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Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
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Re: Order Scheduling Filing Of Statements On Review of Proposed Rule Change to List and Trade Shares of the ForceShares Daily 4X US Market Futures Long Fund and ForceShares Daily 4X US Market Futures Short Fund Under Commentary .02 to NYSE Arca Equities Rule 8.200

File SR-NYSEARCA-2016-120

Dear SEC:

Here are my comments on the review of the staff's decision to approve the 4X leveraged ETPs on the S&P500 index.

Summary:

- The SEC staff did the right thing in approving this product. The Commission should promptly lift the stay and allow these products to trade.
- 4X ETPs on the S&P 500 are far less risky than most of the common stocks that trade in the U.S.
- ETPs still have other problems that the SEC should deal with, namely settlement failures.

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else for that matter.

- This proceeding is a waste of time and taxpayer dollars. It demonstrates that the SEC's allocation of scarce resources can be improved.

Background

The NYSE-ARCA filed a rule change to permit the listing of two exchange-traded products (ETPS): one that would provide four times the daily return of the S&P500 futures contract, along with an inverse product that would provide the negative of four times the daily return.[2] Unlike most exchange-traded-funds (ETFs), these products are not labeled as mutual funds or ETFs but instead are labeled as public commodity pools. They are to be offered under the Securities Act of 1933 rather than the Investment Company Act of 1940.

The rule change was duly put out for public comment and ….

NO COMMENTS WERE RECEIVED!

That's right. Exactly zero. None. Nada. Zip.

Normally, the public comment process does a pretty good job of soliciting opinion from a wide range of market participants. In general, if there are any problems with a proposal, the public comment process will unearth them. Publicly minded citizens and consumer watchdogs don't hesitate to comment.

Despite the earth shattering lack of comments, the SEC instituted proceedings to disapprove. This would have sent a strong signal to everyone in the industry along with consumer watchdogs that there could be something fishy about this proposal and maybe people should comment. Once again…

NO COMMENTS WERE RECEIVED!

The proposal was amended, most likely due to micromanagement of its details by the SEC staff. It was put out for public comment again and …

NO COMMENTS WERE RECEIVED!

Once again, despite the earth shattering lack of comments, the SEC instituted proceedings to disapprove, and …

[2] These are the ForceShares Daily 4X US Market Futures Long Fund and ForceShares Daily 4X US Market Futures Short Fund.

NO COMMENTS WERE RECEIVED!

Finally, after many long delays, the proposal was approved by the staff under delegated authority.

And now, the Commission in its infinite wisdom has stayed the approval order so that it can continue to waste scarce Commission resources on this unopposed proposal. A few comments have dribbled in so far, all in favor of lifting the stay.

The SEC staff did the right thing to approve the products.

There are two main things that differentiate this product from the over 1,500 other ETPs that trade in the U.S.:

1) They are 4X daily leveraged products.
2) They are commodity pools rather than ETFs.

To be sure, leveraged daily return products have their downsides. The biggest of these is what I call "beta drift", in that over a period of time longer than one day the return on the product may differ dramatically from the advertised leverage factor. For example, if the S&P goes up 5% one day and down 5% the next day, the two day return on the S&P will be (1+.05)*(1-.05) – 1 = -0.25%. However, the two day return on a 4X leveraged product will be (1 + 4*.05)*(1-4*.05) = -4%, not the -1% that one would expect from four times the S&P Return.

Thus, investors seeking longer-term leverage should not expect these products to provide exactly 4X the return even if they perfectly deliver each day on their promised 4X daily returns. But beta drift alone is not enough of a disadvantage to warrant rejecting the product.

These products are less risky than many common stocks.

Perhaps the Commission is scared of the leverage implicit in these products. It should not be. The volatility of these products will be lower than many if not most of the common stocks that trade in our markets. As of this writing, the CBOE Volatility Index, the VIX, stands at about 12%, indicating that an unleveraged S&P 500 based index product will have an annualized volatility of about 12%. The leverage in these 4X products indicates their annualized volatility will be around four times that, or 48%.

Investors have many opportunities to invest in far riskier products. Many individual stocks are far more volatile than 48%. For example, Tesla has an implied volatility of 51% and United States Steel has an implied volatility of 65%. It is not hard to find many, many more such firms.

Beyond individual stocks, investors can get arbitrarily high leverage and thus volatility through options and futures positions. Thus, there is nothing inherently new or different about the risk level of these products. There is nothing inherently bad about a 4X leveraged product as long as investors understand what they are getting into. The labels make it clear that these are daily 4X products.

The fundamental philosophy of U.S. securities regulation is disclosure, not merit regulation. The SEC should resist the temptation to get into merit-based regulation and leave the investment decisions to properly informed investors. The SEC should focus more on how to improve the level of communication with investors. Unfortunately, the practice is to focus on repetitive and expensive “disclosure” that checks legal boxes but does little to communicate relevant information to investors.

I don’t see any problem with the second difference, that of the commodity pool label instead of an ETF label. If this were a serious issue, it should have been clearly mentioned in the notices of the disapproval proceedings or the review of the staff decision.

<u>The whole class of ETPs has other problems that merit more attention.</u>

In particular, the large levels of settlement failures and high borrowing costs seen in many ETPs are indicative of a lack of liquidity and frictions in the create/redeem process. SEC resources would be better spent coming up with solutions for these problems rather than navel-gazing over whether 4X leverage is too much.

<u>The SEC should take steps to mitigate ETP settlement failures.</u>

The ongoing large and protracted settlement failures in ETFs are a blemish on the integrity of the U.S. equity markets. Their persistence despite the Regulation SHO Threshold List mechanism and Regulation 204’s knife-edge buy-in requirements are an embarrassment to the U.S. equity markets and its regulator, the SEC. Regulation 204 cleaned up most of the settlement failures in corporate stocks, but the SEC allows the problem to continue to fester in ETPs.

This is ironic in that settlement failures are even more problematic and damaging to ETPs than to corporate stocks. Persistent settlement failures and long-term membership on the Reg SHO Threshold list are not just cosmetic problems. These protracted failures exacerbate the illiquidity facing many ETPs. Stocks experiencing protracted settlement failures and Regulation SHO treatment are hard to borrow, which means that they are difficult to short, and expensive to borrow when they can be shorted. This makes it much more difficult to short ETPs, narrowing the pool of traders willing and able to arbitrage ETPs and their underlying assets.

With fewer traders willing to conduct arbitrage and provide liquidity, there is less liquidity, higher trading costs, and the deviations between ETP prices and the underlying market values are likely to be larger and more frequent.

The higher cost and inability to borrow/short these ETPs shares with high delivery fails increases the risks to investors in short positions. I have personally and painfully been bought in on a short position in an ETF. Even though market makers are not bought in until T+6, they too may be hesitant to provide liquidity due to the risk of being forced to buy in because they could not borrow the shares.[3]

As it is harder and more expensive to conduct arbitrage on short-constrained ETPs, such ETPs are more likely to experience disruptions during times of market turmoil. With fewer arbitrageurs and liquidity providers able to engage in arbitrage and liquidity provision, during times of market disruption it becomes more likely that there will be no arbitrage and ETP prices will deviate substantially from underlying values, as occurred on August 24, 2015 and in the Flash Crash.

The following steps should be considered as a means of mitigating settlement failures:

- ***Reduce size of Creation Units.*** ETP issuers should be encouraged to keep the size of Creation Units, the minimum number of shares that can be created or redeemed, as small as possible, even as low as 100 shares for some ETPs. The only real constraint is a need to avoid fractional shares for a large number of constituents. Indeed, fractional shares for a small number of the smallest constituents need not be a show stopper because such small amounts can be settled in cash. As creation and redemption can only be done by Authorized Participants, there is no danger that large numbers of retail investors will bother creating or redeeming small numbers of shares.

- ***Encourage ETPs to waive fees for creating ETPs.*** There is no reason why the fees for creation/redemption need to be symmetrical. Operators of toll bridges that are hard to bypass such as the Golden Gate Bridge long ago figured out that it was much more efficient to charge twice the toll in one direction and not bother to charge in the other direction. ETP sponsors should be encouraged to do the same thing. This is in their best interest as it will encourage the creation of more shares and thus lead to more assets under management. By making it easier and cheaper to create ETP shares, there is less excuse for failing to deliver the shares.

- ***Modernize Rule 15c3-3 to make it easier to lend fully paid shares out of cash accounts.*** The well-meaning Customer Protection Rule (15c3-3) imposes numerous paperwork burdens on lending out fully paid shares. However, it is much easier to lend out shares from margin accounts with debit balances. The industry's long track record of safely lending margined shares while

[3] It is a common misconception that market makers have until T+6 to settle their trades. Regulation 204(a) does not exempt market makers from the obligation to deliver shares on the settlement date. It clearly states "A participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date…" The misconception stems from the buy-in provision of 204(a)(3) which states that the buy-in for a fail position resulting from legitimate market making would be on the third day after the settlement date. Thus, market makers are still required to settle on the regular settlement date, but they do not need to be bought in until three days after the settlement date. Market makers who make practice of not delivering on the regular settlement date may be subject to enforcement action.

protecting consumers shows that the current rules on lending fully paid shares can be relaxed without harming consumers.

- ***Permit issuers to lend ETP shares.*** In a typical stock loan, the lender delivers shares and the borrower puts up cash collateral that is marked to market daily. ETP issuers should be permitted to do effectively the same thing in any amount. They should be permitted to instantly create ETP shares on demand using cash collateral, with the understanding that either the underlying shares will be delivered in a timely manner or the loaned ETP shares will be returned. This could totally eliminate the need felt by some market makers to fail to deliver ETP shares on the standard settlement date. This would be little different than the practice that some ETPs have of permitting cash creation and redemption.

- ***Examine other means of reducing frictions in stock lending.*** As part of its reviews of market structure, the SEC should also examine securities lending to find other means of reducing unnecessary frictions in the process.

This proceeding demonstrates improvements that can be made in SEC culture and operations.

The length of time it has taken to approve these unopposed products and the amount of Commission resources spent on the repeated disapproval proceedings are symptoms of a systemic misallocation of resources at the SEC. The SEC is badly underfunded and needs to deploy its assets in the most effective manner.

In particular, the SEC should work to reduce the number of required SRO filings. It should refrain from instituting proceedings to disapprove when no one cares enough to write a comment letter in opposition.

Unnecessary and wasteful proceedings like this one make it hard to justify much needed budget improvements for the SEC. I have heard Congressional staffers say "If we give the SEC more money, they will just waste it." The SEC has a reputation for a debating society culture that focuses on unimportant fine points while ignoring more important issues. For example, while engaging in paper shuffling exercises like this, the SEC failed to exercise its authority to come up with a reasonable fiduciary rule and thus paved the way for the mess that came from the DOL.

Staff time can be much better spent on things like coming up with a comprehensive fiduciary rule that makes sense, finding ways to fight the shrinkage in our equity markets which no longer nurture smaller companies, as well as catching the next Bernie Madoff. The Commission needs to think seriously about its priorities and work to create a more common-sense based and mission-focused culture instead of a debating society.

Respectfully submitted,

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