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NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

September 9, 2009

Via email to rule-comments@sec.gov

U.S. Securities and Exchange Commission
One Station Place
100 F Street, NE
Washington, DC 20549
Attention: Elizabeth Murphy, Secretary

Re: Exchange-Traded Funds; File No. S7-07-08: Release Nos. 33-8901;
IC-28193; Leveraged and Inverse ETFs

Dear Ms. Murphy:

The National Association of Real Estate Investment Trusts® (“NAREIT®”) is the worldwide representative voice for real estate investment trusts (“REITs”) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT’s members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses. We appreciate the opportunity to comment on the proposal (“Proposed Rules”) published by the Securities and Exchange Commission (the “Commission”) regarding exchange-traded funds (“ETFs”).¹

On March 11, 2008, the Commission published the Proposed Rules that, among other things, effectively reduce the length of time it takes for an issuer to introduce a new ETF into the marketplace. In particular, proposed Rule 6c-11 codifies the exemptive orders previously sought by ETFs from the Commission by permitting ETFs to operate without having to obtain any such order. Prior to streamlining this process, we believe the Commission should consider some of the dangers associated with a certain segment of ETFs, namely, leveraged and inverse ETFs and, at the very least, delay the approval of these rules with respect to leveraged and inverse ETFs until further study can be done to understand the risks and market implications of these products.

¹ See Release Nos. 33-8901; IC-28193; File No. S7-07-08 (March 11, 2008); 73 FR 14617 (March 18, 2008).



I. Introduction and Overview

In the past several years, ETFs have become increasingly popular investment vehicles within the financial markets, as they provide a cost effective, efficient investment alternative to mutual funds. We believe that ETFs provide important investment and trading benefits to investors and that it is in the best interest of investors to encourage ETF providers to continue to offer these financial products. In that regard, we support the Commission's proposal to streamline the approval process for new issuances of ETFs.

Notwithstanding our general support for streamlining the ETF approval process, we believe that the Commission should further study the impact of a particular sub-set of ETFs before including such specialized ETFs within the Proposed Rules or any future action the Commission or its staff may take with respect to ETFs. In particular, we urge the Commission to distinguish between traditional ETFs, which we believe provide important and legitimate benefits to investors, and other more recent derivative-like products commonly referred to as "leveraged" and "inverse" ETFs. As the Commission is aware, the characteristics of leveraged and inverse ETFs differ in important respects from traditional ETFs and should therefore be further studied by the Commission and potentially given separate regulatory treatment as discussed more fully below.² Importantly, we believe additional research needs to be conducted on the range of risks associated with these products and, in particular, the potential individual investor and systemic implications of these products.

II. Leveraged and Inverse ETFs in General

A. Structure of Leveraged and Inverse ETFs

As with traditional ETFs, shares of leveraged and inverse ETFs generally represent an interest in a portfolio of securities that track an underlying benchmark or index. Leveraged ETFs seek to deliver multiples of the daily performance of the index or benchmark they track. Inverse ETFs seek to deliver the opposite of the performance of the index or benchmark they track. Leveraged inverse ETFs seek to deliver a multiple of the opposite of the performance of the index or benchmark they track. For purposes of this comment letter, references to leveraged and inverse ETFs include leveraged inverse ETFs.

B. Creation of Leverage

Leveraged and inverse ETFs synthetically create the leverage that is required to deliver multiples of the daily performance of an index or benchmark. Synthetic leverage is created through the use of derivative products. Swaps are the most common type of derivative products used by ETF providers to create this leverage. In order to produce the leveraged returns, ETF providers must "reset" or "re-balance" the portfolio on a daily basis. Re-balancing means, in the instance where the portfolio consists of a swap, that the notional balance of the swap is adjusted upward or downward at the end of each trading day depending on the directional movement that day of the

² See SEC-FINRA Investor Alert on leveraged and inverse ETFs (the "Investor Alert") (available at <http://sec.gov/investor/pubs/leveragedetfs-alert.htm>).

underlying index. This process ensures that the funds are positioned for the next trading day with the proper notional amount on the swap that is required to replicate the intended leveraged or inverse return of the index for the ETF. Re-balancing for both leveraged and inverse ETFs is always in the same direction as the underlying index's daily performance.³ Thus, when an underlying index experiences an end-of-day gain, both leveraged and inverse ETFs must increase their synthetic exposure. Conversely, when an underlying index experiences an end-of-day loss, both leveraged and inverse ETFs must decrease their synthetic exposure. In other words, both bullish and bearish funds will buy when the market is up and both bullish and bearish funds will sell when the market is down.

III. Investor Suitability Issues with Leveraged and Inverse ETFs

Leveraged and inverse ETFs are highly complex financial instruments that are typically designed to achieve their stated objectives on a daily basis.⁴ However, due to the effects of compounding (as further described below), their performance can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark over longer periods of time.⁵ We believe, and an ever-increasing number of market participants agree, that leveraged and inverse ETFs that are reset daily are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets.⁶

The suitability of leveraged and inverse ETFs for retail investors also has recently caught the attention of policymakers. Massachusetts Secretary of State William Galvin has launched a probe into the sales practices of various major issuers of these products.⁷ Secretary Galvin has expressed concern that the leverage inherent in leveraged and inverse ETFs make these products unsuitable for certain investors.⁸ We agree with Secretary Galvin, and we strongly urge the Commission not to underestimate the material adverse effects that investments in leveraged and inverse ETFs can have on buy and hold retail investors.

A. NASD Rule 2310 Suitability Requirement

NASD Rule 2310 requires that firms have a reasonable basis for believing that a recommended investment is suitable for an investor.⁹ This requires firms to apply a two-prong analysis to ensure compliance with NASD Rule 2310. First, firms must determine whether an investment is suitable for investors generally ("reasonable basis suitability").¹⁰ Second, once a general suitability determination is made, firms must then determine whether such investment is suitable

³ See the Barclays Research Paper at 2; Minder Cheng and Ananth Madhavan; (May 9, 2009) (the "Barclays Research Paper") (available at <http://www.barclaysglobal.com/secure/repository/publications/usa/ResearchPapers/Leveraged ETF.pdf>).

⁴ See FINRA Regulatory Notice 09-31 (June 2009) ("FINRA Notice 09-31") (available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118952.pdf>).

⁵ *Id.*

⁶ *Id.*

⁷ See The Wall Street Journal Online; Leveraged ETFs Come Under Fire (July 17, 2009) (available at <http://online.wsj.com/article/SB124770305131348703.html>).

⁸ See CNBC Online; Regulator Sets Sights on Leveraged ETFs (July 15, 2009) (available at <http://www.cnbc.com/id/15840232?play=1&video=1183739041>).

⁹ See FINRA Notice 09-31 (June 2009).

¹⁰ *Id.*



for a particular investor.¹¹ In addition, an investor must be approved by a broker-dealer to open a margin account, trade options or enter into a derivative contract in addition to acknowledging receipt of certain disclosures regarding the risks of such strategies.¹²

In order to satisfy the first prong of NASD Rule 2310, firms must fully understand the recommended investment, including the terms and features of such investment, how it is designed to perform, how it achieves that objective, and the impact that market volatility, the use of leverage, and the customer's intended holding period will have on its performance.¹³

In order to satisfy the second prong of NASD Rule 2310, firms must determine each particular customer's financial status, tax status, investment objectives and any other information needed in order to make a suitable recommendation to that investor regarding an investment.¹⁴

In recent weeks major financial-services firms have suspended or restricted sales of leveraged and inverse ETFs due to concerns over the suitability of such products for many retail investors.¹⁵ Leveraged and inverse ETFs are complex structured products that invest in various derivatives products in order to make what is essentially a daily bet on a particular stock index. These daily bets are made at multiples of 200 or 300 percent of the return of the underlying index. Similar to other recent innovative financial instruments that have been in the headlines, such as sub-prime mortgages and auction rate securities, leveraged and inverse ETFs might pose various individual investor and systemic risks that are not fully understood and that need further analysis prior to even a financial professional being able to analyze such a product for its suitability for a retail investor. Leveraged and inverse ETFs are complex and risky structured products and yet investors in these products, unlike investors trading on margin or who buy/sell options and over-the-counter ("OTC") derivatives, are not required to be separately approved to trade these products or to acknowledge that they understand the risks of such investments.

While we recognize that traditional ETFs are suitable for many retail investors, we believe the Commission and various self-regulatory organizations ("SROs") should further study the suitability of leveraged and inverse ETFs for most retail investors. Therefore, we urge the Commission to examine whether it should be permissible for firms to continue to offer leveraged and inverse ETFs to retail investors. Until further study can be conducted, we believe that the Proposed Rules should carve-out these products with respect to retail investors and limit such investments to sophisticated investors meeting stringent eligibility requirements. Similar eligibility requirements are already required for other complex financial products.¹⁶ We believe

¹¹ *Id.*

¹² *See, e.g.*, NASD Conduct Rule 2341 (2009) (requiring members to furnish to the customer, individually, in writing or electronically, and in a separate document, a margin disclosure statement).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *See* The Wall Street Journal Online; Subpoenas Put Pressure On ETFs With Twist (August 1, 2009) (available at <http://online.wsj.com/article/SB124908326534498157.html>).

¹⁶ *See, e.g.*, NASD Notice to Members 05-59 (2005) (advising members, in part, that "structured products"—*i.e.*, securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency—should be limited to investors that have accounts that have been approved for options trading given the similar risk profile of many structured products and that firms should be prepared to demonstrate the basis for allowing investors with accounts not approved for trading options to purchase structured products).

that this approach strikes a reasonable balance between fostering investments in the capital markets and protecting retail investors from harm, while mitigating the potential for systemic market implications.

B. Compounding Effects Cause Long-Run Erosion in Value for Unsophisticated Buy-and-Hold Investors

Since leveraged and inverse ETFs typically aim to meet their objectives on a daily basis, the synthetic exposure of any swap underlying a leveraged or inverse ETF must be re-balanced on a daily basis in order to produce the expected leveraged returns.¹⁷ This daily re-balancing has a compounding effect on investor returns commonly referred to as “beta slippage.” Consequently, unwary investors (and potentially their financial advisors) might be surprised to learn that returns on their investment are not consistent with the return of the relevant index. In fact, the adverse effects of beta slippage can be so severe that an investor may sustain huge, unexpected losses regardless of the performance of the underlying index or benchmark.¹⁸

Once purchased, the longer a leveraged or inverse ETF is held, the greater the likelihood that the ETF’s long-term return will be significantly diminished.¹⁹ In fact, it is possible for an investor to face a negative return on investment in a leveraged or inverse ETF even though the underlying index has a positive return.²⁰ This buy-and-hold performance drag is more severe for inverse ETFs based on more volatile underlying indexes.²¹

The severity of the deleterious effects of compounding plus leverage can be demonstrated by using a simple double-leveraged ETF as an example. Assume a 10% decline in the underlying index on day one (*i.e.*, 90%), followed by a 10% increase the following day (*i.e.*, 99%). The net effect over this two-day period is an overall 1% decline in the index (down to 90%, and then climbing back up to 99%). Under this scenario, a buy-and-hold investor would expect that the net asset value of this ETF will decline 20% on day one (*i.e.*, 80%) and increase 20% the following day (*i.e.*, 98%), resulting in a 2% decline in the net asset value of the ETF. However, the net asset value of the ETF will actually decline 4% over this two-day period, as it will drop to 80% on day one but will only rebound to 96% on day two.²² This compounding effect is magnified each additional day that an unwary investor continues to hold the ETF. Thus, investors who hold leveraged and inverse ETFs for longer than one day may earn returns that are far different from what they expected. Therefore, because of the complexity of leveraged and inverse ETFs, the possibility for the average investor to suffer an adverse investing experience has increased tremendously.²³

¹⁷ See the Barclays Research Paper at 2.

¹⁸ *Id.* at 17.

¹⁹ *Id.* at 15.

²⁰ *Id.* at 17.

²¹ *Id.*

²² *Id.* at 4.

²³ See Morningstar; Time for Derivative ETFs to Comply (June 12, 2009) (“Morningstar June 12, 2009 Article”) (available at <http://news.morningstar.com/articlenet/article.aspx?id=295136>).

Performance surprises due to beta slippage can be more the norm than the exception in rocky markets.²⁴ In the 12 months ending July 24, 2009, 55% of leveraged ETFs and nearly 88% of inverse ETFs were “flipped,” meaning they delivered negative returns when investors would normally expect positive returns, or vice versa.²⁵ These compounding effects are particularly acute with respect to volatile indexes and inverse ETFs.²⁶ In other words, the likelihood that the returns from an inverse or leveraged ETF will deviate significantly from the performance of its underlying index increases as the daily returns from the index become more volatile. Morningstar Inc.’s director of ETF analysis, Scott Burns, succinctly summarizes these risks as follows:

What we have right now is a situation where these exchange traded derivative funds are allowing individual investors to blindly stumble into products they don’t really understand and at the same time allowing some advisors to back door things like leverage and short sales into their client’s portfolios without approval. Our solution is actually fairly simple. We think that you should look through the basket of exchange-traded funds and say, if this holds a derivative, we should regulate it like a derivative. Whether it’s an inverse leverage fund or a fund that is tracking oil futures, these funds own derivatives and these derivatives are complex, and there are a lot of risks.²⁷

Leveraged and inverse ETFs are, in essence, “exchange-traded derivative funds.”²⁸ These products should not be confused with more-vanilla ETFs²⁹. In fact, the IRS looks through leveraged and inverse ETFs by recognizing that they are made up of derivatives, and taxes them as it would similar derivatives.³⁰ We believe that the Commission should also treat leveraged and inverse ETFs like derivatives for regulatory purposes. In any trading or brokerage account, an investor must be approved to purchase options and other derivatives.³¹ We believe that investors who want to purchase leveraged and inverse ETF derivative products should be required to get similar approval before they are permitted to invest in such risky products.

Recent market events have shown us that complex and not fully understood financial products that are sold to retail investors in good times might have far-reaching and unintended consequences during a market correction. For example, given the fallout in the mortgage markets over the past few years, it is now evident that some of the innovative mortgages that were offered to consumers during the real estate boom were not fully understood by the consumers acquiring them and at times the professionals offering the loans. If such innovative loans had been more fully vetted from a regulatory perspective prior to being made broadly available to consumers, the nature and depth of the recent market correction might have been different. We believe there are sufficient similarities between these and other innovative and complex products (such as

²⁴ See The Wall Street Journal Online; Subpoenas Put Pressure On ETFs With Twist (August 1, 2009) (available at <http://online.wsj.com/article/SB124908326534498157.html>).

²⁵ *Id.*

²⁶ See the Barclays Research Paper at 2.

²⁷ See Morningstar; Do Exotic Derivative ETFs Need to Comply Further? (June 17, 2009) (available at <http://www.morningstar.com/cover/videocenter.aspx?id=295709>).

²⁸ See Morningstar June 12, 2009 Article.

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

credit default swaps) such that further study by the Commission of the possible impact of these products is needed.

C. Transaction Costs Impose a Further Drag on Performance for Buy-and-Hold Investors

The cumulative impact of transaction costs can also dramatically affect the returns to a long-run investor in leveraged and inverse ETFs.³² In addition to explicit costs such as management fees, there are implicit costs associated with a buy-and-hold strategy such as dealer hedging costs and the costs arising from daily re-balancing activity, which represent a further hidden drag on longer-term performance.³³ As leveraged and inverse ETFs re-balance their exposure of total return swaps on a daily basis, they incur significant transaction costs. The cumulative costs cannot be underestimated given the daily nature of the funds' re-balancing activity.³⁴

D. Taxes Impose a Further Drag on Performance for Buy-and-Hold Investors

Taxes can also dramatically affect the returns to a long-run investor in leveraged and inverse ETFs.³⁵ Leveraged and inverse ETFs are not designed for tax efficiency, and an investor's after-tax performance might be significantly lower than an investment strategy using leverage with less turnover than leveraged and inverse ETFs.³⁶ This is so because ETF providers are required to pay substantial capital gains tax distributions as high as 86%.³⁷ This tax burden is then passed on to investors, thereby further decreasing any potential return.

E. Leveraged and Inverse ETFs are Highly Complex Financial Products that Require a Greater Degree of Disclosure and Regulation

Leveraged and inverse ETFs are highly complex financial products. These products are not well understood by investors and some industry professionals alike.³⁸ Indeed, some of the features of these funds are not even fully understood among professional asset managers and traders.³⁹ In some respects, the apparent lack of understanding of the range of possible risks and implications associated with leveraged and inverse ETFs is similar to the apparent lack of full understanding of various complex derivative products that some market participants have argued contributed to the recent market correction.

In addition to being complex structured products themselves, leveraged and inverse ETFs invest in a range of OTC derivatives products that are highly complex and largely unregulated. In a sense, one could argue that investors in leveraged and inverse ETFs are taking on risks associated with multiple layers of complex derivatives products. We believe the full implications

³² *Id.* at 17.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.* at 18.

³⁶ *Id.*

³⁷ *Id.* at 19.

³⁸ *Id.* at 1.

³⁹ *Id.* at 2.

of such an investment should be more thoroughly studied by the Commission, perhaps in conjunction with the other conversations taking place regarding OTC derivatives, prior to granting any regulatory relief to such products or permitting such products to be made available broadly to retail investors.⁴⁰ In the interim, we believe that investment in such products, if allowed to continue, should be limited to institutional investors.

IV. Leveraged and Inverse ETFs May Contribute to Market Volatility

A. Increased Volatility Near Market Close

A recent market study suggests that there are empirical grounds to support the argument that daily re-leveraging by leveraged and inverse ETFs contributes to market volatility, particularly at the close of the market.⁴¹ As a result of re-leveraging activity, this study suggests that there is a heightened impact on the liquidity and volatility of the underlying index and the securities comprising the index during the closing period (*e.g.*, the last hour or half-hour) of the day's trading session.⁴² In addition, the study suggests that traders may take advantage of the leveraged and inverse ETFs' predictable trading rituals by placing orders in anticipation of an ETF's rebalancing orders.⁴³

Since leveraged and inverse ETFs must buy more exposure on a day when the market is up to keep their leverage ratio constant, ETF issuers buy in lockstep in the last few minutes of an up day for their index.⁴⁴ Conversely, ETF issuers must sell in a swarm at the end of a down day.⁴⁵ A well-respected trading research analyst has estimated that if a market index moves significantly in a day, leveraged ETFs could constitute the majority of all volume at the close of trading.⁴⁶ Therefore, a major shift in an index could send volatility higher, and increase downward price pressure, in a day's final minutes.⁴⁷ On days when multiple indexes make big moves, leveraged and inverse ETFs could contribute to increased buying or selling at the market close.⁴⁸ We believe the Commission should heed these early warnings and further study the possible systemic impact that leveraged and inverse portfolio trading could have on market volatility, including possibly contributing to end of day market selling/buying pressure.

⁴⁰ See, *e.g.*, Testimony Concerning Regulation of Over-the-Counter Derivatives by Chairman Mary L. Schapiro of the SEC before the Subcommittee on Securities, Insurance, and Investment Committee on Banking, Housing and Urban Affairs, U.S. Senate (June 22, 2009) (available at <http://www.sec.gov/news/testimony/2009/ts062209mls.htm>).

⁴¹ See the Barclays Research Paper at 7.

⁴² *Id.* at 8.

⁴³ *Id.*

⁴⁴ See The Wall Street Journal Online; Will Leveraged ETFs Put Cracks in Market Close? (April 18, 2009) (available at <http://online.wsj.com/article/SB124000593149930309.html>).

⁴⁵ *Id.*

⁴⁶ *Id.* (quoting Ananth Madhavan, head of trading research at Barclays PLC's Barclays Global Investors) (available at <http://online.wsj.com/article/SB124000593149930309.html>).

⁴⁷ *Id.*

⁴⁸ *Id.*

B. FINRA Recently Increased Margin Requirements for Leveraged and Inverse ETFs Due to Their Inherent Volatility

Leveraged and inverse ETFs generally are more volatile than their underlying benchmark or index.⁴⁹ These products can swing significantly depending on the direction of the market.⁵⁰ In response to the increased volatility of leveraged and inverse ETFs compared to their non-leveraged counterparts, FINRA has recently announced that it is increasing the maintenance margin requirements for leveraged and inverse ETFs and associated uncovered options by a factor commensurate with their leverage.⁵¹ While we believe that this measure is a step in the right direction, we believe that the Commission should take further regulatory action to ensure that retail investors cannot freely invest in such volatile products unless they meet the stringent requirements outlined herein.

V. Leveraged and Inverse ETFs Permit Circumvention of Federal Reserve Board Mandated Margin Requirements

Section 7 of the Securities and Exchange Act of 1934 (the “Exchange Act”) governs securities credit activities of broker-dealers, other lenders and borrowers. The purpose of Section 7 of the Exchange Act is to prevent the excessive use of credit for the purchase or carrying of securities.⁵² The House Report discussing Section 7 of the Exchange Act states that the main purpose of Section 7 of the Exchange Act is to reduce the aggregate amount of the nation’s credit resources which can be directed by speculation into the stock market.⁵³ In furtherance of this objective, the Federal Reserve Board promulgated Regulations T, U and X, which impose certain margin requirements on investors purchasing or holding securities.

Leveraged and inverse ETFs use derivatives to achieve leverage, bypassing the protections of Regulation T, U and X and extending this leverage to investors. Such use of leverage permits these ETFs and their investors to effectively use the nation’s credit resources to speculate on movements in indexes without having to meet any margin requirements. We believe that this is precisely the sort of trading activity that legislators sought to curb for fear that such activity could potentially lead to another market crash. We urge the Commission to carefully consider whether these ETFs and their investors should be permitted to effectively trade on margin through the use of leverage yet circumvent the margin requirements designed to prevent systemic market failure.

VI. Prior Exemptive Relief Granted to ETF Issuers

In addition to obtaining an exemptive order from the Commission, ETF’s are also required to obtain no-action relief from the Commission staff. While this request for relief is reviewed and

⁴⁹ See FINRA Regulatory Notice 09-53 (August 2009) (“FINRA Notice 09-53”) (available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119906.pdf>).

⁵⁰ See TheStreet.com; Leveraged ETF Margin Rules to Change (September 1, 2009) (available at <http://www.thestreet.com/story/10593192/1/leveraged-etf-margin-rules-to-change.html>).

⁵¹ See FINRA Notice 09-53 (August 2009).

⁵² See Section 7(a) of the Exchange Act.

⁵³ See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).

ultimately granted by members of the Commission's Division of Trading and Markets, we believe the Commission should also consider the statements made by the ETFs and the relief sought under these letters. Through a series of no-action letters, the Commission staff has granted exemptive relief to certain ETF providers for the issuance of leveraged and inverse ETFs.⁵⁴ In the no-action letters, the ETF providers represented to Commission staff that the market price of shares of leveraged ETFs would rise or fall primarily in accordance with the changes in the value of the underlying securities of the relevant underlying index and that such shares would not experience a significant decline in market value unless the value of such underlying securities had similarly declined.⁵⁵ Similarly, ETF providers represented that the market price of shares of inverse and leveraged inverse ETF would rise or fall primarily in accordance with the inverse changes in the value of the underlying securities of the relevant underlying index and that such shares would not experience a significant decline in market value unless the value of such underlying securities had similarly increased.⁵⁶ Significantly, ETF providers represented to Commission staff that any temporary disparities in market value between shares of any leveraged, inverse or leveraged inverse ETF and the relevant underlying securities, derivatives products and/or money market instruments held by such ETF would be corrected immediately by arbitrage activity.⁵⁷

We believe that recent market events raise doubts about the accuracy — under all possible market conditions — of the representations relied upon by Commission staff in granting exemptive relief to ETF providers. One market study has shown that there might not be a consistent correlation between the value of the underlying securities of an index and the value of the related leveraged and inverse ETF when these investments are held for longer than one day.⁵⁸ Rather, there appear to be situations where there can be a significant decline in the market value of a leveraged ETF despite the fact that the value of the related underlying securities of an index had actually increased.⁵⁹ In fact, the high incidences of “flipping” discussed above may create increased levels of risk for unwary buy-and-hold investors. Moreover, arbitrage activity has failed to correct this imbalance.⁶⁰

In granting such exemptive relief to ETF providers, Commission staff expressly stated that the exemptions granted and no-action positions taken by Commission staff were based solely on the representations and facts presented by parties seeking relief.⁶¹ The relief further noted that leveraged and inverse ETF transactions for which relief was granted should be discontinued in the event that any material change occurred with respect to any of the facts or representations made to Commission staff and that the exemptions, interpretations, and no-action positions were subject to modification or revocation if at any time the Commission staff determined that such

⁵⁴ See, e.g., NO-ACT, WSB File No. 0717200603, ProShares Trust (June 20, 2006) (the “ProShares No-Action Letter”).

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ See generally the Barclays Research Paper.

⁵⁹ *Id.*

⁶⁰ Some investors recently have sued some inverse and leveraged ETF issuers over alleged inadequate disclosures concerning these issues. See The Wall Street Journal Online; ProShare Draws Suit Over a Leveraged ETF (August 7, 2009) (available at <http://online.wsj.com/article/SB124961014025313309.html>).

⁶¹ See the ProShares No-Action Letter.

action was necessary or appropriate in furtherance of the purposes of the Exchange Act.⁶² For the reasons discussed above, we strongly urge the Commission to further study whether under certain market conditions some of the factual assumptions underlying the no-action relief granted may not be entirely accurate and, based on such, study whether various Commission or staff actions (such as exemptive orders and no-action letters) should be amended or withdrawn with respect to leveraged and inverse ETFs.

VII. Conclusion

While we support the Proposed Rules and the Commission's efforts to streamline the ETF approval process, we ask that the Commission further study leveraged and inverse ETFs prior to granting any regulatory relief to these products. In any event, we believe these products significantly differ from traditional ETFs such that they should be considered under a separate and distinct review process. We also believe that recent market events and studies indicate that leveraged and inverse ETFs may pose systemic and individual investor risks that currently are not fully understood, and that prior Commission and/or staff action on these products should be revisited to ensure that any factual assumptions underlying such relief is still accurate.⁶³

We appreciate this opportunity to submit, and the Commission's consideration of, our comments on the rules governing leveraged and inverse ETFs. Please contact me at (202) 739-9409 or mgrupe@nareit.com, or Tony Edwards, NAREIT's Executive Vice President and General Counsel, at (202) 739-9408 or tedwards@nareit.com if you would like to discuss this matter in more detail.

Respectfully submitted,



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⁶² *Id.*

⁶³ See the Barclays Research Paper at 19.