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November 7, 2011

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (File No. S7-33-11)

Dear Ms. Murphy:

Rafferty Asset Management, LLC ("Rafferty") appreciates the opportunity to provide its views on the concept release issued by the Securities and Exchange Commission ("SEC" or "Commission") regarding the use of derivatives by investment companies under the Investment Company Act of 1940, as amended ("Act").[1] Rafferty is the sponsor and investment adviser of the Direxion Shares ETF Trust ("Direxion ETFs")[2] and Direxion Funds ("Direxion Funds" and together with the Direxion ETFs, the "Direxion Trusts"), which offer primarily leveraged and inverse as well as tactical index funds (collectively, the "Funds").

Rafferty supports the Commission's determination to review the use of derivatives by investment companies and its issuance of the Concept Release in this regard. This letter includes five sections. Section I introduces Rafferty and the Direxion Trusts, and provides background on the leveraged and inverse Funds offered by the Direxion Trusts. Section II addresses Rafferty's unique interest in and perspective on funds' usage of derivatives and the Concept Release. Section III addresses the principal question Rafferty understands the Commission to be asking in the Concept Release – namely, whether the U.S. regulatory regime for derivatives, as it currently exists, is appropriate and sufficient. Section IV addresses certain of the more specific questions posed by the SEC staff ("Staff") in the Concept Release regarding concentration and exposure to securities-related issuers. Section V summarizes Rafferty's comments and conclusions.

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1 Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (August 31, 2011) ("Concept Release").

2 Each series of the ETF Trust operates as an index-based exchange-traded fund ("ETF") pursuant to an exemptive order granted by the Commission. Investment Company Act Release Nos. 28889 (August 27, 2009) (notice) and 28905 (September 22, 2009) (order); Investment Company Act Release Nos. 28379 (September 12, 2008) (notice) and 28434 (October 6, 2008) (order).

I. RAFFERTY AND THE DIREXION TRUSTS

Rafferty is a pioneer in providing sophisticated investment solutions for active investors. Rafferty launched its first leveraged and inverse funds in 1997. Those funds were designed to serve as trading tools for active investors, unlike traditional "buy-and-hold" mutual funds.

In 2008, Rafferty moved to provide the leveraged and inverse strategies that were used in its mutual funds as ETFs. Thus, Rafferty established Direxion Shares ETF Trust. Like the Commission,[3] we understood that the ETF structure was designed, in part, to move frequent trading by investors away from a fund portfolio and on to an exchange, and we determined that such a structure could be beneficial to our investors in light of, among other considerations, the fact that our strategies and funds were widely regarded and used by sophisticated investors as trading tools and *not* as buy and hold investments.

Direxion ETFs currently have listed on a national securities exchange 50 ETFs that are predominantly leveraged and inverse ETFs that seek *daily* investment results, before fees and expenses, of up to 300% of the performance or the inverse performance, of the benchmark index that they track. In short, they provide investors with an investment vehicle that is more sensitive to daily market movements than traditional index ETFs and, accordingly, allow investors to execute trading strategies based on their short-term views of the market.

The leveraged Direxion ETFs, which generally seek 300% of the daily performance of an index, are referred to (here and in the market) as "Bull Funds." The inverse Direxion ETFs, which generally seek the inverse of 300% of the daily performance of an index, are referred to as "Bear Funds." In the remainder of this letter, we use the term "leveraged ETFs" to refer to both leveraged and inverse ETFs (*i.e.*, to both Bull Funds and Bear Funds) without distinction, unless a discussion pertains only to leveraged (or Bull) Funds or only to inverse (or Bear) Funds, in which case we use the term Bull Fund or the term Bear Fund explicitly.

As highlighted above, each Bull and Bear Fund seeks to achieve its investment objective *on a daily basis.* For example, the Daily Large Cap Bull 3X Shares seeks investment results equal to three times the performance of the Russell 1000 Index each business day, and the Daily Large Cap Bear 3X Shares seeks investment results equal to the inverse of three times the performance of the Russell 1000 on a daily basis. The daily nature of each Fund's investment objective is signaled by each Fund's name (*e.g.*, *Daily* Large Cap Bull 3X Shares (emphasis added)). The Direxion ETFs prominently disclose on the cover of their prospectus that the Funds are appropriate *only* for sophisticated investors and *only* for investors that intend to monitor their portfolios.

The Direxion Trusts invest substantially in swap transactions to achieve their objectives. The swap transactions in which the Direxion Trusts invest are neither illiquid nor are they

[3] *See* Actively-Managed ETF Concept Release, Investment Company Act Rel. No. 25258 at 7 (November 8. 2001).

difficult to value. Each swap is valued based on the market value of the securities in the underlying index and can be terminated by the Fund at any time. Such swaps are a more efficient means for Direxion Trusts to track their underlying indices than are other investment strategies: they track an underlying index more closely than other types of investments, including direct investment in the index securities (due to lower transaction costs); they are more cost effective than purchasing and selling the component securities of an underlying index; and they allow Rafferty flexibility in managing the risk of a Fund's investment in the index.

Since 2008, the Direxion ETFs have gathered approximately $7.5 billion in assets under management ("AUM"). While this number sounds significant and Rafferty is proud of the relative success of its ETFs and its growth as a small business, it is important to put this number in context. Leveraged ETF assets – meaning those in the Direxion ETFs and competing leveraged ETFs – constitute only about 3% of total domestic ETF AUM. Even more modestly, standing alone, the Direxion ETFs constitute less than 1% of total domestic ETF AUM. In short, while leveraged ETFs are important to the sophisticated investors that rely on such trading tools to execute their trading strategies, Rafferty and their competitors, these ETFs are insignificant participants in the broader equity markets.

II. RAFFERTY'S INTEREST IN AND PERSPECTIVE ON THE CONCEPT RELEASE

The Concept Release invites comments on any matters, in addition to the specific highlighted ones, that are relevant to the use of derivatives by funds.[4] Because there has been a recurring focus on leveraged ETFs, Rafferty is taking this opportunity to discuss the use of derivatives by leveraged ETFs and to share its experience and views with the Commission.

1. The Direxion Trusts Provide Clear Disclosure Regarding the Investment Strategies and Risks of the Funds

Based on Rafferty's reading of the Concept Release and its understanding of the Commission's basic concerns regarding leverage,[5] Rafferty believes that its interests are aligned with the objectives of the Commission.

Rafferty has devoted considerable energy and resources to making available to investors important disclosure and educational materials. Rafferty follows rigorous disclosure practices and employs aggressive investor education efforts in order to promote the use of Direxion ETFs *only* by sophisticated investors. Our prominent and clear disclosures are nowhere more apparent than on the cover page of the Direxion ETF prospectuses. The following disclosure (in the same boldface text used below) appears on the cover page of each leveraged Direxion ETF prospectus:

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4 Concept Release at 10.

5 *See* Investment Trusts and Investment Companies, Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt.1, 265-275 ("SEC Testimony on 1940 Act").

The Funds seek *daily leveraged* investment results and are intended to be used as short-term trading vehicles. The Funds with "Bull" in their names attempt to provide daily investment results that correlate to the performance of an index or benchmark and are collectively referred to as the "3X Bull Funds." The Funds with "Bear" in their names attempt to provide daily investment results that correlate to the inverse (or opposite) of the performance of an index or benchmark and are collectively referred to as the "3X Bear Funds." The Funds are not intended to be used by, and are not appropriate for, investors who do not intend to actively monitor and manage their portfolios. The Funds are very different from most mutual funds and exchange-traded funds. Investors should note that:

(1) The Funds pursue *daily leveraged* investment goals, which means that the Funds are riskier than alternatives that do not use leverage because the Funds magnify the performance of the benchmark of an investment.

(2) Each 3X Bear Fund pursues investment goals that are inverse to the performance of its benchmark, a result opposite of most mutual funds and exchange-traded funds.

(3) The Funds seek *daily leveraged* investment results. The pursuit of these investment goals means that the return of a Fund for a period longer than a full trading day will be the product of the series of daily leveraged returns for each trading day during the relevant period. As a consequence, especially in periods of market volatility, the path of the benchmark during the longer period may be at least as important to a Fund's return for the longer period as the cumulative return of the benchmark for the relevant longer period. 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 the Fund's stated goal and the performance of the target index for the full trading day. 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. 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) 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 objectives and an investment in a Fund could lose money. No single Fund is a complete investment program.

> **If a Fund's underlying benchmark moves more than 33% 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 ("Rafferty" or "Adviser"), will attempt to position each Fund's portfolio to ensure that a Fund does not lose more than 90% of its net asset value on a given trading day. The cost of such downside protection will be limitations on a Fund's gains. As a consequence, a Fund's portfolio may not be responsive to benchmark movements beyond 33% on a given trading day in a direction favorable to the Fund. For example, if a 3X Bull Fund's underlying benchmark was to gain 35%, that Fund might be limited to a daily gain of 90%, which corresponds to 300% of a benchmark gain of 30%, rather than 300% of a benchmark gain of 35%.**[6]

Because the use of derivatives is a principal investment strategy of the Direxion ETFs, they disclose in their prospectus the types of derivatives in which they invest and how they use them to achieve the investment objective. Correspondingly, the principal risks of such derivatives, as well as the risks of investing in leveraged ETFs, also are disclosed in their prospectus.

In this respect, the Direxion ETFs – and leveraged funds in general – actually present fewer concerns than do other funds that use derivatives but are not marked as "leveraged." In particular, a key risk that can arise from the extensive use of derivatives in such funds is that the derivatives, in certain circumstances, can produce leveraged returns and volatility in performance that might not be anticipated by an investor in such a fund. In contrast, the use of derivatives by leveraged and inverse funds is the primary means of achieving the returns for which those funds were specifically designed.

In addition, the Direxion ETFs' holdings are fully transparent. On a daily basis, they post their full portfolio holdings on their website. Accordingly, investors can see at the beginning of each business day the securities and derivatives exposures of each Direxion ETF.

The Direxion ETFs also use their website to help educate investors. The website includes materials such as an on-line course potential investors can complete to help them determine if investing in the Funds is right for them.

One focus of the Direxion ETFs' educational materials is the nature of the ETFs' investment objectives – *i.e.*, to seek returns equal to a multiple of the performance of an index *on a daily basis*. For example, these materials highlight the implications of the Direxion ETFs pursuing *daily* leveraged returns, including the fact that they do not seek to return a multiple of the performance of the index *over a period of time longer than one day*.

A second focus of the Direxion ETFs' educational materials is to promote the usage of the Funds by sophisticated investors *only*. The Direxion ETFs engage in aggressive investor

[6] The construction of this disclosure may vary by prospectus.

education efforts in order to promote the use of Direxion ETFs *only by sophisticated investors*. To this end, as noted above, each Direxion ETF includes disclosure *on its cover in boldface type* that it “should be utilized” only by sophisticated investors. As a result of these efforts to ensure that investors have access to clear and complete disclosure about the Direxion ETFs and as evidenced by the liquidity of these products, we believe that Direxion ETFs are overwhelmingly used by investors who understand the products. Our ETFs allow such investors to manage both the risks and the returns of their portfolios in varying market environments.

As with all mutual funds and any other type of investment, all ETFs are not suitable for all investors. Investor education and consideration of suitability standards will continue to be important considerations for regulators in their oversight of ETFs, whether leveraged or otherwise. Indeed, the SEC even now may be considering a recent industry proposal that would require different types of exchange-traded products (*e.g.*, exchange-traded notes, exchange-traded commodity pools, etc.) to use different labels to identify themselves.[7] Rafferty generally would support such an initiative and is prepared to work with the Commission and other industry participants to achieve a labeling system and other reforms that enhance investor education.

We note, however, that if additional regulations were to make the operation of such ETFs more costly or impracticable, the trading tools that our investors find to be so valuable could cease to exist and our investors’ trading would likely move into less regulated – even potentially unregulated, offshore vehicles – whose trading could have the same impact on the market, but be more expensive and less accessible by our clients and less transparent to the SEC. We do not believe this result would be good for us, our investors, the SEC or the U.S. capital markets.

2. The Direxion ETFs Do Not Cause Market Volatility

Some commentators assert that leveraged ETFs have created or contributed to U.S. market volatility. Specifically, certain commentators have asserted that (a) markets are extending intra-day moves into the market close more than they have in the past, and (b) end-of-day volatility has risen. These commentators attribute the changed market behavior to the daily rebalancing activity of leveraged ETFs which occurs at the end of the day. None of these commentators has offered any statistical or other support for the assertions about market extension, increased end-of-day volatility or activity of leveraged ETFs. Perhaps unsurprisingly, their basic contentions are incorrect.

Using data provided by the New York Stock Exchange, we analyzed the contention that market movements from the open to 3:30 p.m. are confirmed and extended from 3:30 p.m. to the

7 *See* Statement of Noel Archard, BlackRock Inc., Before the Subcomm. on Securities, Insurance and Investment of the Sen. Comm. on Banking, Housing and Urban Affairs, 1st Sess., 112th Cong., October 19, 2011; Testimony of Eileen Rominger, Director of the Division of Investment Management, U.S. Securities and Exchange Commission, on Market Micro-Structure: An Examination of ETFs, Before the Subcomm. on Securities, Insurance and Investment of the Sen. Comm. on Banking, Housing and Urban Affairs, 1st Sess., 112th Cong., October 19, 2011.

close of trading more frequently since the advent of leveraged ETFs than before such ETFs existed. To examine this concept, we compared (a) index price moves for the SPDR S&P 500 ETF Trust ("SPY")[8] from the previous day's 4:00 p.m. price to the current day's 3:30 p.m. price and (b) from 3:30 p.m. through 4:00 p.m. to determine whether correlations between the two have increased since leveraged ETFs became popular in 2007 and beyond.

Table 1 below shows, for each year since 2000, how often the SPY extended moves at 3:30 p.m. to 4:00 p.m. The market on average has extended from 3:30 p.m. to 4:00 p.m. 53% of the trading days. In 2011, the market has extended itself 50% of the trading days. The data in the table below makes clear that markets are no more likely to extend intra-day market moves into the close now than they were before the introduction of leveraged ETFs. Thus, the conventional wisdom of the commentators – that the market action is extended by leveraged ETFs – is contradicted by this data.

Table 1

Year	Annual Trading Days	Extended Occurrences	% Extended Occurrences
2000	233.00	113.00	0.49
2001	242.00	112.00	0.46
2002	246.00	146.00	0.59
2003	245.00	135.00	0.55
2004	250.00	126.00	0.50
2005	248.00	143.00	0.58
2006	247.00	117.00	0.47
2007	247.00	132.00	0.53
2008	248.00	162.00	0.65
2009	248.00	125.00	0.50
2010	252.00	135.00	0.54
2011	197.00	99.00	0.50
Total	2903.00	1545.00	0.53

Using the same NYSE data, we analyzed the relationship between end-of-day volatility and intraday volatility to determine whether end-of-day volatility has increased. For this purpose, we measured volatility using industry standard practices.[9] The standard deviations are then scaled for time, to allow for comparing time periods of unequal length. To look at end-of-day volatility, we examined price movements of the SPY from 3:30 p.m. to 4:00 p.m., and to

[8] This analysis was completed using data based on SPY because we believe it serves as a proxy for the board market.

[9] Volatility is measured as the standard deviation of the log changes in prices of a given intraday time period aggregated with monthly. The standard deviations are then scaled for time, to allow for comparing time periods of unequal length.

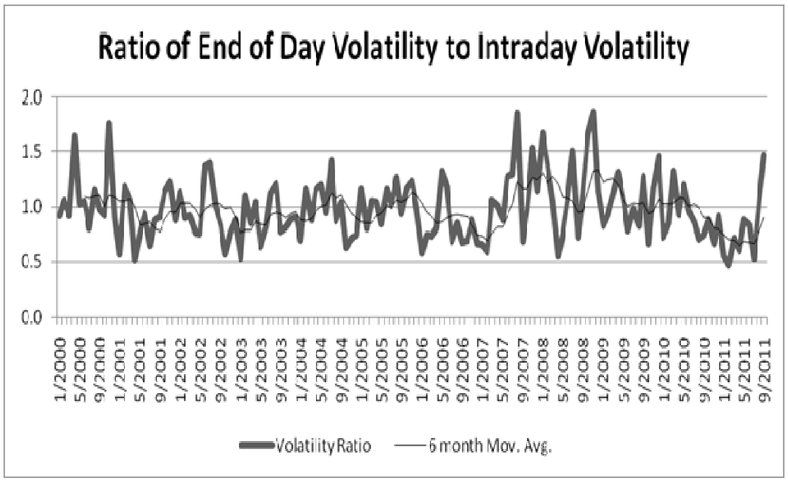
study intraday volatility, we looked at price moves from the previous day's 4:00 p.m. price to the current day's 3:30 p.m. price. These two periods comprise a full day's price movement, and allow us to isolate volatility between the two periods.

As Table 2 below illustrates, for the period from January 1, 2000 through September 30, 2011, the average ratio (end-of-day volatility/intraday volatility) was .98. Graph 1 (next to Table 2 below) illustrates that the average ratio from January 1, 2000 through June 30, 2006, the introduction of leveraged ETFs, was .97 and, for the period from July 1, 2006 through September 30, 2011, it was .99. More importantly, the 2011 average ratio through September is .79, well below the historical average. In short, there is no evidence that end-of-day volatility has risen – end-of-day volatility is no higher now than it has been historically.

Table 2

Year	Values Average of ratio
2000	1.10
2001	0.90
2002	0.94
2003	0.89
2004	0.96
2005	1.06
2006	0.82
2007	1.08
2008	1.21
2009	1.04
2010	0.90
2011	**0.79**
Grand Total	**0.98**

Graph 1



The SEC's Division of Trading and Markets has gathered data from leveraged ETF sponsors to understand and analyze the size of the ETF activity in the context of the equity flows. We have done a similar analysis of our own. Leveraged and inverse ETFs tracking equity indexes hold less than $25 billion in assets and represent less than 3% of total ETF assets. Our analysis indicates that the average daily market activity of leveraged ETFs in 2011 has been approximately 0.55% of total equity volumes and 0.32% of the sum of equity volumes and equity futures volumes. Even in the last half-hour of trading, the activity has represented just 3.2% of total equity volumes and just 2.2% of the sum of equity volumes and equity futures volumes. Rafferty does not believe these flows are large enough to disrupt the markets, especially given that the leveraged ETFs' trading is predictable and public. We believe that the Commission will similarly conclude that the trading, direct or indirect, of leveraged ETFs is not material in the context of overall daily flows in equities and equity futures – and small even in relation to total order flows between 3:30 p.m. and the market close.

III. SEC REGULATION OF DERIVATIVES: LEVERAGE AND SEGREGATION

The Concept Release asks whether the current definition of "leverage" articulated by the Commission in Release 10666[10] is sufficiently precise and appropriate to limit the risks addressed by the senior security prohibition of Section 18.[11] The Concept Release also asks whether the current segregated account approach adequately addresses the investor protection purposes and concerns underlying Section 18 of the Act.[12] While additional guidance from the Commission would be helpful in certain areas, we believe that the current framework is strong and has served investors well for nearly three decades.

1. The Current Framework Regarding Leverage and Segregation Works Well

In seeking these comments, among others, the Commission summarizes and discusses the current regulatory regime under the Act as well as alternative potential regimes. In this regard, the Concept Release discusses and focuses on the issues raised in a report of a task force organized by the American Bar Association ("ABA Task Force") at the invitation of the SEC Staff to advise it on funds' use of derivatives.[13] In its report, the ABA Task Force explained that: "The SEC and its staff traditionally have applied the prohibitions of Section 18 of the 1940 Act to a fund's use of derivatives instruments.…. The SEC staff has taken the position that the use of certain derivative instruments may entail the issuance of prohibited senior securities. In this way, the SEC is equating a fund's obligation to make payment on the derivative instrument with a note written by, or an evidence of indebtedness of, the fund that has a payment priority senior to payment on the shares issued by the fund."[14]

After its review, the ABA Task Force noted that "the basic framework as articulated in Release 10666 has worked very well. With additional guidance and clarifications recommended [in the *ABA Derivatives Report*], the Task Force believes that the Release 10666 framework will continue to provide an appropriate structure for funds' investments in derivatives."[15]

Rafferty agrees with the ABA Task Force. Rafferty believes that the current definition of leverage and the current segregated account approach is fundamentally sound and has served funds and their investors well for three decades. The fund industry has used the framework of segregation for thirty years without creating degrees of leverage that have harmed investors or

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[10] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (April 27, 1979) ("Release 10666").

[11] Concept Release at 38.

[12] *Id.*

[13] *See The Report of the Task Force on Investment Company Use of Derivatives and Leverage*, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) (the "*ABA Derivatives Report*"), *available at* http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf.

[14] *ABA Derivatives Report* at 11.

[15] *ABA Derivatives Report* at 16.

created systemic risks. Indeed, the Concept Release does not cite a single example where the use of derivatives has resulted in a fund's insolvency or in losses that could not be reasonably anticipated based on a fund's disclosures, nor does it argue that funds and their managers have not sufficiently managed the risks resulting from the use of derivatives.

The Commission describes and requests comments in the Concept Release on a number of potential alternatives to the current asset segregation framework, including the regulatory regime set forth by the European Union for Undertakings for Collective Investment in Transferable Securities. We note that the legal and administrative context for the U.S. as compared to most EU nations is very different. As a result, the EU approach of detailed calculations and schedules of derivatives may be difficult, if not impossible, to administer and keep up to date in the U.S. regulatory framework. Further, the EU approach seems counter to the general U.S. regulatory approach of more principle-based regulation.

For these reasons, the ABA Task Force also recognized that comprehensive guidance by the Commission is unlikely to be achievable or to take into account variations in individual transactions or innovations in derivative instruments or markets. Thus, the ABA Task Force proposed an alternative approach under which individual funds would establish their own asset segregation standards for derivative instruments that involve leverage.[16] Rafferty recognizes that certain further guidance from the Commission would benefit industry participants and agrees with this general approach proposed by the ABA Task Force.

2. <u>Prior Review by SEC Staff of Derivatives Activities Determined that Disclosure is Effective</u>

The Staff last conducted a formal review of derivatives activities by mutual funds in 1994. At that time, the Staff was "concerned about both indebtedness and economic leverage that are potentially made available to funds through the use of certain derivatives. The potential for increased volatility from such leverage may result in significant losses to investors."[17] In sharing its assessment of the adequacy of the current framework and reliance on Release 10666, the Staff stated, "In practice, section 18 has proven to be a somewhat crude tool for addressing the leverage issues raised by derivatives, largely because it was originally designed to address a different problem, namely, the leverage created by the issuance of public senior securities."[18]

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16 *ABA Derivatives Report* at 17-18.

17 *Mutual Funds and Derivatives Instruments*, Memorandum from the U.S. Securities and Exchange Commission Division of Investment Management to SEC Chairman Levitt at 24 (transmitted to Chairman Markey and Representative Fields, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives) (September 26, 1994) (the "Division Memorandum"), *available at* http://www.sec.gov/news/studies/deriv.txt.

18 Division Memorandum at 25. Derivatives do not present the same concerns as public senior securities for several reasons, including that, among other things, they do not allocate the risks of an investment to one class of security holders and the rewards (for taking such risks) to another class and, certainly with respect to leveraged

Interestingly, the Staff of the Division of Investment Management considered whether to restrict or prohibit the use of derivatives by mutual funds. The Staff, however, determined not to recommend substantive regulation of mutual fund investments for three reasons:

(1) such regulations could chill the use of instruments in a manner that is beneficial for funds;

(2) such prohibition would be inconsistent with the general approach of the Act – few substantive limits and funds permitted to invest without regard to their volatility; and

(3) it would be extremely difficult, if not impossible, to devise appropriate prohibitions or restrictions on the use of derivatives because of the wide variety of instruments that may be considered "derivatives."[19]

As a result, the Staff explained that the most effective manner for addressing its leverage concerns is disclosure, except where disclosure does "not prove to be sufficiently protective of the interests of fund shareholders." In that situation, the Staff stated that it "may reconsider whether to recommend that the Investment Company Act be amended to place substantive limits on derivatives use."[20]

Rafferty believes that the same analysis and conclusions of the Staff in 1994 continue to be applicable today and that disclosure has proven to be the most effective method of educating investors as to the derivatives investments a fund makes and their corresponding risks. Rafferty also believes that the use of derivatives, particularly by leveraged ETFs, does not raise unique investor protection issues for all of the reasons we discuss in this letter: the use of derivatives is disclosed and transparent to shareholders; the derivative investments in which the Direxion Trusts engage are not illiquid or difficult to value; leveraged ETFs serve investors' objectives; the Direxion Trusts' prospectuses and other marketing materials contain clear disclosure to investors; and the industry and Rafferty continue efforts to educate investors regarding structure of ETFs, not just leveraged ETFs.

3. Rafferty Supports the Current Framework and the Recommendations of the ABA Task Force for Certain Enhancements to the Framework

The Concept Release requests comments on whether the current segregated account approach articulated under Release 10666 addresses the investor protection purposes and concerns underlying Section 18 of the Act. Rafferty recognizes that the current approach provides a patchwork of formal and informal guidance to the industry and, as a result, different

ETFs, they do not result in an investment being riskier than anticipated by investors. SEC Testimony on 1940 Act at 238-43 and 266-72.

19 Division Memorandum at 24-25.

20 Division Memorandum at 25.

derivatives instruments may be treated differently by different funds. Notwithstanding this, industry participants have applied the guidance that does exist to develop flexible practices under which participants typically examine the characteristics and risks presented by each type of derivative and determine how to apply the segregation requirements under the current approach on a case-by-case basis. Rafferty believes that this approach has served investors well given the complexity and ever changing nature of derivatives.

For example, because the swap transactions in which the Direxion Trusts engage are fully cash settled, the Direxion Trusts segregate: (1) the amount (if any) by which the swap is out of the money to the fund (*i.e.*, the estimated amount that the fund would be required to pay upon an early termination, hereinafter referred to as the "fund's out of the money amount"), marked-to-market daily, plus (2) the amount of any accrued but unpaid premiums or similar periodic payments, net of any accrued but unpaid periodic payment payable by the counterparty. Pursuant to SEC guidance with respect to other derivatives, the amount that must be segregated is reduced to the extent that the fund has posted collateral against its obligations under the swap.

For most swaps, the fund's out of the money amount reflects the net amount that, based on current market conditions, the fund ultimately would be required to pay, regardless of whether the swap remains in effect until its stated termination date or is terminated early. For some swaps, however, the fund's out of the money amount reflects an amount that the fund would be required to pay only if there is an early termination. We note that even with respect to swaps, the amount a fund would be required to pay and under what circumstances varies depending on the type of swap transaction. Nevertheless, Rafferty believes that this approach adequately protects fund investors and is consistent with Section 18 because the segregation requirements would apply to whatever amount a fund would be required to pay on a daily mark-to-market basis.

Rafferty notes that, within the current framework, the Direxion Trusts typically segregate more than is required under Release 10666 and its progeny. As noted above, counterparties to the Direxion Trusts' swap contracts typically require the Funds to post collateral equal to approximately 20% of the notional value of the swap transaction, without regard to the Fund's out of the money amount on the contract. In other words, regardless of whether a swap contract is in the money or if the out of the money value of the contract is zero (as all swap contracts are at the time the parties enter into the contract), a Fund currently posts up front collateral (called an "independent amount" comparable to initial margin) equal to approximately 20% of the notional value of the contract. So, for example, on a swap contract with a notional value of $10 million, even when the contract is in the money to the Fund by $1 million or worth $0 to the Fund, the Fund posts $2 million of collateral on the contract. This margin requirement prevents the Fund from investing the margined assets or using them to collateralize other investments, including other derivatives. In this way, the margin requirement – which is required by market practice though not the SEC – already effectively imposes segregation-type requirements on the Funds that are in addition to those imposed by Release 10666 and serve as a sort of "buffer" to a fund's derivatives trading.

In addition, Rafferty takes additional steps to protect Fund investors from certain leveraging effects of the Funds' investments in derivatives. Most importantly, swap transactions for the Direxion ETFs typically include "caps" and "floors" on the Funds' daily investment returns to protect the Funds from losses in excess of liquid assets. The "caps," in effect, cap the daily upside returns of the Funds at 90%, even in the face of a market movement that would dictate higher returns. Conversely, the "floors" cap the daily downside returns in the same manner.

IV. THE DIREXION TRUSTS' APPROACH TO CONCENTRATION AND SECURITIES-RELATED ISSUERS

We now address the Concept Release's request for comment on registered funds' current practices with respect to derivatives, and specifically the practices used to determine compliance with the concentration and securities-related issuer provisions of the Act when investing in derivatives.[21] With respect to these matters, Rafferty generally takes the same approach as the majority of the industry – or, in some cases, a more conservative approach than the industry – to comply with the concentration and securities-related issuer provisions of the Act.

1. Concentration: The Direxion Trusts Follow the Industry Standard in Calculating Industry Exposures

Section 8(b) of the Act requires every fund to disclose whether it has a policy to concentrate its investments in a particular industry or group of industries. A fund typically is deemed to concentrate for this purpose if it invests more than 25% of its assets in the securities of issuers within a particular industry or group of industries.

Each Direxion Fund that is not a "sector" fund has a policy stating that it will not concentrate in any industry or group of industries. Each sector Fund has a policy stating that it will concentrate in the particular industry or group of industries that is referenced in the Fund's name.

For purposes of complying with their stated concentration policies, the Direxion Trusts typically look to the underlying exposures achieved through derivatives, rather than to the derivatives counterparty, and they clearly disclose that this is how they determine compliance with their concentration policies. Specifically, Fund disclosures state, among other things, that the Fund invests in securities and/or in other financial instruments that provide "exposure" and produce substantially the same investment results as a direct investment in the underlying security or index to which the derivative relates.

[21] We are not addressing the Concept Release's questions regarding diversification because the Direxion Trusts are non-diversified.

The Direxion Trusts' approach is consistent with the industry practice and with the recommendations put forth by the ABA Task Force.[22] In addition, a contrary approach could result in many Funds being deemed to concentrate their investments in the financial services industry (because counterparties typically are members of that industry), even though the investment returns typically would have no performance correlation to that industry (except for those series that specifically focus on financial industry investments). As a result, Rafferty believes that the practices described are the most reasonable way for funds to determine compliance with the Act's concentration requirements and should be endorsed by the Commission, as also recommended by the ABA Task Force.

2. Securities-Related Issuers: The Direxion Trusts Employ Conservative Practices in Calculating Industry Exposures

Section 12(d)(3) of the Act generally prohibits a fund from purchasing the securities of "securities-related issuers," including investment advisers and broker-dealers. Rule 12d3-1 under the Act, however, provides certain exemptions to this otherwise blanket prohibition. Specifically, under certain circumstances, funds may acquire up to 5% of a securities-related issuer's equity securities and up to 10% of a securities-related issuer's debt securities.

Each Direxion Fund typically treats its swap counterparties as securities-related issuers for purposes of Section 12(d)(3) compliance. Thus, each Direxion Fund currently has adopted a policy and practice of closing out existing swap positions with a swap counterparty when such swap positions have a value to the Fund equal to 5% or more of the Fund's total assets (*i.e.*, when their in-the-money value to the Fund is equal to 5% or more of the Fund's total assets).

In computing the 5% limit to which each Direxion Fund adheres, Rafferty uses the dollar amount owed to the Fund by each counterparty. In other words, Rafferty uses the current market value of the swap to the Fund and believes that this approach is appropriate in light of the underlying purpose of Section 12(d)(3), which is to restrict a fund's exposure to investments in securities-related issuers, as each Fund's effective exposure to a swap counterparty is, at any given moment, the amount owed to the Fund by the swap counterparty.

Pursuant to the Trust's counterparty risk procedures, the Funds have entered into swap agreements with multiple counterparties. As a result, they limit their exposure to any one counterparty and do not depend on just one or two counterparties to effectuate their investment strategies.

The Funds' credit risk exposure to swap counterparties is further mitigated by provisions negotiated for the Funds' swap agreements. Such provisions: (1) require a counterparty to post collateral daily equal at least to the amount owed to a Fund by the counterparty as of that date; (2) permit each Fund to close out its entire swap position (or any portion thereof) with a

[22] *See ABA Derivatives Report* at 30 (stating industry practice) and 29 (providing Task Force recommendation).

counterparty without prior notice or consent; (3) require daily mark-to-market valuation of the collateral posted by the Fund; and (4) require that any collateral posted by a Fund be held in a Fund account at its own custodian bank not hold by the counterparty.

In addition, as discussed above, many of the Funds' swap agreements include "caps" and "floors." These caps and floors limit the daily amount of gain or loss that can be realized by either party pursuant to the swap agreement, regardless of any change in price of the reference index on a given day. The caps and floors were negotiated by the Funds with their swap counterparties in order to guard against the possibility of a one-day market movement resulting in the liquidation of a Fund in the unlikely event that a reference index has an intra-day movement of more than 33% in value on that day. Like other material features of the Funds' investment strategies and investment techniques, these caps and floors are clearly disclosed in the Funds' prospectus.

Rafferty believes that the Commission could issue guidance or new rules that would help funds to mitigate further counterparty risks. For example, although the Direxion Trusts' counterparties do post collateral equal to the counterparty's liabilities to the Funds and that collateral is marked-to-market on a daily basis, other funds' swap counterparties may not post collateral.

Rafferty believes that the Commission should alleviate the burden of Section 12(d)(3) compliance to the extent that a fund's exposure is collateralized. Specifically, Rafferty recommends that the Commission consider permitting a fund, when entering into a swap transaction with a counterparty that posts collateral to cover its liabilities in the transaction to the fund and marks such collateral to market on a daily basis, to "look through" the counterparty to the underlying collateral to assess the risk of the swap transaction to the fund. In effect, Rafferty recommends that the Commission consider adopting an approach for swap transactions that is substantially similar to the approach provided for repurchase transactions in Rule 5b-3 under the Act. Rule 5b-3 allows funds to look through counterparties to repurchase agreements when such repurchase agreements are collateralized fully (as defined by the rule). Given such full collateralization, Rafferty does not believe that a fund should continue to be considered to be exposed to the counterparty; therefore, to the extent that a counterparty is a securities-related issuer under Section 12(d)(3), the amount of such exposure should not count against the limits established by Section 12(d)(3) and Rule 12d3-1. Such an approach, Rafferty believes, is consistent with the policy considerations underlying those provisions of the Act.

In addition, Rafferty believes that the Commission should consider permitting funds, under certain circumstances, to act as counterparties for one another. As noted above, the Direxion ETFs are usually offered in pairs, *e.g.*, the Daily Large Cap Bull 3X Shares and the Daily Large Cap Bear 3X Shares. As also noted above, the pairs of Funds seek opposite returns: the Bull Fund seeks a 300% return on the benchmark index; and the Bear Fund seeks a -300% return on the index. If, instead of entering into swap transactions with a third party swap dealer, the Bull and Bear Funds could enter into swap transactions with one another, the Funds would avoid counterparty risk altogether and potential exposure to a securities-related issuer. Further, assuming that the Funds continued to post collateral in connection with *entering* into a swap transaction (as Funds do now for counterparties), any risk that the Fund in whose favor the market moved for purposes of the swap contract would not be made whole would be mitigated. For these reasons, Rafferty recommends that the Commission issue guidance or no-action relief to permit such transactions between Funds.

V. CONCLUSION

The Funds provide sophisticated investors with cost-effective trading vehicles that allow such investors to implement active trading strategies in different market environments. In order to achieve their leveraged investment objectives, the Funds use derivatives extensively. While Rafferty recognizes that the Commission is examining potential modifications for the current framework, we urge caution regarding any significant changes to the current framework that could undermine the ability of the Direxion Trusts to operate.

The Funds' usage of derivatives is transparent to investors, the market and regulators. The Funds' investment strategies, including its use of derivatives, are clearly disclosed in their prospectuses. In addition, the Direxion ETFs' full portfolio holdings are updated and published daily on the Funds' website. Thus, all of the information that is necessary for market participants and regulators to understand the Funds is publicly available at all times.

The transparency of the Direxion ETFs allows investors and other market participants to know how the Funds will behave under different market conditions. This has led to a perception that the ETFs are somehow responsible for recent market volatility. Trading data refutes that notion, however. Such data indicates that market volatility levels are within historic norms and that leveraged ETFs, which are a very small percent of the market but trade on the market close, contribute minimally to trading volumes.

The regulatory regime established by Release 10666 and subsequent no-action letters has allowed for innovators like Rafferty to develop innovative investment vehicles for active investors that can be registered under the Act. Such registration benefits the Funds' investors, the Commission and the U.S. markets. Investors benefit from investing in a vehicle that is registered and, therefore, is subject to the shareholder protections of the Act. The Commission benefits from the transparency that its regulatory jurisdiction over such vehicles ensures. And, the U.S. capital market benefits because, absent such registered vehicles, the Funds' strategies may only be available in an unregulated format and/or offshore. Thus, while Rafferty recognizes that the Commission is examining potential modifications for the current framework, there is no need to implement changes that could undermine the ability of leveraged funds to operate effectively.

Further, the regulatory framework established by Release 10666 and the subsequent no-action letters to limit funds' leverage through segregation works. While additional guidance from the Commission would be helpful in certain areas, as noted in this letter, the current regulatory regime in the U.S. for derivatives serves investors well and its basic approach should be maintained.

* * *

Rafferty appreciates the opportunity to provide its views on various questions raised by the Concept Release and hopes that its comments will assist the Commission in formulating its regulatory approach to derivatives.

Sincerely,

Daniel O'Neill

Daniel D. O'Neill
President