and the Balancing Amount in effect on the date a request for redemption is made, minus any Transaction Fee.[19] The Index Receipt Agent, on the

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[19] In the event that the Trust or any Fund is terminated, the composition and weighting of the securities to be made available to redeemers shall be established as of such termination date. There will be no specific termination events, but the Trust or any Fund may be terminated either by a majority vote of the Board or by the affirmative vote of a majority of the holders of the Trust or the Funds entitled to vote. Although the ETS will not be automatically redeemable upon the occurrence of any specific event, the Trust's organizational documents will provide that the Board will have the unrestricted power to alter the number of ETS in a Creation Unit. Therefore, in the event of a termination, the Board in its discretion could determine to permit the ETS to be individually redeemable. In such circumstances, the Trust might elect to pay cash redemptions to all shareholders, with an in-kind election for shareholders owning in excess of a certain stated minimum amount.

Trust's behalf, will publish daily the Redemption Securities.[20] In some instances, the Deposit Securities may differ slightly from the Redemption Securities because the Redemption Securities will identify the portfolio securities currently held in a Fund's portfolio and the Deposit Securities will identify securities to be added to the portfolio.[21] The Trust will transfer the securities comprising the In-Kind Payment plus any Balancing Amount owed to the redeeming Beneficial Owner no later than the third Business Day next following the date on which request for redemption is made.

The Conventional Funds and Leveraged Funds will comply with the federal securities laws in accepting Deposit Securities and satisfying redemptions with Redemption Securities, including that such securities are sold in transactions that would be exempt from registration under the Securities Act. As a general matter, the Deposit Securities and the Redemption Securities will correspond *pro rata* to the securities held by each Conventional Fund and Leveraged Fund. In some cases, because it is often impossible to break up bonds beyond certain minimum sizes needed for transfer and settlement, there may be minor differences between a basket of Deposit Securities or Redemption Securities and a true pro rata slice of a Fixed Income Fund's portfolio. In accepting Deposit Securities and satisfying redemptions with Redemption Securities that are restricted securities eligible for resale pursuant to Rule 144A under the Securities Act, the Fixed Income Funds will comply with the conditions of Rule 144A,

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[20] The Adviser and the Distributor have adopted a Code of Ethics as required under Rule 17j-1 of the Act, which contains provisions reasonably necessary to prevent Access Persons (as defined in Rule 17j-1) from engaging in any conduct prohibited in Rule 17j-1. The Adviser has also adopted Policies and Procedures to Detect and Prevent Insider Trading as described in section 204A of the Advisers Act which are reasonably designed taking into account the nature of their business, to prevent the misuse, in violation of the Advisers Act and the Exchange Act or the rules or regulations thereunder, of material non public information. Similarly, any sub-adviser to a Fund will also have a Code of Ethics and Policies and Procedures to Detect and Prevent Insider Trading.

[21] Such differences would occur only under limited circumstances such as during periods of change in the composition of the Underlying Index.

including in satisfying redemptions with such Rule 144A eligible restricted Redemption Securities. The prospectus for the Fixed Income Funds will also state that “An Authorized Participant that is not a Qualified Institutional Buyer (“QIB”) as defined in Rule 144A under the Securities Act of 1933 will not be able to receive, as part of a redemption, restricted securities eligible for resale under Rule 144A.”

Creation Units of Inverse Funds will be redeemable for an All-Cash Payment. Redemptions will occur through procedures that are analogous (in reverse) to those for purchases. The Trust and Distributor will accept redemptions of Creation Units received by at least three means. First, they will accept redemptions by U.S. mail, which is received, opened and time-stamped periodically throughout the day. Any request for redemption of Creation Units received by U.S. mail on any Business Day prior to the Order Cut-Off Time will be processed on the same Business Day.

Second, the Trust and Distributor will accept redemptions of Creation Units through the Order System operated by the Transfer Agent. Any request for redemption of Creation Units made through the Order System on any Business Day prior to the Order Cut-Off Time will be processed on the same Business Day.

Applicants also will accept telephone and facsimile requests as a third means for submitting redemptions with respect to ETS. Such requests to redeem Creation Units will be required to be received by the Order Cut-Off Time in order to be processed on the Transmittal Date.

The Order Cut-Off Time for redemptions may be truncated in the case of custom requests for redemption. Specifically, the Order Cut-Off Time may be shortened by up to two (2) hours in the case of custom requests, requiring them to be placed no later than 2:00 p.m. E.T.

In addition, on days when the Exchange or bond markets close earlier than normal, the Fixed Income Funds may require requests for custom redemptions of Creation Units to be placed earlier in the day. For example, on days when the generally accepted close of the bond market occurs earlier than normal (such as the day before a holiday), the Order Cut-Off Time for custom redemptions is expected to be no later than 11:00 a.m. E.T. Like the standard Order Cut-Off Time, exceptions to it, including for custom redemption requests, will be disclosed in the Participant Agreement.

All requests for redemption are subject to acceptance by the Trust and must be preceded or accompanied by an irrevocable commitment to deliver the requisite number of ETS of the relevant Fund, which delivery must be made to the Trust through, or outside, the ETS Clearing Process, according to the procedures set forth in the Participant Agreement. If a request for redemption is rejected by the Trust, the Trust will so notify the redeemer, which would have to re-submit the request in good order. Transmission of cash amounts, including the Transaction Fee, must be accomplished in a manner acceptable to the Trust and as specified in the Participant Agreement. An entity redeeming ETS in Creation Units outside the ETS Clearing Process or through an All-Cash Payment may be required to pay a higher Transaction Fee than would have been charged had the redemption been effected through the ETS Clearing Process, calculated in the manner as disclosed in the Prospectus and/or SAI.

N. Dividend Reinvestment Service

The Trust will not make the DTC book-entry Dividend Reinvestment Service available for use by Beneficial Owners for reinvestment of their cash proceeds but certain individual brokers may make a dividend reinvestment service available to their clients. The SAI will inform investors of this fact and direct interested investors to contact such investor's broker to ascertain the availability and a description of such a service through such broker.

O. Shareholder Transaction and Distribution Expenses

No sales charges for purchases of Creation Units are anticipated to be imposed by any Fund. As indicated above, each Fund may impose a Transaction Fee on those investors purchasing and redeeming Creation Units of its ETS. Investors purchasing and selling ETS in the secondary market may incur customary brokerage commissions. The Trustees have adopted a "**12b-1 Plan**" for each Fund in accordance with Rule 12b-1 under the Act. The fees payable under the 12b-1 Plan may differ by Funds. The amount of the 12b-1 Plan fee for each Fund will be disclosed in its Prospectus.

P. Shareholder Reports

The Trust will furnish to DTC Participants for distribution to Beneficial Owners (a) the required notifications with respect to each distribution and (b) an annual notification as to the tax status of such Fund's distributions. The Trust will also distribute its semi-annual report and its annual report containing audited financial statements to Beneficial Owners through DTC and DTC Participants.

Q. Sales and Marketing Materials

The materials describing ETS will not make references to redeemability of such ETS. In all marketing materials where the features or method of obtaining, buying or selling Creation Units are described, or where there is reference to redeemability, there will be a prominent statement or statements to the effect that (i) individual ETS trading on an Exchange are not individually redeemable and that owners of ETS may acquire and tender such ETS for redemption to the Trust in Creation Units only and (ii) the purchase price and sale price of individual ETS trading on an Exchange may be below, at, or above the most recently calculated NAV for such ETS. Neither the Trust nor any Fund will be advertised, marketed, or otherwise held out as a traditional open-end investment company or a mutual fund. The same approach will be followed in connection with shareholder reports and other investor education materials issued or circulated in connection with the ETS.

R. Availability of Information Regarding Funds, Underlying Indices and ETS

1. General.

The daily NAV for each Fund will be calculated and disseminated publicly each Business Day.

a. *Information Provided to Authorized Participants*

All Authorized Participants, regardless of whether they transact outside the ETS Clearing Process, may access the following information. Applicants note that Authorized Participants that are not also NSCC members may have to either join NSCC or obtain the portfolio composition file ("**PCF**") from a third-party data vendor.

(1) Conventional and Leveraged Funds

At the end of each Business Day, the Trust will prepare the next day's Deposit Basket and the Redemption Basket for Conventional Funds and Leveraged Funds and send this information to the Index Receipt Agent. The same evening, the Index Receipt Agent will add to this the cash information effective as of the close of business on that Business Day and create a PCF for each Fund, which it will transmit to NSCC before the open of business the next Business Day. The information in the PCF will be available to all NSCC members and sufficient for them to calculate the IIV for Conventional Funds during the next Business Day and will be the basis for the next day's NAV calculation.[22]

(2) Inverse Funds and Leveraged Funds

The NSCC's system for the receipt and dissemination to its participants of the PCF was designed for portfolios consisting entirely of equity or fixed income securities, cash and Money Market Instruments. As a result, it is not currently capable of processing information with respect to Financial Instruments, although Applicants expect that it may become so in the future. Therefore, the Adviser has developed what it calls an "**IIV File**", which it will use to disclose Funds' holdings of Financial Instruments until such time (or perhaps longer, if the Trust deems it advisable) as the NSCC's PCF system can process information regarding Financial Instruments. The Trust, Adviser or Index Receipt Agent, on the Trust's behalf, will post the IIV File to a password-protected website before the opening of business on each Business Day, and all Authorized Participants will have access to the password and the website containing the IIV File.[23] The IIV File will contain, for each Inverse Fund and each Leveraged Fund, as relevant, information sufficient by itself or in connection with the PCF for market participants to calculate a Fund's IIV and effectively arbitrage the Fund. For example, the following information would be provided in the IIV File for a Leveraged Fund holding swaps, futures contracts and equity securities: (A) the total value of the equity securities held by such Fund, (B) the notional value of the swaps held by such Fund (together with an indication of the index on which such swap is

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[22] Conventional Domestic Funds may also invest up to 5% of their assets, and Conventional Foreign and Fixed Income Funds may invest up to 20% of their assets, in Financial Instruments, as described above. To the extent that a Conventional Fund does hold Financial Instruments, information regarding these instruments will be disclosed in an IIV File (as defined below), if necessary.

[23] Applicants understand that certain Exchanges receive PCF files from the NSCC and expect that the Primary Listing Exchange for each Fund would receive PCF files.

based and whether the Fund's position is long or short), (C) the most recent valuation of the swaps held by the Fund, (D) the notional value of any futures contracts (together with an indication of the index on which such contract is based, whether the Fund's position is long or short and the contract's expiration date), (E) the number of futures contracts held by the Fund (together with an indication of the index on which such contract is based, whether the Fund's position is long or short and the contract's expiration date), (F) the most recent valuation of the futures contracts held by the Fund, (G) the Fund's total assets and total shares outstanding, and (H) a "net other assets" figure reflecting expenses and income of the Fund to be accrued during and through the following Business Day and accumulated gains or losses on the Fund's Financial Instruments through the end of the Business Day immediately preceding the publication of the IIV File. The IIV File for a Leveraged Fund or Inverse Fund holding collars, caps, reverse repurchase agreements or other Financial Instruments would contain analogous information for such instruments. To the extent that any Leveraged Fund or Inverse Fund holds cash or Money Market Instruments about which information is not available in a PCF, information regarding such cash and Money Market Instrument positions will be disclosed in the IIV File for such Fund.

The information in the IIV File, together with the information on securities contained in the PCF, which will be prepared at the end of each Business Day, will be sufficient for calculation of IIV for Leveraged Funds on the next Business Day. The IIV File, together with the applicable information in the PCF in the case of Leveraged Funds, will also be the basis for the next Business Day's NAV calculation.

Under normal circumstances, there will be no Deposit Securities or Redemption Securities for Inverse Funds, which will be created and redeemed entirely for cash. The IIV File published before the open of business on a Business Day will, however, permit NSCC participants to calculate the IIV of each Inverse Fund, as well as the amount of cash required to create a Creation Unit and to be paid upon redemption of a Creation Unit for an Inverse Fund on that Business Day.

b. *Information Provided to General Public*

In addition, the Trust (or Adviser or Index Receipt Agent, on the Trust's behalf,) will make publicly available the portfolio holdings of each Fund.[24] The full portfolio holdings of each Fund will be disclosed on the website of the Trust and/or the Primary Listing Exchange ("**Website**"). This Website disclosure of portfolio holdings will be made and updated daily and will include, as applicable, the names and number of shares held of each security, the specific types and characteristics of each Financial Instrument, similar information on Money Market Instruments and cash in the Fund's portfolio.[25] The portfolio holdings information made available on the Website on each Business Day will form the basis for the relevant Fund's NAV calculation as of 4:00 pm E.T. on that Business Day and will reflect portfolio trades made on the immediately preceding Business Day. The Trust or the Primary Listing Exchange will also calculate and publish the IIV and the current updated value of each Underlying Foreign Index and Underlying Domestic Index every 15 seconds throughout the trading day, if such

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[24] The Trust will comply with its obligations, imposed by Form N-1A, to describe in the SAI its portfolio disclosure policies and procedures and to state in the Prospectus that such description with respect to each Fund is available in the SAI. See Release No. IC-26418.

[25] The information on the public Website will be the same as that disclosed to Authorized Participants in the PCF and IIV File, except that (i) the information provided on the Website will be formatted to be reader-friendly and (ii) the portfolio holdings data on the Website will be calculated and displayed on a per Fund basis, while the information in the PCF/IIV File will be calculated and displayed on a per Creation Unit basis. Both the IIV File / PCF and the Website will reflect dividends paid and accruals for expenses incurred, as well as the next Business Day's estimated dividend and expense accrual information. While Applicants intend to make the Website disclosure reader-friendly, the PCF and IIV File will be formatted so that it is compatible with the systems that the Primary Listing Exchange and Authorized Participants use to retrieve and process such data.

information about the Underlying Index is not already available from another organization authorized by the relevant Underlying Index Provider. Underlying Fixed Income Indices will only be calculated and published once per day, not every 15 seconds throughout the day.

With respect to each type of Financial Instrument held by a Fund, Applicants expect the following to be disclosed on the Website: a description of the Financial Instrument; a statement as to whether the Fund's position in the Financial Instrument is long or short; the most recent closing or other value of the Financial Instrument; the number of such Financial Instruments held; and the aggregate notional value of such Financial Instrument.

2. IIV

The IIV is designed to provide investors with a reference value which can be used in connection with other related market information. Applicants believe that the Primary Listing Exchange will disseminate, every 15 seconds, during regular trading hours, through the facilities of the Consolidated Tape Association, the IIV for each Fund, on a per ETS basis.[26]

The Primary Listing Exchange will calculate the IIV for each Fund, including those Funds that do not hold equity or fixed income securities, in the manner discussed below. The Primary Listing Exchange will not guarantee the accuracy or completeness of the IIV. Neither the Trust, nor the Trustees or Adviser is responsible for the calculation or dissemination of the IIV; and therefore, they make no warranty as to its accuracy, or its usefulness to traders of ETS.

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[26] This value is variously referred to as an "Underlying Trading Value," "Indicative Optimized Portfolio Value" ("IOPV"), and "Intraday Value," in the prospectuses, marketing and other written materials of Prior ETFs.

a. *IIV Calculation for Conventional Funds.*

The Primary Listing Exchange will calculate the IIV throughout the trading day for each Conventional Fund by (i) calculating the current value of the Deposit Basket based on the last sale prices, (ii) calculating the estimated amount of cash and/or Money Market Instruments per Creation Unit held in the Fund's portfolio ("**Estimated Cash**"), (iii) adding the foregoing two amounts together to arrive at a value, and then (iv) dividing the resulting value by the number of ETS outstanding in order to obtain the IIV.

b. *IIV Calculation for Leveraged Funds.*

The Primary Listing Exchange will calculate the IIV throughout the trading day for each Leveraged Fund by (i) calculating the current value of all securities held by the Fund, (ii) calculating the Estimated Cash, (iii) calculating the marked-to-market gains or losses from the Fund's total return equity swap exposure based on the Underlying Index percentage change, the swap costs determined by the daily imbedded weighted interest rate and the notional value of the swap contracts, if any, (iv) calculating the marked-to-market gains or losses of the futures contracts and other Financial Instruments held by the Fund, if any, (v) adding the current value of equity securities, the Estimated Cash, the marked-to-market gains/losses from swaps and the futures contracts and other Financial Instruments, to arrive at a value and (vi) dividing that value by the total ETS outstanding to obtain the IIV.

c. *IIV Calculation for Inverse Funds.*

The Primary Listing Exchange will calculate the IIV throughout the trading day for each such Fund by (i) calculating the Estimated Cash, (ii) calculating the marked-to-market gains/losses of swaps, futures and other Financial Instruments held by the Fund in the manner described above, (iii) adding the Estimated Cash and the marked-to-market gains or losses of the

Financial Instruments to arrive at a value and (iv) dividing that value by the total ETS outstanding to obtain the IIV.

3. Underlying Index Value.

Applicants understand that the value of each Underlying Domestic Index and Underlying Foreign Index will be updated intra-day on a real time basis as its individual component securities change in price. These intra-day values of each Underlying Index will be disseminated every 15 seconds throughout the trading day by the Primary Listing Exchange or another organization authorized by the relevant Underlying Index Provider. The Underlying Fixed Income Indices for the Fixed Income Funds are calculated and published once a day, not every 15 seconds during the day.

4. Additional Information and Data.

In addition, for all Funds, the Trust expects to maintain a website, which will display the Prospectus, the SAI, and quantitative information that is updated on a daily basis, including daily trading volume, closing price, and closing NAV. Also, the Primary Listing Exchange intends to disseminate a variety of data with respect to ETS on a daily basis by means of CTA and CQ High Speed Lines, including the NAV and the number of ETS outstanding as of the previous day's close.

The previous day's closing price of the securities in each Deposit Basket will be readily available from, as applicable, the relevant Exchange, automated quotation systems, publications, on-line information services such as Quotron, Bloomberg or Reuters, or other public sources. Similarly, the previous day's closing price and volume of ETS will be published daily in the financial sections of many newspapers. In addition, secondary market prices and volume of ETS will be available on a real time basis throughout the trading day. Applicants expect, given the history of the Prior ETFs, that ETS will be followed by stock market and mutual fund professionals as well as investment advisers who will offer their analysis of why investors should purchase, hold, or sell ETS. Exchange listing of ETS should help ensure that there is a substantial amount of raw data available, and that such data is packaged, analyzed and widely disseminated to the investing public.

S. Procedure by Which ETS Will Reach Investors

1. Categories of Interested Investors

Applicants expect that there will be several categories of market participants who are likely to be interested in purchasing Creation Units of one or more Funds, including institutional investors, arbitrageurs, traders and other market participants. First, institutional investors, including traders, may wish to purchase or redeem Creation Units of a Fund to take advantage of the potential arbitrage opportunities in much the same manner as the arbitrageurs discussed in the next sentence. Second, arbitrageurs, who stand ready to take advantage of any slight premium or discount in the market price of a Fund's ETS on the Exchange versus the Fund's NAV, may seek to transact in Creation Units. Applicants do not expect that arbitrageurs will hold positions in ETS for any length of time unless the positions are appropriately hedged. Applicants believe that arbitrageurs will purchase or redeem Creation Units of a Fund in pursuit of arbitrage profit, and in so doing will enhance the liquidity of the secondary market in ETS, as well as keep the market price of ETS close to their NAV. Third, Exchange Specialists and Market Makers, acting in the role of providing a fair and orderly secondary market for the ETS, may from time to time find it appropriate to purchase or redeem Creation Units of ETS in connection with their market-making activities. In the above examples, those who purchase ETS in Creation Units may hold those ETS or may at a later time sell such ETS into the secondary market.

Applicants believe that there is also a significant segment of institutional and retail investors interested in buying and selling market basket index securities on an intra-day, short term or long-term basis. Applicants therefore expect that secondary market purchasers of ETS will include both institutional and retail investors for whom ETS provide a useful, retail-priced, exchange-traded mechanism that provides leverage and risk limited to the amount invested and/or allows for hedging or gaining "short" exposure. Market participants of all types, including institutional and retail investors, financial advisers and portfolio managers, have expressed interest in the availability of a product that would help them manage their exposure to market risk on a low-cost basis and with the risk of loss limited to the amount of their initial investment. The Adviser's experience with mutual funds with objectives similar to those of the Funds is that retail investors in such funds tend to be fairly active (as opposed to buy-and-hold) mutual fund investors and frequently (but not always) make use of such funds through or with the assistance of an investment professional. Similar retail investors may be interested in the Funds. Other investors have expressed interest in using the Funds to obtain gains, or hedge a portfolio, in anticipation of a declining market, or to manage market risks through the use of a combination of Funds.

As discussed above, certain Funds intend to use Financial Instruments and investment techniques to help achieve their required exposure to their relevant Underlying Index (e.g. 300% of the S&P 500 Index). Applicants believe that the use of such Financial Instruments and investment techniques will neither alter the arbitrage opportunities nor inhibit arbitrage activity. The Adviser expects that the arbitrageurs and other institutional investors will take advantage of premiums or discounts in the market price of ETS as described above, just as such entities now do in connection with the shares of the Prior ETFs. The Adviser believes that the IIV will continue to provide useful data to these institutional investors.

Shares of ETFs trade via unlisted trading privileges ("**UTP**") on the NYSE and various regional exchanges. Thus, in addition to the Exchange Specialists, persons seeking liquidity for transactions in ETF shares have numerous options. These participants, including electronic communications networks ("**ECNs**"), are expected to be active in the trading of ETS.

Furthermore, the liquidity in ETFs, unlike traditional equity securities, is not derived solely from market participants and their willingness to transact in a particular ETF, but also from the liquidity in the portfolio securities held by such ETF. Therefore, as long as Authorized Participants are able to deliver or receive the securities and/or cash in exchange for Creation Units, there will be liquidity in the ETS as a result of the arbitrage opportunities discussed above. No Exchange Specialist or Market Maker will be an affiliated person, within the meaning of section 2(a)(3) of the Act, of a Fund, promoter, or principal underwriter of a Fund, or an affiliated person of such persons, except under sections 2(a)(3)(A) or 2(a)(3)(C) of the Act due to ownership of ETS.

2. The Prospectus

The Prospectus will be included with the purchase confirmation delivered with each secondary market purchase of ETS of each Fund for the 25 calendar days following the first day of trading of such ETS. As discussed above, Applicants expect ETS to be purchased and traded by two basic types of investors: (i) institutional and retail investors that primarily seek to invest in ETS in smaller quantities exclusively through purchases and sales executed on an Exchange and (ii) institutional investors that may purchase and redeem Creation Units directly with the Trust in addition to trading such ETS on an Exchange or otherwise. Applicants therefore intend to tailor the Trust's disclosure document delivery procedures to the distinct investment purposes of these two types of investors. The Prospectus will be delivered to investors dealing directly with the Trust and hence will be tailored to meet the information needs of persons creating and redeeming ETS in Creation Units, whereas the Product Description (as defined and discussed below) will describe the information suitable to investors purchasing individual ETS on an Exchange.

The detailed explanation of the issuance and redemption procedures and the costs thereof for Creation Units will be contained in the Prospectus, which will be available to all investors and will be delivered in connection with all Creation Unit purchases. After the ETS have traded for twelve months or more, the Prospectus and any advertising or sales literature relating to ETS may provide supplementary information on market premiums or discounts relative to the NAV of an ETS; this information will enable present and prospective investors of ETS to evaluate the relative desirability of the ETS' continuous intra-day marketability.

With respect to disclosure in the Prospectus concerning the non-redeemability of ETS, the Trust and the Funds will observe the following policies: (1) the term "mutual fund" will not be used except to compare and contrast the Trust or a Fund with conventional mutual funds; (2) the term "open-end management investment company" will be used in the Prospectus only to the extent required by Form N-lA or other securities law requirements and this phrase will not be included on the Prospectus cover page or summary; (3) the cover page of the Prospectus and summary will include a distinct paragraph or paragraphs setting forth the fact that ETS will be listed on an Exchange (which will be identified) and will be individually non-redeemable; (4) the Prospectus will disclose that the owners of ETS may acquire those ETS from a Fund, and tender those ETS for redemption to the Fund, in Creation Units only and (5) the Prospectus will clearly disclose that individual ETS prices in the secondary market may be below, above, or at the most recently calculated NAV. The Prospectus will disclose prominently that while close tracking of a Leveraged Fund or Inverse Fund to a multiple of its respective Underlying Index may be achieved on any single trading day, over time the cumulative percentage increase or decrease in the NAV of the Leveraged Fund or Inverse Fund may diverge significantly from the cumulative percentage increase or decrease in the multiple of the return of the Underlying Index due to leverage and the compounding effect of losses and gains on the returns of the Leveraged Fund or Inverse Fund ("**Correlation Risk**"). The Prospectus and SAI will provide examples of how Correlation Risk could affect the returns of Leveraged and Inverse Funds. The Product Description for a Leveraged Fund or an Inverse Fund also will disclose prominently the potential for deviation over time between the return of the Funds and the multiple of the return of the corresponding Underlying Index and provide examples of this deviation in returns in the same manner as in the Prospectus.

The Prospectus will also indicate that the proposed method by which ETS will be purchased and traded may raise certain issues under applicable securities laws. Similar disclosure is made in the prospectuses for the Prior ETFs. Because, as described above, ETS in Creation Units will be offered continuously to the public at any point during the life of the relevant Fund, a "distribution", as such term is used in the Securities Act, may be occurring. Broker-dealers and other persons will be cautioned in the Prospectus that some activities on their part may, depending on the circumstances, result in their being deemed participants in a distribution in a manner which could render them statutory underwriters and subject them to the prospectus delivery and liability provisions of the Securities Act. The Prospectus will also state that a determination of whether one is an underwriter must take into account all the facts and circumstances pertaining to the activities of the broker-dealer or its client in the particular case, and may provide examples of activities that could lead to categorization as an underwriter. For example, a broker-dealer firm and/or its client may be deemed a statutory underwriter if it takes Creation Units after placing an order with the Distributor, breaks them down into constituent ETS, and sells ETS directly to its customers; or, if it chooses to couple the purchase of a supply of new ETS with an active selling effort involving solicitation of secondary market demand for ETS, a broker-dealer firm and/or its client may be deemed a statutory underwriter. The Prospectus will also state that dealers who are not "underwriters," but are participating in a distribution (as contrasted to ordinary secondary market trading), and thus dealing with ETS that are part of an "unsold allotment" within the meaning of section 4(3)(c) of the Securities Act, would be unable to take advantage of the prospectus-delivery exemption provided by section 4(3) of the Securities Act.[27]

The Distributor will act as coordinator in connection with the production and distribution of such materials to broker-dealers and will make generally known among the broker-dealer community that a current version of the Prospectus and SAI may be obtained through the Distributor. Brokerage firms will be able to order in advance their anticipated quantities of such materials from the Distributor. Additionally, the Distributor will arrange to

[27] Applicants note that prospectus delivery is not required in certain instances, including purchases of ETS by an investor who has previously been delivered a Prospectus (until such Prospectus is supplemented or otherwise updated) and unsolicited brokers' transactions in ETS (pursuant to section 4(4) of the Securities Act). Also, firms that do incur a prospectus delivery obligation with respect to ETS will be reminded that under Securities Act Rule 153, a prospectus delivery obligation under section 5(b)(2) of the Securities Act owed to a member of the Exchange in connection with a sale on such Exchange, is satisfied by the fact that the Prospectus and SAI are available at such Exchange upon request. The Prospectus also will note that the prospectus delivery mechanism provided in Rule 153 is only available with respect to transactions on the Exchange.

deliver the Prospectus and SAI for each Fund to the relevant Exchange, where they will be available for review by investors.

3. The Product Description.

Subject to the grant of relief from section 24(d) of the Act, Applicants propose to make a "**Product Description**", as discussed below, available for distribution to purchasers of ETS of each Fund trading on an Exchange.[28] The Product Description will contain a "plain English" description of the Trust, the Funds and the ETS in a format similar to the one used in connection with the secondary market sales of the Prior ETFs.

In contrast to the Prospectus, which will be delivered to investors creating or redeeming ETS in Creation Units, the Product Description will not contain detailed disclosure about creations and redemptions of ETS or discuss the legal risks mentioned above. It will provide a straightforward overview of the Fund offered, including its investment objective and strategies, and the material risks and potential rewards of owning ETS of such Fund. It will also provide a clear, brief description of the essential features of ETS, e.g. (i) the manner in which ETS are traded on the Exchange, including applicability of trading halt procedures; (ii) the manner in which the Underlying Index value is reported; (iii) the identity of the Adviser; (iv) the composition and frequency of net dividend distributions and (v) the actions, if any, that would be taken by a Fund if its ETS were delisted or if its right to use the Underlying Index was terminated.

The Product Description also will describe (i) the manner in which a Fund seeks to achieve, on a daily basis, its investment objective by corresponding to a specified multiple or

[28] Applicants believe that Exchange rules applicable to open-end management companies, such as the Trust, require the delivery by members and member organizations of a Product Description prepared by the issuer.

inverse multiple of the performance, or the inverse performance, of its Underlying Index, and (ii) the expected statistical correlation of such Fund to the specified multiple of the performance of the Underlying Index. The Product Description will describe generally the creation and redemption process, and will provide the Website address, and the Underlying Index Provider for the Underlying Index, so that investors who wish to learn more about the Underlying Index, Funds or ETFs in general may do so. It will also clearly disclose that ETS trading in the secondary market (i) are not individually redeemable, (ii) will be bought or sold at a market price that may be lower or higher than, or equal to, the most recently calculated NAV of such shares and (iii) may incur brokerage fees, commissions or charges when bought or sold. The Product Description also will disclose prominently the potential for deviation over time between the return of the Leveraged Fund or Inverse Fund and the multiple of the return of the corresponding Underlying Index and provide an example of this deviation in returns over time in the same manner as in the Prospectus.

The Product Description is not intended to substitute for the full Prospectus, but will only contain information that is also contained in the Prospectus. It will clearly indicate that the Prospectus and SAI may be obtained, without charge, from (i) the Distributor, (ii) the investor's broker or (iii) the Website.

III. IN SUPPORT OF THE APPLICATION

A. Summary of the Application

Applicants seek an order from the Commission (1) permitting the Trust as an open-end investment company to issue ETS that are redeemable in large aggregations only (exemption from sections 2(a)(32) and 5(a)(1)); (2) permitting secondary market transactions in ETS at negotiated prices, rather than at the current offering price described in the Prospectus (exemptions from section 22(d) and Rule 22c-1); (3) permitting certain Foreign Funds to pay redemption proceeds more than seven days after ETS are tendered for redemption; (4) permitting dealers to sell ETS to purchasers in the secondary market unaccompanied by a statutory prospectus, when prospectus delivery is not required by the Securities Act (exemption from section 24(d)); and (5) pursuant to sections 6(c) and 17(b), permitting certain affiliated persons of the Trust to deposit securities into, and receive securities from, the Trust in connection with the In-Kind Payments for the purchase and redemption of Creation Units (exemption from sections 17(a)(1) and 17(a)(2)); all are more fully set forth below.

The exemptive relief specified below is requested pursuant to section 6(c) of the Act, which provides that the Commission may exempt any person, security or transaction or any class of persons, securities or transactions from any provision of the Act:

> if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act].

Applicants believe that ETS will afford the following significant benefits in the public interest: increased investment opportunities, which should encourage diversified investment; in the case of individual ETS of each Fund, a low-cost market-basket security for small and middle-sized accounts of individuals and institutions that would be available at intra-day prices reflecting minute-by-minute market conditions rather than only their once-daily NAV price; a vehicle that would track the selected Underlying Indices (or a stated multiple thereof) more closely than most alternative market-basket investments due, in part, to the realization of efficiencies, cost savings and economies of scale; a security that should be freely available in response to market demand; competition for comparable products available in the U.S. market; increased capital in the U.S. equity market; enhanced liquidity; efficiency of trading in basket instruments based on the Underlying Indices, whether in real or synthetic form; and, in the case of certain Funds, a more tax efficient investment vehicle than most traditional mutual funds or closed-end funds. As such, Applicants believe the ETS of the Trust are appropriate for exemptive relief under section 6(c).

With respect to the exemptive relief specified below regarding section 17(a)(1) and 17(a)(2), relief is also requested pursuant to section 17(b), which provides that the Commission may approve the sale of securities to an investment company and the purchase of securities from an investment company, in both cases by an affiliated person of such company, if the Commission finds that:

> the terms of the proposed transaction are reasonable and fair and do not involve any overreaching on the part of any person concerned, the proposed transaction is consistent with the policy of each registered investment company concerned. . . and the proposed transaction is consistent with the general purposes of [the Act].

The In-Kind Payment for both the sale and redemption of Creation Units of each Conventional and Leveraged Fund will be made on the same terms for all investors, whether or not such investor is an affiliate. In each case, Creation Units will be sold and redeemed by the Trust at their next-calculated NAV. The Deposit Basket for one or more Creation Units will be based on a standard applicable to all and valued in the same manner in all cases. Such transactions do not involve "overreaching" by an affiliated person. Accordingly, Applicants believe the proposed transactions described herein meet the section 17(b) standards for relief because the terms of such proposed transactions, including the consideration to be paid or received in connection with the In-Kind Payments for the Creation Units, are reasonable and fair and do not involve overreaching on the part of any person concerned; the proposed transactions will be consistent with the Act's policies and those of the Trust and the Funds; and are consistent with the general purposes of the Act.

Applicants believe that the exemptions requested are necessary and appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policies and provisions of the Act. The exemptions and Order requested are also substantially similar to those granted to the Prior ETFs.

B. <u>Market-Basket Products</u>

ETS would allow investors to trade a standardized portfolio of securities in a size comparable to a share of common stock. Trading in market-basket products is an important investment strategy, due in part to the widely acknowledged benefits of diversification and in part to the attraction of baskets selected from a market segment or industry sector that investors want to incorporate into their portfolio to express a specific investment theme or to participate in an economic/investment trend.

C. <u>ETS as a Market-Basket Alternative</u>

Traditional open-end index mutual funds do not provide investors the ability to trade at any time during the day. ETS will be listed on an Exchange and will trade throughout the Exchange trading hours. Also, the price at which ETS trade will be disciplined by arbitrage opportunities. This creation and redemption feature should prevent ETS from trading at a material discount or premium in relation to the Fund's NAV. The ability to purchase and redeem ETS in Creation Units also means that ETS prices in secondary trading should not ordinarily be greatly affected by limited or excess availability.

D. <u>Leverage and Portfolio Management Techniques Available Through ETS</u>

ETS will also offer investors and financial professionals the opportunity to experience "leveraged" investment results as well as the ability to manage their exposure to market risk on a low-cost basis and with risk of loss limited to the amount of the initial investment. For example, investors may seek to triple the performance of one or more Underlying Indices through investment in ETS of certain Initial Funds. Other investors interested in obtaining gains, or hedging a portfolio, in anticipation of a declining market, may do so by investing in ETS of Funds that seek to increase in value when the relevant markets and corresponding Underlying Indices decline. Still other investors may be interested in managing their market risk by developing a strategy of targeting, depending on their perception of market conditions, exposure to 300% of the specified Underlying Index, 300% of the inverse of a specified Underlying Index, or a combination of Initial Funds. In such cases, investors purchasing ETS even taking into account brokerage commissions, would typically pay a smaller dollar amount than would otherwise be required to achieve such a result, and would benefit from the lower costs realized by the Funds in acquiring securities due to the Funds' institutional brokerage relationships.

Based on the foregoing, Applicants request the exemptions set forth below.

IV. REQUEST FOR RELIEF

A. Exemption from the Provisions of Sections 2(a)(32) and 5(a)(1)

Section 5(a)(1) of the Act defines an "open-end company" as a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer. The term "redeemable security" is defined in section 2(a)(32) of the Act as:

> any security, other than short-term paper, under the terms of which the holder is, upon its presentation to the issuer or to a person designated by the issuer . . . is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

Applicants believe that the ETS could be viewed as satisfying the section 2(a)(32) definition of a redeemable security and, consequently, the Trust could be viewed as satisfying the definitional requirement of an open-end company offering for sale a redeemable security of which it is the issuer. ETS are securities "under the terms of which" an owner may receive his proportionate share of the issuing Funds' current net assets. The unusual aspect of ETS is that holders of such shares are entitled to redeem only when they are tendered in a Creation Unit. Because the redeemable Creation Unit can be unbundled into individual ETS that are not individually redeemable, a possible question arises as to whether the definitional requirements of a "redeemable security" or an "open-end company" under the Act are met. In light of this possible analysis, Applicants request an order to permit the Trust to register as an open-end management investment company and issue individual ETS of Funds that are redeemable only in Creation Units as described herein.

Creation Units will always be redeemable from the Trust in accordance with the provisions of the Act. Each investor is entitled to purchase or redeem Creation Units rather than trade individual ETS of a Fund in the secondary market, and tender the resulting Creation Unit for redemption. In certain cases, however, the brokerage costs incurred to obtain the necessary number of individual ETS for accumulation into a Creation Unit may outweigh the benefits of redemption. Moreover, listing on an Exchange will afford all holders of ETS the benefit of intra-day liquidity. Because the market price of ETS will be disciplined by arbitrage opportunities, investors should be able to buy or sell ETS in the secondary market during the course of a Business Day at prices that do not vary substantially from the most recently calculated IIV. For the same reason, investors should further be able to buy or sell ETS in the secondary market at or close to 4:00 p.m. E.T. on a Business Day at prices that do not vary substantially from the NAV for that Business Day.

Permitting Funds to be redeemed in Creation Units Aggregations only, does not appear to thwart the purposes of sections 2(a)(32) and 5(a)(1) or any other provision of the Act. As Applicants have noted above, the Commission has considerable latitude to issue exemptive orders under section 6(c) of the Act, which permits the Commission to deal with situations not foreseen when the Act came into effect in 1940. Applicants believe that ETS may be issued and sold on a basis consistent with the policies of the Act and without risk of the abuses against which the Act was designed to protect. Applicants further believe that exempting the Trust to permit the Trust to register as an open-end investment company and issue redeemable Creation Units of individual ETS, as described herein, is appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. Accordingly, Applicants hereby request that this Application be granted.

B. <u>Exemption from the Provisions of Section 22(d) and Rule 22c-1</u>

Section 22(d) of the Act provides that:

> no registered investment company shall sell any redeemable security issued by it to any person except to or through a principal

> underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at current public offering price described in the prospectus.

Rule 22c-1 provides that:

> no registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell . such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security.

ETS of each Fund will be listed on an Exchange and will trade on and away from[29] the Primary Listing Exchange at all times at negotiated prices (generally on the basis of current bid/offer prices and other relevant factors, such as the most recent trading price, supply and demand, and price improvement) and not on the basis of NAV next calculated after receipt of any sale order. The purchase and sale of the ETS in the secondary market, therefore, will neither be accomplished at an offering price described in the Prospectus, as required by section 22(d), nor made in cash at a price based on the current NAV next computed after receipt of an order as required by rule 22c-1.

Applicants believe that the concerns sought to be addressed by section 22(d) and rule 22c-1 with respect to pricing are equally satisfied by the proposed method of pricing for the ETS of each Fund. While there is little legislative history regarding section 22(d), its provisions, as well as those of rule 22c-1, appear to have been intended (1) to prevent dilution caused by

[29] Consistent with rule 19c-3 under the Exchange Act, members of the Primary Listing Exchange are not required to effect transactions in ETS through the facilities of such Exchange.

certain riskless-trading schemes by principal underwriters and contract dealers, (2) to prevent unjust discrimination or preferential treatment among buyers, and (3) to ensure an orderly distribution system of investment company shares by contract dealers by eliminating price competition from non-contract dealers who could offer investors shares at less than the published sales price and who could pay investors a little more than the published redemption price.[30] Applicants believe that none of these purposes will be thwarted by permitting ETS to trade in the secondary market at negotiated prices.

The first two purposes -- preventing dilution caused by riskless-trading schemes and preventing unjust discrimination among buyers -- would not seem to be relevant issues for secondary trading by dealers in ETS. Secondary market transactions in ETS would not cause dilution for owners of such shares, because such transactions do not directly involve Trust assets. Similarly, secondary market trading in ETS should not create unjust discrimination or preferential treatment among buyers. To the extent different prices exist for ETS during a given trading day, or from day to day, such variances occur as a result of third-party market forces, such as supply and demand, but do not occur as a result of unjust or discriminatory manipulation.[31]

With respect to the third possible purpose of section 22(d), Applicants believe that the proposed distribution system will be orderly. Anyone may sell or acquire ETS either by selling or purchasing them on an Exchange or by redeeming or creating a Creation Unit of such ETS; therefore, no dealer should have an advantage over any other dealer in the sale of ETS.

[30] See Protecting Investors: A Half Century of Investment Company Regulation at 299-303; Investment Company Act Release No. 13183 (April 22, 1983).

[31] This "discrimination" is no more "unjust" or a result of preferential treatment than the "discrimination" that occurs when one investor purchases shares of a mutual fund at a higher price than another investor as a result of an increase in the NAV of such shares of the mutual fund.

Indeed, Applicants believe that the presence of an Exchange Specialist will enhance liquidity because the Exchange Specialist has an obligation to promote a fair and orderly market (e.g., a responsibility to effect trades to alleviate temporary disparities in supply and demand for ETS of each Fund). Applicants also expect that Market Makers will actively compete as liquidity providers and provide a vibrant market in ETS on relevant Exchanges. In addition, secondary market transactions in ETS should generally occur at prices roughly equivalent to their NAV. If the prices for ETS of a particular Fund should fall below the proportionate NAV of the underlying assets of such Fund, an investor needs only to accumulate enough of such ETS to constitute a Creation Unit in order to redeem such ETS at NAV. Competitive forces in the marketplace should thus ensure that the margin between NAV and the price for ETS in the secondary market remains narrow.

Applicants believe that the nature of the markets in the equity securities comprising each Underlying Index will be the primary determinant of any premiums or discounts between the ETS market price and NAV. Prices in the secondary market for ETS would, of course, fluctuate based upon the market's assessments of price changes in the portfolio investments held by a Fund. An investor executing a trade in ETS would not know at the time of such sale or purchase whether the price paid in the secondary market would be higher or lower than the NAV next computed by the Trust. Indeed, such an investor might not wish to wait for the computation of such NAV before selling or purchasing. Applicants believe that this ability to execute a transaction in ETS at an intra-day trading price has become, and will continue to be, a highly attractive feature to many investors and offers a key advantage to investors over the once-daily pricing mechanisms of conventional mutual funds. As has been previously discussed, this feature would be fully disclosed to investors, and the investors would trade in ETS in reliance on the efficiency of the market. Since the portfolio of each Fund will be managed passively to attempt to achieve its investment objective relative to its respective Underlying Index, such portfolio could not be managed or manipulated to produce benefits for one group of purchasers or sellers to the detriment of others.

On the basis of the foregoing, Applicants believe (i) that the protections intended to be afforded by section 22(d) and rule 22c-1 are adequately addressed by the proposed methods for creating, redeeming and pricing Creation Units and pricing and trading ETS, and (ii) that the relief requested is appropriate in the public interest and consistent with the protection of investors and the purposes of section 1 of the Act. Accordingly, Applicants hereby request that an order of exemption under section 6(c) be granted in respect of section 22(d) and rule 22c-1.

C. <u>Exemption from the Provisions of Section 22(e)</u>

The Applicants seek an Order of the Commission under section 6(c) of the Act granting an exemption from section 22(e) of the Act. Applicants acknowledge that no relief obtained from the requirements of section 22(e) will affect any obligations Applicants may otherwise have under Rule 15c6-1 under the Exchange Act requiring that most securities transactions be settled within three business days of the trade date.

Section 22(e) of the Act provides that:

> "No registered company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption, except –
>
> (1) for any period (A) during which the New York Stock Exchange is closed other than customary weekend and holiday closings or (B)

during which trading on the New York Stock Exchange is restricted;

(2) for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practical or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or

(3) for such other periods as the Commission may by order permit for the protection of security holders of the company."

Settlement of redemptions for Foreign Funds will be contingent not only on the securities settlement cycle of the United States market, but also on the delivery cycles in local markets for the underlying foreign securities held by the Foreign Funds. Applicants have been advised that the delivery cycles currently practicable for transferring Redemption Securities to redeeming investors, coupled with local market holiday schedules, will require a delivery process longer than seven (7) calendar days for Foreign Funds, in certain circumstances, during the calendar year. Accordingly, with respect to Foreign Funds only, Applicants hereby request relief from the requirement imposed by section 22(e) to provide payment or satisfaction of redemptions within seven (7) calendar days following the tender of a Creation Unit of such Funds. Applicants request that relief be granted such that each of the Foreign Funds holding Redemption Securities which require a delivery process in excess of seven calendar days may provide payment or satisfaction of redemptions within not more than the number of calendar days known to Applicants as being the maximum number of calendar days required for such payment or satisfaction in the principal local foreign market(s) where transactions in the Portfolio Investments of each such Foreign Fund customarily clear and settle. With respect to

Future Funds that will be Foreign Funds, Applicants seek the same relief from section 22(e) only to the extent that circumstances exist similar to those described herein.

Based on information available to Applicants, although certain holidays may occur on different dates in subsequent years, the number of days required to deliver redemption proceeds in any given year is not expected to exceed fourteen (14) calendar days for any of the Funds requiring exemptive relief from the provisions of section 22(e). Of course, it is possible that the proclamation of new or special holidays,[32] the treatment by market participants of certain days as "informal holidays" (e.g., days on which no or limited securities transactions occur, as a result of substantially shortened trading hours[33]), the elimination of existing holidays or changes in local securities delivery practices,[34] could affect the information set forth herein at some time in the future. The Fund's Prospectus, the Product Description and/or SAI will identify those instances in a given year where, due to local holidays, more than seven calendar days will be needed to deliver redemption proceeds and will list such holidays.

The SAI will disclose those local holidays (over the period of at least one year following the date thereof), if any, that are expected to prevent the delivery of redemption

[32] Applicants have been advised that previously unscheduled holidays are sometimes added to a country's calendar, and existing holidays are sometimes moved, with little advance notice. Any such future changes could impact the analysis of the number of days necessary to satisfy a redemption request. See, e.g., the following recent examples of short-notice holiday announcements: (i) on December 17, 1997, South Korea announced a special holiday due to the presidential elections on December 18, 1997; (ii) on December 30, 1997, Thailand announced that the New Year's Eve holiday on December 31, 1997 would be rescheduled to January 2, 1998; and (iii) on January 22, 1998, Indonesia announced that the religious holiday on January 29 and January 30, 1998, marking the start of Lebaran, would include January 28, 1998.

[33]A typical "informal holiday" includes a trading day in the relevant market that is immediately prior to a regularly scheduled holiday; early closures of the relevant market or of the offices of key market participants may occur with little advance notice. Any shortening of regular trading hours on such a day could impact the analysis of the number of days necessary to satisfy a redemption request.

[34]Applicants observe that the trend internationally in local securities delivery practices has been a reduction in each market's standard settlement cycles (e.g., the U.S. markets change to T+3 in 1995). It remains possible, if unlikely, that a particular market's settlement cycles for securities transfers could be lengthened in the future.

proceeds in seven calendar days and the maximum number of days needed to deliver the proceeds for each Foreign Fund.

Except as set forth herein or as disclosed in the Prospectus, Product Description and/or SAI for any Foreign Fund for analogous dates in subsequent years, deliveries of redemption proceeds by the Foreign Fund relating to those countries or regions are expected to be made within seven days.

Applicants believe that Congress adopted section 22(e) to prevent unreasonable, undisclosed or unforeseen delays in the actual payment of redemption proceeds. Applicants propose that allowing redemption payments for Creation Units of a Foreign Fund to be made within the number of days indicated above would not be inconsistent with the spirit and intent of section 22(e). The Applicants suggest that a redemption payment occurring within such number of calendar days following a redemption request would adequately afford investor protection.

Applicants desire to incorporate the creation and redemption mechanism for Creation Units as much as possible into the processing cycles for securities deliveries currently practicable in the principal market(s) for the Portfolio Investments of a given Foreign Fund. Currently, it is believed that no significant additional system or operational procedures will be needed to purchase or redeem Creation Units beyond those already generally in place in the relevant jurisdiction. Applicants believe that this approach may make creations and redemptions of Creation Units less costly to administer, enhance the appeal of the product to professional participants, and thereby promote the liquidity of the ETS in the secondary market with benefits to all holders thereof. As noted above, Applicants intend to utilize in-kind redemptions to the maximum extent possible principally as a method of assuring the fullest investment of Fund assets in Portfolio Investments (although cash redemptions, subject to a somewhat higher redemption transaction fee, are expected to be available or required in respect of certain Funds). Applicants are not seeking relief from section 22(e) with respect to Foreign Funds that do not effect creations and redemptions of Creation Units in-kind.

If the requested relief is granted, Applicants intend to disclose in each Foreign Fund's SAI and all relevant sales literature that redemption payments will be effected within the specified number of calendar days following the date on which a request for redemption in proper form is made. Given the rationale for what amounts to a delay typically of a few days in the redemption process on certain occasions and given the facts as recited above, the Applicants believe that the redemption mechanism described above will not lead to unreasonable, undisclosed or unforeseen delays in the redemption process. Applicants assert that the request for relief from the strict seven-day rule imposed by section 22(e) is not inconsistent with the standards articulated in section 6(c). Given the facts as recited above, Applicants believe that the granting of the requested relief is consistent with the protection of investors and the purposes fairly intended by the policies and provisions of the Act.

Applicants note that exemptive relief from section 22(e) substantially identical to the relief sought in this Application was obtained by the Prior ETFs in orders relating to each of those funds.

On the basis of the foregoing, Applicants believe (i) that the protections intended to be afforded by section 22(e) are adequately addressed by the proposed method and securities delivery cycles for redeeming Creation Units and (ii) that the relief requested is appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. Accordingly, Applicants hereby respectfully request that an order of exemption be granted under section 6(c) in respect of section 22(e).

D. **Exemption from the Provisions of Section 24(d)**

1. Applicability of Section 24(d) of the Act

Applicants respectfully seek an order of the Commission under section 6(c) granting relief from the prospectus delivery requirements imposed by section 24(d) of the Act under the circumstances described below.

Section 5(b)(2) of the Securities Act requires that a statutory prospectus accompany or precede the sale of a security. Although section 4(3) of the Securities Act exempts certain dealer[35] transactions from the provisions of section 5 of the Securities Act, section 24(d) of the 1940 Act disallows such exemption for transactions in redeemable securities issued by an open-end investment company if any other security is currently being offered or sold by the issuer, or by or through an underwriter, in a public distribution.

Because the provisions of section 24(d) apply to redeemable securities of open-end investment companies, a technical interpretation of such section could result in the prospectus delivery exemption provided by section 4(3) being available for secondary market transactions in individual ETS (i.e., transactions for ETS in numbers less than Creation Units). However, since individual ETS bundled into Creation Units are (i) redeemable, (ii) issued by an open-end management investment company, and (iii) continually in distribution, the provisions of section 24(d) appear to require the delivery of a statutory prospectus prior to, or at the time of the confirmation of, each solicited secondary market sale involving a dealer (for a customer that has not previously received a statutory prospectus).

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[35] As used in the Securities Act, the term "dealer" includes both a dealer effecting trades for its own account as well as a dealer effecting trades for the accounts of others. See Section 2(a)(12) of the Securities Act,

Applicants request that the Commission grant an exemptive order under section 6(c) of the Act to provide relief from the prospectus delivery requirements resulting from section 24(d), to the extent necessary to allow sales of ETS by dealers in the secondary market unaccompanied by a Prospectus (except during the first 25 days after the ETS are first offered to the public), for the reasons described below. Applicants emphasize that relief is not being sought from the prospectus delivery requirement for non-secondary market transactions, such as transactions in which an investor purchases ETS in Creation Units from the issuer or an underwriter.[36] The substantial amounts involved in assembling a Creation Unit (in excess of $1 million for any Fund) effectively precludes an average retail investor from creating or redeeming ETS through the Trust. Therefore, secondary market investors regard ETS in a manner similar to other securities, including closed-end fund shares, that are listed, bought and sold on an Exchange in the secondary market. That is, they are listed, bought and sold on an Exchange in the secondary market, and they are not redeemable. Closed-end fund shares are not subject to section 24(d) and hence they are sold in the secondary market unaccompanied by a prospectus. As discussed above, investors purchasing ETS in the secondary market will have access to extensive information about each Fund and its ETS. Applicants therefore assert if other investment companies issuing securities that are listed and traded on an Exchange are not burdened with prospectus delivery requirements, including certain Prior ETFs, the Funds should be permitted to be free of such restrictions with respect to their ETS trading in the secondary market.

[36] Applicants note that prospectus delivery is not required in certain instances. See above note 23.

2. Discussion of Section 24(d) of the Act and Rule 415 and Rule 174 under the Securities Act

Applicants do not believe the protections intended by section 24(d) are relevant to the circumstances under which ETS will be sold in the secondary market. The methods of distribution and trading of Funds differ substantially from those of conventional open-end funds, including those funds with which Congress was concerned in 1954 when it adopted amendments to section 24(d) to make unavailable the dealer transaction exemption. The House Report issued in connection with the 1954 amendments to the Act that eliminated (via section 24(d)) the dealer exemption from the prospectus delivery requirement stated that the

> continuous offering practices of UITs and open-end investment companies justified the requirement that all dealers be compelled to deliver a prospectus so long as the offering continued.[37]

The legislative history is consistent with the analysis that the existence of an ongoing offering is the basis for disallowing the dealer exemption, but it refers to the existence of a primary offering rather than a constructive offering due to sponsor activity in the secondary market or due to an ongoing distribution by an underwriter. That the existence of a "continuous offering" justifies denying the section 4(3) exemption is further evidenced by the omission of securities issued by closed-end companies under the Act from the provisions of section 24(d). Closed-end companies do not continuously offer securities, and section 24(d) does not eliminate the section 4(3) dealer exemption for securities issued by closed-end companies.

It is also useful to explore what a "continuous offering" meant at the time the amendment to section 24(d), disallowing the dealer exemption, was passed. Prior to the adoption of rule 415 under the Securities Act, with the exception of offerings involving employee benefit

[37] H. Rep. 1542, 83rd Cong., 2d Sess. 21, 30 (1954).

plans, options, warrants, convertible securities and other limited circumstances, securities that were continuously offered were also largely redeemable by definition. Continuous offerings outside the context of the Act became commonplace, however, with the adoption of rule 415 in 1983. Continuous offerings under rule 415, however, did not elicit the same concern with respect to prospectus delivery by dealers that was evidenced by the amendments to section 24(d) in 1954; the exemption provided by section 4(3) of the Securities Act remained applicable to continuous offerings under Rule 415.

Applicants believe it is also useful to examine the prospectus delivery obligations applicable to dealers pursuant to rule 174 under the Securities Act. These provisions relax the prospectus delivery obligations of dealers under the Securities Act in specified circumstances. Rule 174, as amended in 1988,

> reduced the aftermarket prospectus delivery period with respect to offerings by issuers that were not reporting companies before filing their registration statements to 25 calendar days after the offering of securities that are . . . listed on a national securities exchange[38]

The Rule 174 Release stated that

> Rife existence of regulatory requirements applicable to exchange listed . . . securities and market processes provide adequate investor protection to permit relaxation of the prospectus delivery requirement. Listing standards, filing and disclosure requirements, and market information requirements assure the availability and timely dissemination of material information.[39]

Applicants believe that ETS, as listed equity securities, meet these criteria as well and likewise merit a reduction in unnecessary compliance costs and regulatory burdens attendant

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[38] SEC Securities Act Release No. 6763 (April 4, 1988) at 1 (the "Rule 174 Release"). Note that rule 174 shortened the period during which dealers were required to deliver a prospectus to secondary market purchasers from 90 days to 25 days.

[39] Rule 174 Release.

to prospectus delivery obligations in the secondary market. As described below, far more information -- constantly updated and widely disseminated -- will be readily available about Funds than is available for a typical "Form S-3 issuer" that is eligible for the relaxed prospectus delivery obligations under rule 174.

Moreover, Applicants point out that rule 174 does not distinguish between securities that are offered continuously and those that are not. The relaxed prospectus delivery obligations effected by rule 174 apply to all securities that meet the requirements of the Rule, irrespective of whether or not they are continuously offered. The fact that rule 174 applies to securities offered continuously pursuant to rule 415 demonstrates the Commission's conclusion that the existence of a continuous offering does not, by itself, require that a prospectus or other offering document be delivered in connection with all secondary market sales. ETS will trade just as the securities of publicly-traded non-investment companies trade: in the marketplace and without intervention or market making by the issuer.

Assuming the rationale behind section 24(d) is, as the legislative history indicates, requiring the delivery of a prospectus where there is a continuous offering of securities, the adoption of rule 415 and current practices in connection with continuous offerings evidence an evolution in thinking about attendant prospectus delivery requirements. Investment companies issuing securities that are listed on an Exchange, and trade on such Exchange in the secondary market in the same manner as securities issued pursuant to the Securities Act, should not be burdened with prospectus delivery requirements simply because they engage in continuous offerings when, at the same time, non-investment company issuers may make continuous offerings free of such restrictions in the secondary market. If Securities Act issuers are permitted to offer securities continuously and enjoy the benefits of section 4(3), investment companies affected by section 24(d) that list their securities on an Exchange for secondary market trading should not be deprived of the ability to do the same. This is indeed the case with respect to securities issued by closed-end companies, which are mostly listed securities and are not subject to the restrictions of section 24(d). Prior ETFs have also been afforded this relief from section 24(d).

3. Availability of Information; Exchange Listing

An exemption from section 24(d) with respect to prospectus deliveries in connection with secondary market trades of ETF shares is especially appropriate when information about their Underlying Indices, portfolio constituents and values, and related data are readily available to investors as described above.

Additionally, the Trust will be subject to the periodic reporting requirements for open-end investment companies pursuant to section 30 of the Act. Each Fund will provide semi-annual and annual reports to all Beneficial Owners of ETS. In addition, the Funds, as open-end management investment companies, will be required to file holdings reports on Form N-Q as of the close of the first and third quarters of each fiscal year. Further, as described elsewhere in this application, a Prospectus and an SAI will be available at no charge to any retail investor wishing to obtain a copy from (i) the Distributor (ii) the investor's broker or (iii) the Website.

In conclusion, the quotation, price and volume information available for the ETS of each Fund will be the same kind of market information as is available for other exchange-traded equity securities. The secondary market in ETS has essentially the same characteristics as the secondary market in any other exchange-traded equity security and, accordingly, should be treated similarly with respect to Prospectus delivery and Product Description obligations.

4. Costs

Applicants believe significant savings would accrue to the Funds' shareholders if Prospectuses were not printed for dealers to use in connection with secondary market sales of ETS.

5. The Product Description

While Applicants believe that the applicable statutory and regulatory requirements together with market forces will assure the adequate dissemination of information, Applicants expect an Exchange to require that its members and member organizations provide purchasers of ETS with the Product Description and, upon the request of any such purchaser, a Prospectus and SAI. Such Prospectus and SAI will be free of charge to retail investors. Product Descriptions will be delivered to the same investors in the same manner and to the same extent as Product Descriptions are delivered for all the Prior ETFs that have received the relief requested hereunder.

Exchange rules applicable to the Funds will require that, with respect only to Funds that have received relief from section 24(d) of the Act, all members and member organizations provide a Product Description to purchasers of Fund ETS not later than the time a confirmation of the first transaction in such securities is delivered to such purchaser.[40] These requirements apply to Exchange member broker-dealers even if the purchases of Fund ETS occur away from the Exchange.[41]

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[40] E.g., AMEX Rules 1000 and 1000A.

[41] See Exchange Act Rule 12f-5. To date, Exchanges seeking UTP for an exchange-traded investment company security have adopted rules that are the same or substantially the same as the rule in effect for the Primary Listing Exchange for such security.

Applicants believe that the protections intended to be afforded by section 24(d) are not relevant to the circumstances under which ETS will be sold in the secondary market. Applicants note that they are not seeking relief from the requirements to deliver a Prospectus in the primary market to those investors who purchase Funds in Creation Units. Applicants therefore respectfully request that the Commission grant an exemptive order under section 6(c) of the Act to provide relief from the prospectus delivery requirements under section 24(d) of the Act to the extent necessary to allow sales of ETS by dealers in the secondary market unaccompanied by any prospectus when prospectus delivery is not otherwise acquired by the Securities Act. This exemption would be consistent with the public interest and the protection of investors for the reasons discussed herein.

E. Exemption from the Provisions of Sections 17(a)(1) and 17(a)(2)

Applicants seek an exemption from sections 17(a)(1) and 17(a)(2) of the Act pursuant to sections 6(c) and 17(b) of the Act to permit certain affiliated persons to effectuate purchases and redemptions “in-kind”. Section 17(a)(1) of the Act, in general, makes it unlawful

> . . . for any affiliated person . . . [of] a registered investment company . . . or any affiliated person of such a person . . . acting as principal, [k]nowingly to sell any security . . . to such registered investment company or to any company controlled by such registered company [with certain exceptions not here relevant] .. .

Section 17(a)(2) of the Act makes it unlawful

> . .. for any affiliated person . .. [of] a registered investment company . . . or any affiliated person of such a person , .. acting as principal, [k]nowingly to purchase from such registered investment company, or from any company controlled by such registered company, any security [with one exception not here relevant] . . . .

An "affiliated person" of a fund, pursuant to section 2(a)(3)(A) of the Act, includes any person directly or indirectly owning, controlling or holding with power to vote 5% or more of the fund's outstanding voting securities and, pursuant to section 2(a)(3)(C), includes any person directly or indirectly controlling, controlled by, or under common control with the fund. Section 2(a)(9) of the Act provides that a control relationship will be presumed where one person owns 25% or more of another person's voting securities. Section 2(a)(9) also defines "control" as the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.

The Funds may be deemed to be controlled by the Adviser or an entity controlling, controlled by or under common control with the Adviser and hence affiliated persons of each other. In addition, the Funds may be deemed to be under common control with any other registered investment company (or series thereof) advised by the Adviser or an entity, controlling, controlled by or under common control with the Adviser (an "**Affiliated Fund**").

Section 17(b) provides that the Commission will grant such an exemption if evidence establishes that the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned, that the proposed transaction is consistent with the policy of each registered investment company concerned, and that the proposed transaction is consistent with the general purposes of the Act. Because section 17(b) could be interpreted to exempt only a single transaction from section 17(a) and, as discussed below, there may be a number of transactions by persons who may be deemed to be affiliates, Applicants are also requesting an exemption under section 6(c) of the Act as well.[42]

One or more holders of Creation Units of a Fund could own more than 5% of a Fund, or in excess of 25% of the Fund, and would therefore be deemed to be an affiliate of such Fund under section 2(a)(3)(A) or section 2(a)(3)(C) of the Act. Also, the Exchange Specialist or Market Maker for ETS of any relevant Funds might accumulate, from time to time, more than 5%, or in excess of 25%, of ETS of one or more Funds. Such persons would therefore be deemed to be affiliates of the Trust or such Funds under section 2(a)(3) of the Act. For so long as such holders of Funds were deemed to be affiliates, section 17(a)(1) could be read to prohibit such person from making an In-Kind Payment for a Creation Unit (an "in-kind" purchase); likewise, section 17(a)(2) could be read to prohibit such persons from receiving an In-Kind Payment in connection with a redemption from such Fund. Applicants request an exemption to permit persons that are affiliated persons of the Funds (or affiliated persons of such persons) solely by virtue of one or more of the following: (1) holding 5% or more, or more than 25%, of the outstanding ETS of one or more Funds; (2) an affiliation with a person with an ownership interest described in (1); or, (3) holding 5% or more, or more than 25%, of the shares of one or more Affiliated Funds, to effectuate In-Kind Payments.

Applicants assert that no useful purpose would be served by prohibiting these affiliated persons from making "in-kind" purchases or "in-kind" redemptions of ETS in Creation Units. Both the deposit procedures for "in-kind" purchases of Creation Units and the redemption procedures for "in-kind" redemptions will be effected in exactly the same manner for all

[42] See, e.g., Keystone Custodian Funds, Inc., 21 S.E.C. 295 (1945), where the Commission, under section 6(c) of the Act, exempted a series of transactions that otherwise would be prohibited by section 17(a).

purchases and redemptions, regardless of size or number. All will be issued and redeemed in the same manner. There will be no discrimination among purchasers and redeemers. In all cases, the Deposit Securities and Redemption Securities, whether deposited into, or redeemed from, any Fund, will be valued in the same manner and according to the same standards, as those securities currently held by the relevant Fund for purposes of calculating NAV. Applicants submit that, by using the same standards for valuing securities held by a Fund as are used for calculating the value of In-Kind Payments for redemptions or purchases, the Fund will ensure that its NAV will not be adversely affected by such transactions. Also, the valuation of In-Kind Payments will be made in an identical manner regardless of the identity of the purchaser or redeemer.

Applicants also note that the ability to take deposits and make redemptions "in-kind" will help each Fund to track closely its Underlying Index and therefore help the Fund to achieve its objectives. Applicants do not believe that In-Kind Payments for purchases and redemptions will result in abusive self-dealing or overreaching, but rather assert that such procedures will be implemented consistently with each Fund's objectives and with the general purposes of the Act. Applicants believe that In-Kind Payments for purchases and redemptions will be made on terms reasonable to Applicants and any affiliated persons because they will be valued pursuant to verifiable objective standards.

For the reasons set forth above, Applicants believe that (i) with respect to the relief requested pursuant to section 17(b), the proposed transactions are reasonable and fair and do not involve overreaching on the part of any person concerned, the proposed transactions are consistent with the policies of each Fund, and that the proposed transactions are consistent with the general purposes of the Act, and (ii) with respect to the relief requested pursuant to section 6(c), the requested exemption for the proposed transactions is appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

V. EXPRESS CONDITIONS TO THIS APPLICATION

Applicants agree that any order of the Commission granting the requested relief will be subject to the following conditions:

1. The Prospectus and the Product Description will clearly disclose that, for purposes of the Act, ETS are issued by the Funds and the acquisition of ETS by investment companies is subject to the restrictions of section 12(d)(1) of the Act, except as permitted by an exemptive order that permits registered investment companies to invest in a Fund beyond the limits in section 12(d)(1), subject to certain terms and conditions, including that the registered investment company enter into an agreement with the Fund regarding the terms of the investment.

2. As long as the Trust operates in reliance on the requested order, the ETS will be listed on an Exchange.

3. Neither the Trust nor any Fund will be advertised or marketed as an open-end fund or a mutual fund. The Prospectus will prominently disclose that ETS are not individually redeemable shares and will disclose that the owners of ETS may acquire those ETS from a Fund and tender those ETS for redemption to a Fund in Creation Units only. Any advertising material that describes the purchase or sale of Creation Units or refers to redeemability will prominently disclose that ETS are not individually redeemable and that owners of ETS may acquire those ETS from a Fund and tender those ETS for redemption to a Fund in Creation Units only.

4. Before a Fund may rely on the order, the Commission will have approved, pursuant to rule 19b-4 under the Exchange Act, an Exchange rule or an amendment thereto, requiring Exchange members and member organizations effecting transactions in ETS to deliver a Product Description to purchasers of ETS.

5. The Trust's website, which will be publicly accessible at no charge, will contain the following information, on a per ETS basis, for each Fund: (a) the prior Business Day's NAV and the reported closing price, and a calculation of the premium or discount of such price against such NAV; and (b) data in chart format displaying the frequency distribution of discounts and premiums of the daily closing price against the NAV, within appropriate ranges, for each of the four previous calendar quarters (or the life of the Fund, if shorter). In addition, the Product Description for each Fund will state that the Trust's website has information about the premiums and discounts at which the ETS have been traded.

6. The Prospectus and annual report for each Fund will also include: (a) the information listed in condition 5(b), (i) in the case of the Prospectus, for the most recently completed year (and the most recently completed quarter or quarters, as applicable) and (ii) in the case of the annual report, for the immediately preceding five years (or the life of the Fund, if shorter); and (b) the following data, calculated on a per ETS basis for one, five and ten year periods (or life of the Fund, if shorter), (i) the cumulative total return and the average annual total return based on NAV and closing price, and (ii) the cumulative total return of the relevant Underlying Index.

7. The requested relief to permit ETF operations will expire on the effective date of any Commission rule under the Act that provides relief permitting the operation of index-

based exchange-traded funds and exchange traded funds that seek to return a multiple, the inverse or an inverse multiple of an index.

VI. NAMES AND ADDRESSES

All correspondence concerning this Application should be directed to the persons listed on the facing page of this Application. The following are the names and addresses of the Applicants.

Rafferty Asset Management, LLC
Direxion Shares ETF Trust
33 Whitehall Street, 10^{th} Floor
New York, NY 10004

Date: September 12, 2008

Rafferty Asset Management, LLC

/s/ Daniel O'Neill
By: Daniel O'Neill
Managing Member

Direxion Shares ETF Trust

/s/ Daniel O'Neill
By: Daniel O'Neill
President

EXHIBIT A

UNDERLYING INDICES

Russell 3000® Index. The Russell 3000® Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. The companies included in the index have an average market capitalization of $5.4 billion dollars and a median market capitalization of $1 billion as of April 30, 2008.

Russell 1000® Index. The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market and has an average market capitalization of $14.3 billion dollars and a median market capitalization of $5 billion dollars as of April 30, 2008.

Russell Midcap® Index. The Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap® Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap® Index represents approximately 31% of the total market capitalization of the Russell 1000 companies and has an average market capitalization of $5.5 billion dollars and a median market capitalization of $3.8 billion dollars as of April 30, 2008.

Russell 2000® Index. The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe and is comprised of the smallest 2000 companies in the Russell 3000® Index, representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The companies included in the index have an average market capitalization of more than $700 million dollars and a median market capitalization of $500 million dollars as of April 30, 2008.

MSCI EAFE® Index. The EAFE® Index is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada. As of September 30, 2007, the EAFE Index consisted of the following 20 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. MSCI®’ is not a sponsor of, or in any way affiliated with, the Developed Markets Funds.

MSCI Emerging Markets. The MSCI Emerging Markets Index℠ is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of September 30, 2007, the MSCI Emerging Markets Index℠ consisted of the following 21 emerging market country indices: Argentina, Brazil, Chile, China, Czech Republic, Egypt, Hong Kong, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Peru, Philippines, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

BNY BRIC Select ADR Index. The BNY BRIC Select ADR Index^{SM} is a free float-adjusted capitalization-weighted index designed by the Bank of New York to track the performance of a basket of companies who have their primary equity listing on a stock exchange of an emerging market country and which also have depositary receipts that trade on a U.S. exchange or on the NASDAQ. Decisions regarding additions to and deletions form the Index are guided by conditions established by the bank of New York with the intention of creating and maintaining a benchmark for emerging market equity performance. The index currently includes securities from issuers in the following countries, among others: Argentina, Brazil, China, India, Indonesia, Israel, Korea, Russia, Taiwan, South Africa and Taiwan. As of April 30, 2008, the index had 50 components with an average market capitalization of over $35.8 billion dollars and a median market capitalization of $19.9 billion dollars.

BNY China Select ADR Index. The BNY China Select ADR Index is a free float-adjusted capitalization-weighted index designed by the Bank of New York to track the performance of a basket of companies who have their primary equity listing on a stock exchange in China and which also have depositary receipts that trade on a U.S. exchange or on the NASDAQ. Decisions regarding additions to and deletions form the Index are guided by conditions established by the bank of New York with the intention of creating and maintaining a benchmark for emerging market equity performance. As of April 30, 2008, the index comprised of ADRs of 40 companies with an average market capitalization of over $14.3 billion dollars and a median market capitalization of $2.4 billion dollars.

Indus India Index. The Indus India Index, which is designed to replicate the Indian equity markets as a whole, through a group of 50 Indian stocks selected from a universe of the largest companies listed on two major Indian exchanges. The India Index has 50 constituents, spread among the following sectors: Information Technology, Health Services, Financial Services, Heavy Industry, Consumer Products and Other. The India Index is supervised by an index committee, comprised of representatives of the Index Provider and members of academia specializing in emerging markets.

S&P Latin America 40 Index. The S&P Latin America 40 Index is an equity index drawn from four major Latin American markets: Argentina, Brazil, Chile and Mexico. The index constituents are leading, large liquid companies from the Latin American markets with a total market capitalization of $505 billion and a median market capitalization of $5 billion, each as of December 31, 2007. Brazil, Mexico, Chile and Argentina provide 18, 10, 10 and 2 companies, respectively. The Brazilian companies provide 63% of the market capitalization of the index, with Mexican, Chilean and Argentinean companies accounting for 27%, 7% and 3%, respectively.

S&P Global Clean Energy Index™. The S&P Global Clean Energy Index is designed to provide liquid and tradable exposure to 30 companies from around the world that are involved in clean energy related businesses. The index is comprised of a diversified mix of clean energy production, clean energy technology and equipment provider companies.

Russell 1000® Energy Index. The Russell 1000® Energy Index is a capitalization-weighted index of companies engaged in energy-related businesses, such as oil companies involved in the exploration, production, servicing, drilling and refining processes, and companies primarily involved in the production and mining of coal and other fuels used in the generation of consumable energy. Also included are gas distribution, gas pipeline and related companies. These companies span a broad range of industries including: domestic, international and crude oil producers, offshore drilling, oil well equipment and service, machinery and energy equipment, coal, utilities, gas pipelines and miscellaneous energy services.

Russell 1000® Financial Services Index. The Russell 1000® Financial Services Index is a capitalization-weighted index of companies that provide financial services. As of April 30, 2008, the index had 227 components, derived from the Russell 1000 Index with an average market capitalization of over $11 billion dollars and a median market capitalization of $4.4 billion dollars.

Russell 1000® Technology Index. The Russell 1000® Technology Index is a capitalization-weighted index of companies that serve the electronics and computer industries or that manufacture products based on the latest applied science. The index currently has 105 components, derived from the Russell 1000, with an average market cap of over $19 billion dollars and a median market capitalization of $6.1 billion dollars as of April 30, 2008.

Dow Jones Wilshire REIT Index. The Dow Jones Wilshire REIT Index is a float-adjusted market capitalization weighted index that is comprised of REITs that are components of the Dow Jones Real Estate Securities Index. This index is constructed to provide measures of real estate securities that serve as proxies for direct real estate investing. This index does not include securities that are not directly tied to the value of underlying real estate. Each component of the index must be both an equity owner and operator of commercial and or residential real estate and have a minimum market capitalization of more than $200 million dollars. As of April 30, 2008, the components in the index had an average market capitalization of $3.2 billion dollars and a median market capitalization of $1.6 billion dollars.

S&P Homebuilding Select Industry Index™. The S&P Homebuilding Select Industry Index is an equal weighted index that draws constituents from companies involved in homebuilding, directly and indirectly through furnishings, retailing, manufacturing, textiles and chemicals keyed to homebuilding. The median market cap of the 24 holdings as of April 30, 2008 was $2.08 billion and the average weighted market cap was $5.86 billion.

EXHIBIT B

SECURITIES AND EXCHANGE COMMISSION

Rafferty Asset Management, LLC
Direxion Shares ETF Trust

Notice of Application
Release No. 40-_____; File No. 812-13483

September __, 2008

Action: Notice of application for an order under section 6(c) of the Investment Company Act of 1940 (the "Act") for an exemption from sections 2(a)(32), 5(a)(1), 22(d), 22(e) and 24(d) of the Act and Rule 22c-1 under the Act, and under sections 6(c) and 17(b) of the Act for an exemption from sections 17(a)(1) and 17(a)(2) of the Act.

Summary of Application: Applicants request an order that would permit: the Trust (as defined below), whose portfolios ("Funds") will consist of financial instruments, money market instruments and, under certain circumstances, the component securities of Underlying Indices (a defined below), to issue shares with limited redeemability ("ETS"); secondary market transactions in the ETS at negotiated prices; certain Funds that invest in foreign securities to honor redemptions more than seven days after the request for redemption is made; certain affiliated persons of the Trust to deposit securities into, and receive securities from, the Trust in connection with the purchase and redemption of aggregations of ETS.

Applicants: Rafferty Asset Management, LLC ("Adviser") and Direxion Shares ETF Trust ("Trust").

Filing Dates: The application was filed on January 23, 2008 and an amendment to the application was filed on May 8, 2008.

Hearing or Notification of Hearing: An order granting the application will be issued unless the SEC orders a hearing. Interested persons may request a hearing by writing to the SEC's Secretary and serving applicants with a copy of the request, personally or by mail. Hearing requests should be received by the SEC by 5:30 p.m. on September __, 2008 and should be accompanied by proof of service on applicants, in the form of an affidavit, or, for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons may request notification of a hearing by writing to the SEC's Secretary.

Addresses: Secretary, SEC, 100 F Street NE, Washington, DC 20549; Applicants, 33 Whitehall Street, 10th Floor, New York, New York 10004.

For Further Information Contact: Emerson S. Davis, Senior Counsel, and Julia Kim Gilmer, Branch Chief (202) 551-6821 (Division of Investment Management, Office of Investment Company Regulation).

Supplementary Information: The following is a summary of the application. The complete application may be obtained for a fee from the SEC's Public Reference Branch, 100 F Street NE, Washington, DC 20549.

Applicants' Representations:

1. The Trust is an open-end management investment company organized as a Delaware statutory trust. The Trust is authorized to issue an unlimited number of Funds. In addition to the initial funds ("Initial Funds"), which are the subject of the Application, Applicants seek relief for future Funds ("Future Funds"). Each Fund, including each Future Fund, will be advised by the Adviser or an entity controlling, controlled by, or under common control with the Adviser, and comply with the terms and conditions of this Application. The Adviser will act as investment adviser for each Fund. A broker-dealer registered under the Securities Exchange Act of 1934 ("Exchange Act"), will serve as the principal underwriter of each Fund on an agency basis ("Distributor").

2. Each Fund will have a distinct investment objective. Each Fund will attempt, on a daily basis, to achieve returns that correspond to a specified multiple of the performance, or the inverse performance, of a particular securities index ("Underlying Index"). Funds that seek to match the daily performance, before fees and expenses, of a specified Underlying Index are termed "Conventional Funds." Funds that seek daily investment results that correspond, before fees and expenses, to a multiple of the daily performance of an Underlying Index are termed "Leveraged Funds." Funds that seek daily investment results, before fees and expenses, of a multiple of the inverse (or opposite) of the daily performance of an Underlying Index are termed "Inverse Funds."

3. Each Fund will invest in a portfolio of financial instruments, money market instruments, government obligations and, under certain circumstances, equity and/or fixed income securities, which generally consist of the component securities of the underlying index ("Portfolio Investments"). Each Fund, will hold a mixture of Portfolio Investments determined by the Adviser using a mathematical model based on well-established principles of finance.[43]

4. Applicants expect that each Conventional Fund's and Leveraged Fund's statistical correlation to the performance of Underlying Index will be .95 or greater and that the performance of each Conventional Fund and Leveraged Fund will have an annual tracking error of less than five percent (5%) relative to the Underlying Index. Similarly, Applicants expect that an Inverse Fund's statistical correlation to the specified multiple of the performance of its Underlying Index will be -.95 or greater and that the performance of each Inverse Fund will have

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[43] The Adviser will consider each security or other financial instrument for inclusion in a Fund's portfolio based on proprietary quantitative and statistical analyse it developed.

a daily tracking error of less than five percent (5%) relative to the specified multiple of the inverse performance of the Underlying Index.

5. With respect to each Fund, the Trust will issue ETS on a continuous offering basis, generally in aggregations of 25,000 to 100,000 ETS ("Creation Units"). The price of a Creation Unit will be at least $1,000,000 (based on an initial price of $25 to $250). To purchase a Creation Unit, an investor must be or transact through an "Authorized Participant, "which is (a) a broker-dealer or other participant in the Continuous Net Settlement ("CNS") System of the National Securities Clearing Corporation ("NSCC"), a clearing agency registered with the Commission, or (b) a participant in DTC ("DTC Participant") that, in either case, has entered into a "Participant Agreement" with the Trust and/or Distributor.

6. Except with respect to Funds, such as Inverse Funds, that sell Creation Units in exchange for an all-cash deposit, an investor wishing to purchase a Creation Unit from the Trust will have to transfer to the Trust a "Deposit Basket" consisting of (i) a portfolio of securities selected by the Adviser and/or (ii) a cash payment.[44] Each day that a Fund is open for business, including as required by section 22(e) of the Act ("Business Day"), the Adviser will make the Fund's Deposit Basket publicly available prior to the opening of trading on the Fund's listing Exchange. An investor purchasing a Creation Unit from the Trust may be charged a purchase fee ("Transaction Fee") to prevent the dilution of the interests of the remaining shareholders resulting from a Fund incurring costs in connection with the purchase of the Creation Units.[45] Each Fund will disclose in its prospectus the Transaction Fees charged by such Fund and will disclose in the statement of additional information ("SAI") the method of calculating such Transaction Fees.

7. Orders to purchase Creation Units will be placed with the Distributor who will be responsible, with respect to foreign Funds for coordinating with the Fund's custodian and sub custodians, and with respect to all Funds for transmitting the orders to the Trust. The Distributor will issue confirmations of acceptance, issue delivery instructions to the Trust to implement the delivery of Creation Units, and maintain records of the orders and the confirmations. The Distributor also will be responsible for delivery of prospectuses to purchasers of Creation Units.

8. Persons purchasing Creation Unit aggregations of ETS from the Trust may hold the ETS or sell some or all of them in the secondary market. ETS will be listed on a national securities exchange ("Exchange") and trade in the secondary market in the same manner as other equity securities. A specialist will be assigned, or market makers will agree, to make a market in each Fund's ETS. The prices of ETS on an Exchange will be based on a current bid/offer market. Transactions involving the purchase and sale of ETS in the secondary market will be subject to customary brokerage commissions and charges. Applicants expect that the price at

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[44] The identity and number of shares of securities in a Fund's Deposit Basket may change as rebalancing adjustments, corporate events, and weighting or composition adjustments are made to an Underlying Index.

[45] The Transaction Fee for each Fund will be separately determined. The Transaction Fee will be limited to amounts determined by the Adviser to be appropriate and will take into account the transaction costs associated with the Creation Units for the relevant Fund.

which the ETS trade will be disciplined by arbitrage opportunities created by the ability to continually purchase or redeem Creation Units at their NAV, which should ensure that the ETS will not trade at a material discount or premium in relation to their NAV.

9. Applicants expect that purchasers of ETS in Creation Units will include institutional investors and arbitrageurs (which could include institutional investors). The exchange specialist or market maker also may purchase ETS in connection with its activities on the relevant Exchange. Applicants expect that secondary market purchasers of ETS will include both institutional and retail investors.[46]

10. ETS will not be individually redeemable. ETS will only be redeemable in Creation Units.[47] To redeem, an investor will have to accumulate enough ETS to constitute a Creation Unit. An investor redeeming ETS in a Creation Unit will receive a portfolio of securities and/or a payment of cash, as published daily by the Trust or one of its agents, on the Trust's behalf, and in effect on the date the redemption request is made. A redeeming investor may pay a Transaction Fee calculated in the same manner as a Transaction Fee payable in connection with the purchase of a Creation Unit.

11. Applicants state that neither the Trust nor any Fund will be marketed or otherwise held out as a "mutual fund." Rather, Applicants state that the Trust and its Funds will be marketed as an "exchange-traded fund." All marketing materials will refer to the Trust as an "investment company" and "fund" without reference to an "open-end fund" or "mutual fund," except to contrast ETS with the shares of a conventional open-end management investment company. In all marketing materials where the method of obtaining, buying or selling ETS is described, applicants will include a statement to the effect that ETS are not redeemable except in Creation Units. The same type of disclosure will be provided in each Fund's prospectus and SAI, advertising materials, and all reports to shareholders.[48]

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[46] ETS will be registered in book-entry form only. DTC or its nominee will be the registered owner of all outstanding ETS. Records reflecting the beneficial owners of ETS will be maintained by DTC or its participants.

[47] Creation Units which are redeemed for securities of a Fund may be redeemed through the Distributor, which will act as the Trust's agent for redemption.

[48] Applicants state the persons purchasing Creation Units will be cautioned in the relevant Fund's prospectus that some activities on their part may, depending on the circumstances, result in their being deemed statutory underwriters and subject them to the prospectus delivery and liability provisions of the Security Act of 1933 ("Securities Act"). For example, a broker-dealer firm or its client may be deemed a statutory underwriter if it takes Creation Units after placing an order with the Distributor, breaks them down into the constituent ETS, and sells ETS directly to its customers; or if it chooses to couple the creation of a supply of new ETS with an active selling effort involving solicitation of secondary market demand for ETS. Each Fund's prospectus will state that whether a person is an underwriter depends upon all the facts and circumstances pertaining to that person's activities. It will state that broker-dealer firms should also note that dealers who are not "underwriters" but participating in a distribution (as contrasted to ordinary secondary trading transactions), and thus dealing with ETS that are part of an "unsold allotment" within the meaning of section 4(3)(C) of the Securities Act, would be unable to take advantage of the prospectus delivery exemption provided by section 4(3) of the Securities Act.

Applicants' Legal Analysis:

1. Applicants request an order under section 6(c) of the Act granting an exemption from sections 2(a)(32), 5(a)(1), 22(d) and 24(d) of the Act and rule 22c-1 under the Act; and under sections 6(c) and 17(b) of the Act granting an exemption from sections 17(a)(1) and 17(a)(2) of the Act.

2. Section 6(c) of the Act provides that the Commission may exempt any person, security, or transaction, or any class of persons, securities or transactions, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

3. Sections 5(a)(1) and 2(a)(32) of the Act defines an "open-end company" as a management investment company that is offering for sale or has outstanding any redeemable security of which it is the issuer. Section 2(a)(32) of the Act defines a redeemable security as any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer is entitled to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent. Because ETS will not be individually redeemable, applicants request an order that would permit the Trust and each of its Funds to register and operate as an open-end management investment company. Applicants state that investors may purchase ETS in Creation Units from each Fund and redeem ETS in Creation Units. Applicants further state that because the market price of Creation Units will be disciplined by arbitrage opportunities, investors should be able to sell ETS in the secondary market at prices that do not vary substantially from their NAV.

4. Section 22(d) of the Act, among other things, prohibits a dealer from selling a redeemable security that is being currently offered to the public by or through an underwriter, except at a current public offering price described in the prospectus. Rule 22c-1 under the Act generally requires that a dealer selling, redeeming, or repurchasing a redeemable security do so only at a price based on its NAV. Applicants state that secondary market trading in ETS will take place at negotiated prices, not at a current offering price described in the prospectus, and not at a price based on NAV. Thus, purchases and sales of ETS in the secondary market will not comply with section 22(d) and rule 22c-1. Applicants request an exemption from these provisions.

5. Applicants assert that the concerns sought to be addressed by section 22(d) and Rule 22c-1 with respect to pricing are equally satisfied by the proposed method of pricing ETS. Applicants maintain that while there is little legislative history regarding section 22(d), its provisions, as well as those of rule 22c-1, appear to have been designed to (i) prevent dilution caused by certain riskless-trading schemes by principal underwriters and contract dealers, (ii) prevent unjust discrimination or preferential treatment between and among buyers resulting from sales at different prices, and (iii) assure an orderly distribution of investment company shares by eliminating price competition from dealers offering shares at less than the published sales price and repurchasing shares at more than the published redemption price.

6. Applicants believe that none of these purposes will be thwarted by permitting ETS to trade in the secondary market at negotiated prices. Applicants state (i) that secondary market trading in ETS does not involve any Fund as a party and cannot result in dilution of any

Fund, and (ii) to the extent different prices exist during a given trading day, or from day to day, such variances occur as a result of third-party market forces, such as supply and demand, not as result of unjust or discriminatory manipulation. Therefore, Applicants assert that secondary market transactions in ETS should not lead to discrimination or preferential treatment among purchasers. Finally, Applicants contend that the proposed distribution system will be orderly because arbitrage activity will ensure that the difference between the market price of ETS and their NAV remains narrow.

7. Section 22(e) of the Act generally requires registered funds to deliver redemption proceeds within seven days of a request for redemption. Applicants state that due to the potential confluence of holidays in domestic and foreign markets, the Funds may be required to deliver redemption proceeds later than seven days after a request of redemption. Applicants state that section 22(e) was intended to prevent unforeseen delays in the delivery of redemption proceeds to investors. Applicants state that they will disclose, if known, all holidays that may delay the delivery of redemption proceeds. Applicants seek relief to permit them to deliver redemption proceeds up to 12 days after a request for redemption.

8. Section 24(d) effectively imposes prospectus delivery requirements for transactions in redeemable securities issued by a unit investment trust or open-end investment company if any other security is currently being offered or sold by the issuers. The section appears to impose such delivery requirements prior to or at the time of the confirmation of each secondary market sale of ETS. Applicants request that the Commission grant an exemptive order under section 6(c) to provide relief from the prospectus delivery requirements resulting from section 24(d) to the extent necessary to allow sales of ETS by dealers in the secondary market unaccompanied by a prospectus (except during the first 25 days after the ETS are first offered to the public). Applicants emphasize that relief is not being sought for non-secondary market transactions. Applicants contend that the substantial amounts involved in assembling a Creation Unit preclude a retail investor from creating or redeeming ETS in non-secondary market transactions. Applicants also contend that secondary market investors will regard ETS as similar to other securities, including closed-end fund shares, that are listed, bought and sold on an Exchange. Applicants observe that closed-end fund shares are not subject to section 24(d) and hence are sold in the secondary market unaccompanied by a prospectus. Applicants assert that, because such other investment companies are not burdened with prospectus delivery requirements, the Funds should not be either. Further, Applicants argue, Exchange rules applicable to the Funds will require that all members and member organizations provide a “Product Description” to purchasers of Fund ETS not later than the time a confirmation of the first transaction in such securities is delivered to such purchaser. These requirements will apply to Exchange member broker-dealers even if the purchases of Fund ETS occur away from the Exchange. As a result, Applicants state, investors will have access to extensive information about each Fund and its ETS absent prospectus delivery.

9. Section 17(a) of the Act generally prohibits an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security to or purchasing any security from the company. Because purchases and redemptions of Creation Units may, from time to time, involve “in-kind” transfers of securities, rather than cash, section 17(a) may prohibit affiliated persons of the Trust from purchasing or redeeming Creation Units. Because the definition of “affiliated person” in section 2(a)(3) of the Act includes any person

owning five percent or more, or more than 25%, of an issuer's outstanding voting securities, certain purchasers (including the initial purchasers) of Creation Units may become affiliated with the Trust. Applicants request an exemption from section 17(a) under sections 6(c) and 17(b) to permit such affiliated persons to effect in-kind purchases and redemptions of Creation Units.

10. Section 17(b) of the Act authorizes the Commission to exempt a proposed transaction from section 17(a) if evidence establishes that the terms of the transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned, and the proposed transaction is consistent with the policies of the registered investment company and the general provisions of the Act. Applicants contend that no useful purpose would be served by prohibiting the above-described affiliated persons of the Trust or a Fund from purchasing or redeeming Creation Units. The composition of each Deposit Basket will be the same regardless of the investor's identity, and will be valued under the same standards as are applied to valuing the Fund's Portfolio Investments. Therefore, Applicants state, "in kind" purchases and redemptions will afford no opportunity for an affiliated person of the Trust to effect a transaction detrimental to the other holders of its ETS.

Applicants' Conditions:

Applicants agree that the order granting the requested relief will be subject to the following conditions:

1. The prospectus and the Product Description will clearly disclose that, for purposes of the Act, ETS are issued by the Funds and the acquisition of ETS by investment companies is subject to the restrictions of section 12(d)(1) of the Act, except as permitted by an exemptive order that permits registered investment companies to invest in a Fund beyond the limits in section 12(d)(1), subject to certain terms and conditions, including that the registered investment company enter into an agreement with the Fund regarding the terms of the investment.

2. As long as the Trust operates in reliance on the requested order, the ETS will be listed on an Exchange.

3. Neither the Trust nor any Fund will be advertised or marketed as an open-end fund or a mutual fund. The prospectus will prominently disclose that ETS are not individually redeemable shares and will disclose that the owners of ETS may acquire those ETS from the Trust and tender those ETS for redemption to the Trust in Creation Units only. Any advertising material that describes the purchase or sale of Creation Units or refers to redeemability will prominently disclose that ETS are not individually redeemable and that owners of ETS may acquire those ETS from the Trust and tender those ETS for redemption to the Trust in Creation Units only.

4. Before a Fund may rely on the order, the Commission will have approved, pursuant to rule 19b-4 under the Exchange Act, an Exchange rule or an amendment thereto, requiring Exchange members and member organizations effecting transactions in ETS to deliver a Product Description to purchasers of ETS.

5. The Trust's website, which will be publicly accessible at no charge, will contain the following information, on a per ETS basis, for each Fund: (a) the prior Business Day's NAV and the reported closing price, and a calculation of the premium or discount of such price against such NAV; and (b) data in chart format displaying the frequency distribution of discounts and premiums of the daily closing price against the NAV, within appropriate ranges, for each of the four previous calendar quarters (or the life of the Fund, if shorter). In addition, the Product Description for each Fund will state that the Trust's website has information about the premiums and discounts at which the ETS have been traded.

6. The prospectus and annual report for each Fund will also include: (a) the information listed in condition 5(b), (i) in the case of the prospectus, for the most recently completed year (and the most recently completed quarter or quarters, as applicable) and (ii) in the case of the annual report, for the immediately preceding five years (or the life of the Fund, if shorter); and (b) the following data, calculated on a per ETS basis for one, five and ten year periods (or life of the Fund, if shorter), (i) the cumulative total return and the average annual total return based on NAV and closing price, and (ii) the cumulative total return of the relevant Underlying Index.

7. The requested relief to permit ETF operations will expire on the effective date of any Commission rule under the Act that provides relief permitting the operation of index-based exchange-traded funds and exchange traded funds that seek to return a multiple, the inverse or an inverse multiple of an index.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

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As filed with the Securities and Exchange Commission on July 20, 2009

UNITED STATES OF AMERICA

BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

Amendment No. 3 to Application for an Amended Order under Section 6(c) of the Investment Company Act of 1940, as amended, for an exemption from Sections 2(a)(32), 5(a)(1), 22(d), and 22(e) of the Act and Rule 22c-1 under the Act and under Sections 6(c) and 17(b) of the Act for an exemption from Sections 17(a)(1) and 17(a)(2) of the Act.

In the Matter of

Rafferty Asset Management, LLC

Direxion Shares ETF Trust

File No. 812-13610

Please send all communications to:

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In the Matter of Rafferty Asset Management, LLC Direxion Shares ETF Trust 33 Whitehall Street, 10th Floor New York, NY 10004 File No. 812-13610	Amendment No. 3 to Application for an Amended Order under Section 6(c) of the Investment Company Act of 1940, as amended, for an exemption from Sections 2(a)(32), 5(a)(1), 22(d), and 22(e) of the Act and Rule 22c-1 under the Act and under Sections 6(c) and 17(b) of the Act for an exemption from Sections 17(a)(1) and 17(a)(2) of the Act.

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I. Summary of Application

Direxion Shares ETF Trust (**the "Trust"**) currently operates pursuant to an order previously granted by the Securities and Exchange Commission (**"Commission"**) to the Applicants (**"Prior Order"**).[1] In this amendment dated July 20, 2009, to the application dated December 17, 2008 (**"Application"**), the undersigned Applicants (**"Applicants"**) respectfully apply for and request an order amending the Prior Order under Section 6(c) of the Investment Company Act of 1940, as amended (**"Act"**), for an exemption from Sections 2(a)(32), 5 (a)(1), 22(d), and 22(e) of the Act and Rule 22c-1 under the Act and under Sections 6(c) and 17(b) of the Act for an exemption from Sections 17(a)(1) and 17(a)(2) of the Act (**"Amended Order"**). All defined terms contained in the Prior Application are equally applicable to this Application unless expressly modified or altered herein.

The Prior Order permits, among other things:

- the Funds to issue shares that would trade on a national securities exchange (**"Exchange"**), such as NYSE Arca, Inc., at negotiated market prices rather than at net asset value (**"NAV"**);
- the Funds' exchange-traded shares (**"ETS"**) to be redeemable in large aggregations only (**"Creation Units"**);
- dealers to sell ETS to purchasers in the secondary market unaccompanied by a statutory prospectus, when prospectus delivery is not required by the Securities Act of 1933, as amended (**"Securities Act"**);
- certain series to pay redemption proceeds, under certain circumstances, more than seven days after the tender of ETS for redemption; and

[1] Investment Company Act Release Nos. 28379 (September 12, 2008) (notice) and 28434 (October 6, 2008) (order). The application on which the Prior Order was issued is referred to as the "Prior Application."

- certain affiliated persons of the Funds to buy securities from, and sell securities to the Funds, in connection with the in-kind purchase and redemption of such Funds' ETS.[2]

Applicants seek to amend the Prior Order as described below. Applicants propose:

- to amend the term "Financial Instruments" defined in the Prior Application to now include short positions **("Short Positions")** in the component securities **("Component Securities")** comprising the relevant Underlying Indices, as defined below, for the Funds;
- to expand the ability of each Fund designed to correspond to the return of its Underlying Index (each a **"Conventional Fund")** to invest a minimum of only 80% of its total assets (exclusive of collateral held for purposes of securities lending) in the Component Securities;
- to expand the category of Conventional Funds to include Funds that seek to match the performance of an index that primarily is focused on U.S. equity securities and that applies a strategy referred to as 130/30 ("130/30 Funds");
- to permit Funds to seek a specified multiple, up to 300%, of the performance of an Underlying Index **("Leveraged Funds")** and Funds to seek a specified multiple, up to 300%, of the inverse performance of an Underlying Index **("Inverse Funds")**[3];
- to amend the Prior Order to permit a Leveraged Fund to determine what percentage, if any, of its total assets to invest in the Component Securities;
- to amend the Prior Order by deleting the relief granted from the requirements of Section 24(d) of the Act and revising the Prior Application by deleting all discussions relating to

[2] *See*, footnote 1, *supra*.

[3] Applicants acknowledge that this definition of Leveraged Funds and Inverse Funds supersedes the definition of these terms in the Prior Application.

such relief, including all references to Product Descriptions in the body of the Prior Application and in the conditions; and

- to amend the terms and conditions of the Prior Application such that all representations and conditions contained in the Prior Application and the current Application that require a Fund to disclose particular information in the Fund's Prospectus and/or annual report shall remain effective with respect to the Fund until the time the Fund complies with the disclosure requirements adopted by the Commission in Investment Company Act Release No. 28584 (Jan. 13, 2009).

All Funds will be offered pursuant to the same terms, provisions and conditions of the Prior Application and the Prior Order, as further amended or modified by this Application.

Applicants believe that (i) with respect to the relief requested pursuant to Section 6(c), the requested exemption is appropriate, in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act and (ii) with respect to the relief requested pursuant to Section 17(b), the proposed transactions are reasonable and fair and do not involve overreaching on the part of any person concerned; that the proposed transactions are consistent with the policies of each Fund; and that the proposed transactions are consistent with the general purposes of the Act. Such relief is collectively referred to herein as "Relief."

II. Background

A. Applicants

Direxion Shares ETF Trust was organized under the laws of Delaware as a statutory trust on April 23, 2008. The Trust is registered under the Act as an open-end management investment company and is authorized to offer an unlimited number of series.

The Trust currently offers and sells ETS of certain of the Funds pursuant to a registration statement filed with the Commission on Form N-IA, as amended **("Registration Statement")**. Applicants request that any Amended Order issued in respect of this Application apply equally to any Fund that operates pursuant to the terms and conditions of the Prior Application as revised by this Application. Each Fund will be advised by Rafferty Asset Management, LLC (**"Adviser"**), or an entity controlled by or under common control with the Adviser. Applicants will not seek to register any Fund or list the ETS of any Fund without complying with all applicable listing rules of the primary listing Exchange.

The Adviser may enter into subadvisory agreements with additional investment advisers who may serve as subadviser to the Trust and any of its series. Any subadviser to the Trust or a Fund will be registered under the Investment Advisers Act of 1940 **("Advisers Act")**.

B. Applicants' Proposal

As was stated in the Prior Application, Applicants expect each Conventional Fund to have an annual tracking error of less than 5% relative to its Underlying Index. Applicants expect each Leveraged Fund and Inverse Fund to have daily tracking error of less than 5% relative to the specified multiple, inverse, or inverse multiple (as applicable) of the performance of its relevant Underlying Index. The Prospectus and Statement of Additional Information **("SAI")** of each Fund disclose that, while close tracking of a Leveraged Fund or Inverse Fund to the multiple, the inverse, or the inverse multiple of its respective Underlying Index may be achieved on any single trading day, over time, the cumulative percentage increase or decrease in the NAV of such Leveraged Fund or Inverse Fund and the cumulative percentage increase or decrease in the multiple of the return of its Underlying Index may diverge significantly due to leverage and the compounding effect of losses and gains on the returns of the Leveraged Fund or Inverse

Fund. The Prospectus and SAI of each such Fund provide numerous charts and graphs illustrating the same.

1. Inclusion of Short Positions within the Definition of Financial Instruments.

As stated above, Applicants intend that the definition of Financial Instruments, which has been defined in the Prior Application to include futures contracts, options on securities, indices and futures contracts, equity caps, collars and floors, swap agreements, forward contracts, and reverse repurchase agreements, be expanded to include Money Market Instruments and Short Positions in the Component Securities. At times, using Short Positions may be a more efficient and cost-effective investment technique than using other types of Financial Instruments. Applicants believe that expanding the definition of Financial Instruments will provide for more flexible portfolio management with respect to the Funds as they seek to achieve their investment objectives. Additionally, Applicants wish to clarify that Conventional and Leveraged Funds intend to use Financial Instruments to gain exposure to both the equity securities and the fixed-income securities that are Component Securities.[4]

2. Conventional Funds.

The Prior Application provided that each Conventional Domestic Fund would hold at least 95% and each Conventional Foreign Fund and Conventional Fixed Income Fund would hold at least 80% of its total assets in the Component Securities. As stated above, Applicants now wish to amend the Prior Application to provide that each Conventional Fund will invest at least 80% of its total assets (exclusive of collateral held for purposes of securities lending) in the Component Securities and/or investments that have economic characteristics that are substantially identical to the economic characteristics of the Component Securities. However, a

[4] The discussion of Financial Instruments in the Prior Application did not specifically refer to fixed income securities.

Conventional Fund may at times invest up to 20% of its total assets (exclusive of collateral held for purposes of securities lending) in Financial Instruments and Money Market Instruments, which the Adviser believes will help the Conventional Fund track its index. Except as discussed below with respect to 130/30 Funds, as a general matter, the securities specified as the Deposit Securities and the Redemption Securities will correspond, pro rata, to the securities held by each Conventional Fund. Applicants believe that such relief would provide Conventional Funds with additional operational flexibility to pursue more efficient and cost-effective techniques in achieving their investment objectives. Applicants also note that the Commission has granted exemptive relief to other exchange-traded funds that follow the 80% standard.[5]

3. <u>130/30 Funds</u>.

As stated above, the Applicants wish to expand the category of Conventional Funds to include 130/30 Funds. In general, "130/30" strategies refer to strategies that: (i) establish long positions in securities such that total long exposure amounts to approximately 130% of net assets; and (ii) simultaneously establish short positions in other securities such that total short exposure amounts to approximately 30% of net assets. Many mutual funds exist that employ an actively-managed 130/30 strategy. Their portfolio managers exercise discretion and select long positions and select short positions based upon their judgment and any constraints imposed on them.

The 130/30 Funds intend to employ a 130/30 approach but in contrast to actively managed 130/30 strategies, the 130/30 Funds will operate as indexed ETFs. The Adviser will not actively select positions for the 130/30 Funds. Instead, the 130/30 Funds will seek to produce the return of an Underlying Index that employs a 130/30 strategy. The 130/30 Funds will not

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[5] *See* ProShare Advisors, LLC and ProShares Trust, ICA Rel. Nos. 28696 (Apr. 14, 2009) (notice) and 28724 (May 12, 2009) (order)

take long positions in any securities that are not Component Securities. The Underlying Indices for the 130/30 Funds will employ a rules-based approach based on specified factors to determine the components and weighting of the components of the index, both long and short. As with other Underlying Indices, the Underlying Indices for 130/30 Funds will have a well developed, fully specified methodology, and be created and operated by a third-party, unaffiliated Underlying Index Provider.

With respect to a 130/30 Fund's 130% of net assets long position, each such Fund plans to hold a combination of Component Securities and total return swap positions that correlate with the leveraged long (130%) piece of their respective Underlying Index. With respect to such Fund's 30% of net assets short position, each 130/30 Fund expects to hold total return swap positions that correlate to the short (-30%) piece of their respective Underlying Index. Accordingly, both traditional index ETFs and the 130/30 Funds will operate in essentially the same fashion; they seek to hold portfolio positions intended to produce the return of their underlying index.

Comparable to other Conventional Funds, each 130/30 Fund will hold at least 80% of its total assets (exclusive of collateral held for purposes of securities lending) in the Component Securities that are specified for the long positions in its Underlying Index. For example, and assuming a 130/30 Fund's total assets equal $100, the Fund would take at least $80 (i.e., 80%) and invest it directly in Component Securities representing the long positions of its Underlying Index. The remaining $20 could be invested in such Component Securities, cash equivalents or other securities. The 130/30 Fund would then enter into financial instruments to replicate the remaining 50% long and 30% short positions as dictated by its Underlying Index. The liquid assets in the 130/30 Fund would collateralize those derivative positions consistent with the requirements of, and SEC staff positions regarding, Section 18(f) of the Act.

The creation and redemption process for the 130/30 Funds will be the same as for the existing Leveraged Funds in that ETS will generally be purchased and redeemed for a basket of in-kind securities and cash, or solely cash. The 130/30 Funds' prospectus will disclose that a Creation Unit can be purchased with and redeemed for either: i) in-kind securities and cash; or ii) solely cash. The Adviser generally permits the Authorized Participant to choose whether to create or redeem an all cash creation or a combination of in-kind securities and cash. The Adviser may permit only one method, however, if in its sole discretion it believes that the alternative method of creation or redemption would be, or potentially would be, harmful to shareholders or the Fund (e.g., adverse tax consequences). There will be no Short Positions in the Deposit Basket or the list of Redemption Securities for 130/30 Funds. Similar to existing Leveraged and Inverse ETFs, the IIV file and the holdings file publicly available on the Funds' website will include Deposit Basket information as well as information relating to derivative positions such that the intraday value of a 130/30 Fund can accurately be calculated. The investment characteristics of the derivative positions used to achieve the 30% short exposure and the remaining long exposure not held directly in Component Securities will be described in sufficient detail for market participants to understand the principal investment strategies of the 130/30 Funds and to permit informed trading of such Funds' ETS.

4. Leveraged Funds.

The Prior Application provided that each Leveraged Fund would hold 80% to 100% of its total assets in Component Securities. As stated above, Applicants now wish to amend the Prior Application to provide each Leveraged Fund with flexibility to determine what percentage, if any, of its total assets to be invested in the Component Securities. Each Leveraged Fund will hold Money Market Instruments and Financial Instruments in percentage levels consistent with the requirements of the Act, rules and regulations promulgated thereunder and Commission staff positions relating thereto. Applicants believe that this additional flexibility will be useful in managing each Leveraged Fund's Portfolio assets because it will provide each such Fund with a broader range of potentially cost-effective measures for gaining the stated exposure to its Underlying Index.

As stated above, Applicants also seek to amend the Prior Order in order to permit Leveraged Funds to seek a specified multiple of up to 300% of the performance of, and Inverse Funds to seek a specified multiple of up to 300% of the inverse performance of, an underlying securities index. Applicants believe that such relief for Leveraged and Inverse Funds would, as compared to the relief afforded by the Prior Order, provide investors and financial professionals with sufficient opportunity to experience "leveraged" investment results, as well as an increased ability to manage their exposure to market risk on a low-cost basis.

5. Conventional Foreign Funds.

Any Conventional Foreign Fund will invest at least 80% of its total assets in the Component Securities of its Underlying Index and Depositary Receipts representing such Component Securities. Each such Conventional Foreign Fund may be invested in Component Securities (whether listed on a foreign or U.S. exchange) and/or Depositary Receipts representing such Component Securities, as well as in Financial Instruments and Money Market Instruments. Applicants are not seeking relief from section 22(e) with respect to holdings of Conventional Foreign Funds of shares of foreign companies that are listed on U.S. exchanges and that are being held as Component Securities.

6. Deletion of Relief in the Prior Order from Section 24(d) under the Act and Changes to Disclosure Requirements.

As stated above, Applicants seek to amend the Prior Order to delete the relief granted to Applicants from Section 24(d) of the Act. Applicants believe that the deletion of the exemption from Section 24(d) that was granted in the Prior Order is warranted because the adoption of the summary prospectus under Investment Company Act Release No. 28584 (Jan. 13, 2009) (the **"Summary Prospectus Rule"**) should supplant any need by a Fund to use a Product Description. Applicants also note that, to date, no Fund has utilized a Product Description. The deletion of the relief granted with respect to Section 24(d) of the Act from the Prior Order will also result in the deletion of related discussions in the Prior Application, revision of the Prior Application to delete references to the Product Description including in the conditions, and the deletion of condition 4 in the Prior Application.

Applicants also seek to amend the terms and conditions of the Prior Application to provide that all representations and conditions contained in the Prior Application and the current Application that require a Fund to disclose particular information in the Fund's Prospectus and/or annual report shall remain effective with respect to the Fund until the time the Fund complies with the disclosure requirements adopted by the Commission in the Summary Prospectus Rule. Applicants believe that the proposal to supersede the representations and conditions requiring certain disclosures contained in the Prior Application and the current application is warranted because the Commission's amendments to Form N-1A with regard to exchange-traded funds as part of the Summary Prospectus Rule reflect the Commission's view with respect to the appropriate types of prospectus and annual report disclosures for an exchange-traded fund.

III. Request for Relief

Applicants seek an order under Section 6(c) of the Act amending the Prior Order to grant an exemption from Sections 2(a)(32), 5(a)(1), 22(d), and 22(e) of the Act and Rule 22c-1 under the Act, as well as an exemption from Sections 17(a)(1) and 17(a)(2) of the Act pursuant to Sections 6(c) and 17(b) of the Act to permit the above-described changes in the operation of the Funds.

IV. Express Conditions to this Application

Applicants agree that any Amended Order of the Commission granting the requested relief will be subject to the same conditions as those imposed by the Prior Order except for condition 4 which will be deleted. All representations and conditions contained in this Application and the Prior Application that require a Fund to disclose particular information in the Fund's Prospectus and/or annual report shall remain effective with respect to the Fund until the time that the Fund complies with the disclosure requirements adopted by the Commission in Investment Company Act Release No. 28584 (Jan. 13, 2009).

V. Names and Addresses

The following are the names and addresses of the Applicants:

A. Direxion Shares ETF Trust
Rafferty Asset Management LLC
33 Whitehall Street
New York, NY 10004

B. Rafferty Asset Management LLC
33 Whitehall Street
New York, NY 10004

All questions concerning this Application should be directed to the persons listed on the facing page of this Application.

Authorization and Signatures

In accordance with Rule 0-2(c) under the Act, Applicants state that all actions necessary to authorize the execution and filing of this Application have been taken, and the persons signing and filing this document are authorized to do so on behalf of Applicants. Daniel O'Neill is authorized to sign and file this document on behalf of the Trust pursuant to the general authority vested in him as President.

Direxion Shares ETF Trust

By: /s/ Daniel D. O'Neill
Name: Daniel D. O'Neill
Title: President

Dated: July 20, 2009

VI. Authorization and Signatures

In accordance with Rule 0-2(c) under the Act, Applicants state that all actions necessary to authorize the execution and filing of this Application have been taken, and the persons signing and filing this document are authorized to do so on behalf of Applicants. Daniel O'Neill is authorized to sign and file this document on behalf of the Adviser pursuant to the general authority vested in him as Managing Member.

Rafferty Asset Management LLC

By: /s/ Daniel D. O'Neill
Name: Daniel D. O'Neill
Title: Managing Member

Dated: July 20, 2009

Verification

The undersigned, being duly sworn, deposes and says that he has duly executed the attached Application for an order, dated as of July 20, 2009, for and on behalf of the Trust; that he is the President of such Trust; and that all actions taken by the trustees and other persons necessary to authorize deponent to execute and file such instrument have been taken. Deponent further says that he is familiar with such instrument, and the contents thereof, and that the facts therein set forth are true to the best of his knowledge, information and belief.

/s/ Daniel D. O'Neill
Name: Daniel D. O'Neill
Title: President

Verification – Rafferty Asset Management LLC

The undersigned being duly sworn deposes and says that he has duly executed the attached Application for and on behalf of Rafferty Asset Management LLC, that he is Managing Member of Rafferty Asset Management LLC., and is authorized to sign the Application on its behalf, and that all actions by officers and other bodies necessary to authorize deponent to execute and file such instrument has been taken. Deponent further says that he is familiar with such instrument and its contents, and that the facts therein set forth are true to the best of his knowledge, information and belief.

/s/ Daniel O'Neill
Daniel O'Neill
Managing Member

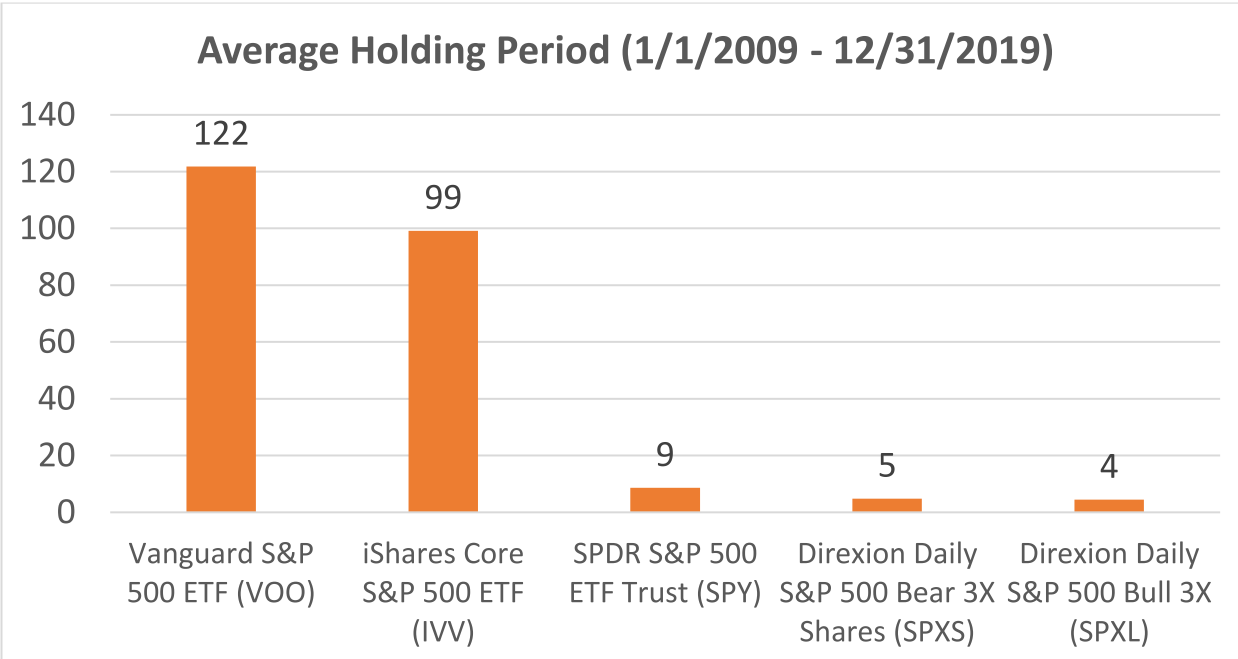
Verification – Direxion Shares ETF Trust

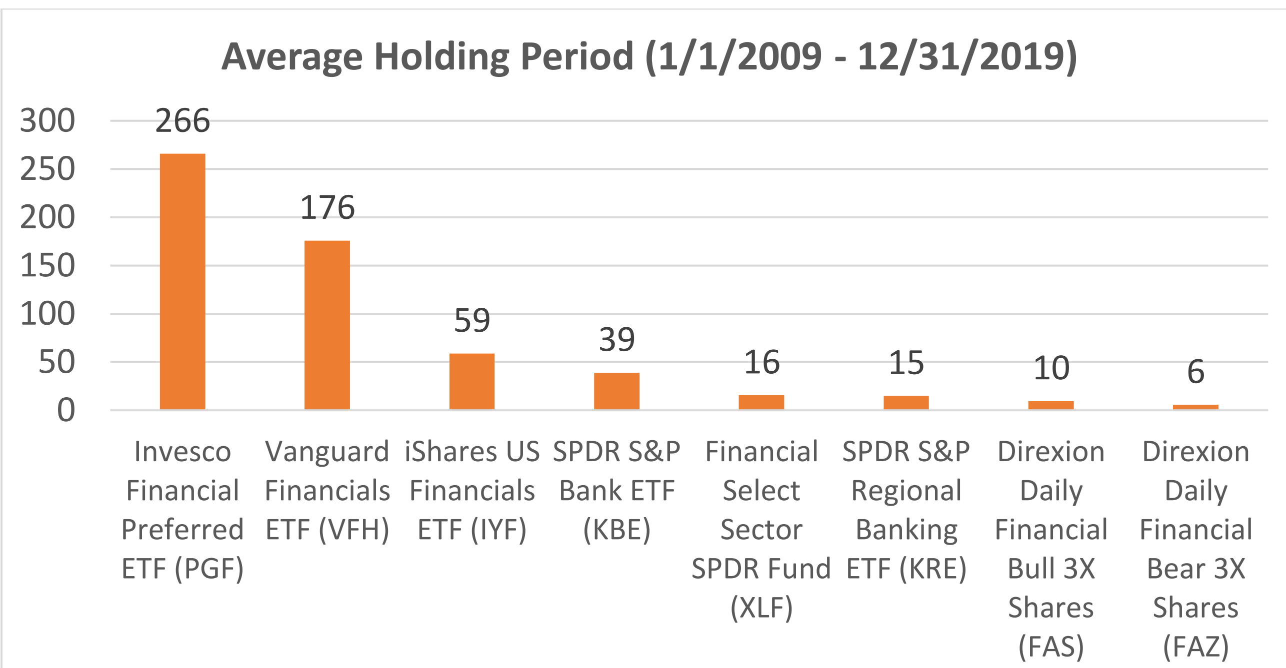
The undersigned being duly sworn deposes and says that he has duly executed the attached Application for and on behalf of Direxion Shares ETF Trust, that he is President of Direxion Shares ETF Trust, and is authorized to sign the Application on its behalf, and that all actions by shareholders, trustees and other bodies necessary to authorize deponent to execute and file such instrument has been taken. Deponent further says that he is familiar with such instrument and its contents, and that the facts therein set forth are true to the best of his knowledge, information and belief.

/s/ Daniel O'Neill
Daniel O'Neill
President

Appendix C

Holding Period Graphs





Source: Bloomberg