May 7, 2021

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

Re: Proposed Rule Change to List and Trade Shares of the 2x Long VIX Futures ETF; Proposed Rule Change to List and Trade Shares of the -1x Short Futures ETF

Secretary Countryman:

The Americans for Financial Reform Education Fund (AFREF) appreciates the opportunity to comment on the above referenced Orders by the Securities and Exchange Commission (the "SEC" or the "Commission") on allowing the listing and trading of both leveraged and inverse ETFs on the CBOE's Volatility Index ("VIX").

We urge the Commission to deny the creation of leveraged VIX ETFs. Unlike other ETFs where investors can invest in companies—either through a diversified portfolio of stocks such as the entire S&P 500 or specific sub-sectors—the VIX is an artificial index that tracks the volatility of the S&P 500. VIX-tied investments are a part of exotic and frequently speculative hedging strategies that could cause significant harm to investors but do not provide companies with needed capital to grow or to compensate and reward employees.

By approving these products, the Commission would invite harm to retail investors by allowing market intermediaries to peddle leveraged ETFs—which are unsuitable for long term investment - to them. The introduction of yet another VIX related product also poses threats to the stability of financial markets as seen in February 2018 with the implosion of Credit Suisse's inverse VIX ETFs."

More generally, before approving more complex products which pose threats to investors and have at best an extremely indirect and unclear relationship to capital formation, the Commission must re-examine its overall approach to complex investment products. In October 2020, the Commission failed to adopt sales practices protections for leveraged investment products in its new rules on the use of derivatives by registered funds, which in our view leaves investors with extremely inadequate protections in this space.[1] The profusion of complex exchange traded products, including alt funds, exchange traded notes, leveraged and inverse ETFs, and much more, calls for a comprehensive re-examination of the relationship between product characteristics and the SEC's mission of investor protection, capital formation, and maintaining fair and efficient markets. The Securities and Exchange Commission is not a Gaming or Gambling Commission charged with approving gambling-like products. The Commission's core purpose is to protect those investors whose savings and earnings fuel the growth of our economy. At a bare minimum, the Commission should not facilitate gambling-like market practices by approving additional products which enable leveraged bets on synthetic indexes.

Leveraged ETFs underperform their benchmarks over the long run and are unsuitable for retail investors

Leveraged ETFs are unsuitable investments for retail investors. The magnification of losses and gains lead to markedly different returns than the long-term performance of the underlying indexes, and in general they significantly underperform these indexes.

For example, in a 3x leveraged long ETF of the S&P 500, a 1% daily gain in the S&P 500 on a $100 balance would lead to a 3% ($3) return for the ETF holder. If however on the next day the S&P 500 drops by 2%, the ETF would lose 6%, or -$6.18 bringing the portfolio's value to $96.82. On the third day, even if the S&P 500 were to regain the prior day's losses and gain 2%, a 6% gain on that lower value would lead to a portfolio value of $102.6, below the $103 prior to the second day selloff. It is this dynamic which led market strategist Michael Kahn to note that they are "very likely to burn a hole in your portfolio."[2]

A comparison of the 10-year return of the Direxion Daily S&P 500 Bull 3X Shares ETF (SPXL) shows returns of 27.51%[3] hardly close to the 206.6% return of the S&P 500 index over the past decade.[4]

In fact, leveraged ETFs often perform so poorly that the ETF sponsors have to engage in a reverse split to artificially boost the ETFs trading price, sometimes to avoid trading below levels that would get them delisted by the exchanges.[5] It is not unusual for a 1-for-10 reverse split to occur where 100 shares of an ETF that has fallen to $1/share instead become 10 shares trading at $10.

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[1] https://www.sec.gov/news/press-release/2020-269. Note that the products in this application would not have fallen under even the proposed sales practice protections because they are not registered funds, which in our view raises even more issues.

[2] Kahn, Michael. Kiplinger. Run Don't Walk From Leveraged ETFs. Mar 5, 2018. https://www.kiplinger.com/article/investing/t022-c009-s001-run-don-t-walk-from-leveraged-etfs.html

[3] Yahoo Finance. Accessed on May 5, 2021. https://in.finance.yahoo.com/quote/SPXL/performance/

[4] YCharts. Accessed on May 5, 2021. https://ycharts.com/indicators/sp_500_10_year_return

[5] Ravo, Nick. Wall Street Journal. Beware of ETF Reverse Splits. Feb 3, 2019. https://www.wsj.com/articles/beware-of-etf-reverse-splits-11549249620

Despite this systematically lackluster performance there is a shocking $58.11 billion in assets in these investment vehicles, paying fees averaging 1.04%.[6]

There is no reason for the Commission to approve yet another leveraged ETF given how they diverge from the returns of their reference index and significantly underperform them over the long run.

VIX related products have repeatedly caused problems for banks and the broader markets

We caution the Commission that exchange traded products referencing the CBOE Volatility Index are especially dangerous, not only for investors, but to their issuers and broader market participants and strongly urge the Commission to reconsider approving any more such products given their disastrous track record.

Unlike other ETFs that reference a basket of securities, the CBOE Volatility Index is not a stock, and sponsors must therefore buy or sell derivatives such as VIX futures daily to rebalance the portfolio. There are no companies who indirectly benefit from VIX ETFs being purchased unlike, for example, a sector specific ETF. Rather, these essentially permit speculative side bets that do not directly support economic activity but pose dangers to innocent bystanders in the market.

The argument usually made for such speculative products is that while they do not lead to capital formation directly, they permit hedging which indirectly reduces the risks of more direct investments. Such claims are often offered by those who materially benefit from these products. They are also generally not supported by any empirical assessment of whether the hedging benefits of actually lead to a net gain in real capital formation.

In addition, when purportedly hedging products actually increase market instability, they increase risks for all investors. One particularly notorious example of this phenomenon in the case of a VIX based product is the VelocityShares Daily Inverse VIX Short-Term Exchange Traded Note called XIV from Credit Suisse. XIV allowed investors to bet that the CBOE Volatility Index would decline. Between Friday, February 2, 2018 and Monday, February 5, 2018, the S&P 500 index started dropping precipitously, causing the VIX to nearly double in one day. In order to rebalance its exposure to these sharp market moves, Credit Suisse ended up having to purchase a significant amount of VIX futures, in the process creating a feedback loop where its XIV ETN would decline further as a result and leading to all sorts of additional knock-on effects for other market participants in a saga often referred to as "Volmageddon."[7] The S&P 500 on February 5th declined 2.1% while the Dow Jones Industrial Average fell by 1,173 points - until the

[6] ETF.com. Accessed on May 5, 2021. https://www.etf.com/channels/leveraged-etfs
[7] Kawa, Luke. Bloomberg. The Day the Vix Doubled: Tales of 'Volmageddon'. Feb 6, 2019. https://www.bloomberg.com/news/articles/2019-02-06/the-day-the-vix-doubled-tales-of-volmageddon?sref=f7rH2jWS

coronavirus pandemic the largest point decline in the index.[8] Investors in XIV lost nearly $2 billion and Credit Suisse is now facing investor lawsuits[9]

Years earlier, Credit Suisse was involved in a similar debacle over a VIX product. In 2010, Credit Suisse launched the VelocityShares Daily 2x VIX Short-Term Exchange Traded Note (TVIX) which was designed to track the daily return of the VIX index.

Credit Suisse, facing difficulty hedging its own exposures from managing the TVIX ETN in 2012, stopped issuing an appropriate amount of new TVIX shares to match the value of the portfolio, leading the shares of TVIX to trade at one point at up to 90% premium over the portfolio's asset value. Credit Suisse then suddenly decided to issue more shares again, but in the process leading to a 50% drop in the stock.[10] VIX related ETFs have become so problematic Credit Suisse was forced to delist several of them last year[11]

We are not alone in these concerns. Prominent academics have raised significant issues and called the attention of regulators to the systemic problems posed by these volatility-linked investment products. A notable paper published in 2010 by Professors Echard Platen and Leunglung Chan of University of Technology Sydney and UNSW Sydney, respectively, warned about the design of volatility derivatives, and suggested regulatory intervention to mitigate potential systemic risks.[12] The Commission's own former Chief Economist Larry Harris and Vineer Bhansali, in a paper released in 2017, warned that VIX-tied strategies could trigger the next market crash.[13]

Finally, we urge the Commission to require a much more rigorous and evidence-based rationale from the creators of financial products that carry unique risks to investors and financial stability. Innovations that pose significant risks to investors and the financial system must be shown to provide unparalleled and irreplaceable economic and market benefits. Neither Cboe's submissions (and several amendments it offered) nor the Commission's release have come anywhere close to meeting this high threshold.

Conclusion

[8] Egan, Matt. CNN Business. Dow plunges 1,175 – worst point decline in history. Feb 5, 2018. https://money.cnn.com/2018/02/05/investing/stock-market-today-dow-jones/index.html

[9] Van Voris, Bob. Bloomberg. Credit Suisse Must Face Suit Over Failed Play on Fear Index. Apr 27, 2021. https://www.bloomberg.com/news/articles/2021-04-27/credit-suisse-must-face-revived-claims-over-failed-investment?sref=f7rH2jWS

[10] Weinberg, Ari I. Forbes. Lessons from the TVIX Washout. Apr 17, 2012. https://www.forbes.com/sites/ariweinberg/2012/04/17/lessons-from-the-tvix-washout/?sh=1d4fb767a6ee

[11] Gurdus, Lizzy. CNBC. Exchange-traded note delistings 'should be criminal', market analyst says. Aug 22, 2020. https://www.cnbc.com/2020/08/22/exchange-traded-note-delistings-should-be-criminal-etf-analyst-says.html

[12] Eckhard Platen and Leunglung Chan, A Cautious Note on the Design of Volatility Derivatives, July 20, 2010, available at https://www.researchgate.net/publication/46462133_A_Cautious_Note_on_the_Design_of_Volatility_Derivatives

[13] Veneer Bhansali and Larry Harris, Everybody's Doing it: Short Volatility Strategies and Shadow Financial Insurers, 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3071457 (last revised Nov. 2020).

Given that these products clearly pose risk to investors and do not provide clear benefits for capital formation, we believe that approving them would conflict with the SEC's mission. While other such risky and synthetic products already exist, this is not a reason to add to the problem. Instead, the Commission should reconsider its overall approach to complex exchange-traded products.

We appreciate your consideration of this important matter. For further discussion, please contact Andrew Park at [redacted]

Sincerely,

Americans for Financial Reform Education Fund