

## Subject File No: S7-24-15

**Comments regarding rule 18f-4 (2019/34-87607), 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**

### SEC stated concerns

.... products are sold on the promise that they deliver a multiple, for example three times, of the returns of a particular index. These complex financial products may serve a legitimate purpose for a subset of sophisticated traders, but in a volatile market an ordinary investor can lose money in these products even when the index increases in value.

The disconnect between an ordinary American family's reasonable expectations and the reality of these products creates real risk that too many investors will find out, too late, how dangerous these products can be.

That's especially true because the data show that too many investors buy and hold these products on the expectation that they are sound investments over the long term—when they're usually not.

the Commission proposed to address this problem by requiring brokers to follow certain practices when selling these products.

We hope commenters will come forward with evidence about whether these steps are enough to protect ordinary investors from the risks presented by leveraged and inverse funds.”

### Response

#### Leveraged & Inverse Exchange-Traded Products - Risks

- The risks with *Leveraged & Inverse Exchange-Traded Products* are:
  - Explicitly stated in prospectus documents
  - Outlined in Brokers’ “*Leveraged & Inverse Exchange-Traded Products Agreement*” that the broker(s) require clients to sign before permitting them to invest in them. Additionally, there are links to other documents that explain the risks in detail.
- The vast majority of risks identified are applicable to any stock, fund, etf, index, etc.
  - Examples include
    - Market Risk
    - Cash Risk
    - Intraday Investment risk
    - Industry risk
    - Capitalization Risk
    - Non-Diversification Risk (sectors, industries & countries)
  - The exception is the daily reset – which could result in losses (decay), or divergence from the underlying index, for both the “Bull & Bear” etfs associated with a specific index in (1) an “untrending” market and (2) during periods of high volatility?
    - This means that L&I products have unique characteristics (which may differ from the underlying index over certain time periods) and must be managed accordingly.

- These products provide exceptional benefits in trending markets (i.e. under “normal” market conditions) – and to obtain the benefits, an investor needs to hold them for the duration of the trend.
  - Day trading in these products is (in my opinion), potentially, far more risky!
- Since my brokers do not permit the use of margins with leveraged etfs, losses are limited to the amount invested.
  - This characteristic differentiates them from options, where (under certain conditions) the investor can lose significantly more than invested.
- Most importantly -- VOLATILITY IS NOT RISK!
  - I have friends that sold near the bottom of the GFC in 2008 – and never got back into the markets. *Panicking and selling at the wrong time, and/or failing to get back in markets timely is what is risky – whether or not leverage is used!*

### My Experience

- As an individual (ordinary?) investor, I have been trading *Leveraged & Inverse Exchange-Traded Products* for more than 10 years.
- Leveraged and inverse funds are important to me, and they allow me to seek enhanced returns.
  - Compounded daily returns are one of the significant benefits of these products.
  - By using Leveraged & Inverse Exchange-Traded Products I have the opportunity to obtain leverage without using margins, options or a 3rd party loans – where I could potentially lose more than my actual cash balance.
- I monitor market performance, and the performance of my investments, daily. Essentially, I only log into my brokers account to buy, sell or confirm trades. I do not need to log in to multiple brokerage accounts to see how my investments are performing -- as there are numerous other options available (e.g. Yahoo Finance, Morningstar, investing.com). These other options are far easier to use when monitoring performance of both markets & investments.
  - I also try to identify in advance what conditions would cause me to conclude (1) the investment(s) are not likely to meet my objectives, or (2) when other opportunities have a higher probability of future outperformance. This exercise is very useful in making buy & sell decisions.
- Finally, my experience leads me to believe that the unique “risks” attributed to L&I Products are grossly overstated for the vast majority of individual (ordinary?) investors that use them.

### Rule 18f-4, Broker-Dealers and Investment Adviser Due Diligence - requirements

(2) A broker or dealer must seek to obtain the following information at a minimum regarding the customer:

- (i) Investment objectives (e.g., safety of principal, income, growth, trading profits, speculation) and time horizon;
- (ii) Employment status (name of employer, self-employed or retired);
- (iii) Estimated annual income from all sources;
- (iv) Estimated net worth (exclusive of family residence);
- (v) Estimated liquid net worth (cash, liquid securities, other);
- (vi) Percentage of the customer’s estimated liquid net worth that he or she intends to invest in leveraged/inverse investment vehicles; and
- (vii) 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.

### My Concerns

I do not understand the issue (in quantifiable terms) that this “requirement” is intended to address? There should be substantial evidence that it is a significant issue and will provide “significant” benefits to the majority of investors that have utilized these products (versus protect a small minority of individuals). No such evidence has been provided.

Five of the seven requirements, (ii) – (vi), cannot realistically be used to determine if a customer or client is capable of evaluating the risk associated with these products, or if the products are consistent with his/her objectives.

However, 10 years of investing experience using these products should provide ample evidence of an investor’s ability to evaluate risks associated with using them! Especially since the investor cannot lose more than the amount invested.

- Knowing Employment status, Net Worth, and Annual Income does not ensure the investor understands the risks associated with L&I products, or the products are consistent with his/her investment objectives.

The current process of requiring a client to review risks associated with using the products, and to formally acknowledge that he/she understands those risks before investing in such products is a much more reasonable requirement. If needed, why not just make a few clarifications to the brokers “Leveraged & Inverse Exchange-Traded Products Agreement”?

I strongly believe the proposed “Due Diligence” regulations are:

1. Bad for Investors. If the proposal is adopted, some investors who could benefit from the enhanced return and portfolio protection potential of leveraged and inverse funds could be prevented from buying them by an overly burdensome qualification process. Brokerage firms could even stop offering these funds altogether due to the difficulty of implementing the regulations.
  - a. Individuals that that both understand and benefit from these products might stop using them because they believe the “Due Diligence” requirements are offensive!
2. Unnecessary. The SEC has not shown there is a problem that needs to be solved with respect to leveraged and inverse funds. They fail to show why these funds should be treated differently than tens of thousands of other public securities, each with their own characteristics and risks.
  - a. Again, the current process of requiring a client to review risks associated with using the products, and to formally acknowledge that he/she understands those risks before investing in such products should be sufficient.
3. A Dangerous Precedent. Requiring an investor to qualify to purchase a security in the public markets would be an unjustified break with how the SEC’s regulation of the sale of securities in the public markets has worked for nearly 90 years. The proposal would be at odds with our long-standing system that gives investors and their advisors the freedom to make their own investment decisions.
  - a. This precedent could open up a Pandora’s Box of new regulatory barriers against the small investor. It is easy to imagine the SEC in future administrations extending these requirements to other asset classes and, perhaps, ultimately to securities markets as a whole.

At some point, investors need to be treated as adults – and be required to assume responsibility for their decisions. Especially when all relevant information has been fully disclosed, and they have formally acknowledged that they understand risks associated with the investment.

Else, regulations will destroy innovative and beneficial products.

Sincerely

Dean Olney