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Reproposed Rule 18f-4—Treatment of Leveraged/Inverse Funds

We are still digesting the SEC's [reproposal](#) for regulating how mutual funds, ETFs, closed-end funds and BDCs ("funds") may use derivatives in compliance with [Section 18](#) of the Investment Company Act of 1940 (proposed Rule 18f-4), but one surprising aspect is proposed Rule 15l-2 under the Securities Exchange Act of 1934. As explained more fully below, Rule 15l-2 would increase the due diligence required before a broker/dealer permits a customer to trade in "leveraged/inverse investment vehicles." Including this rule in the proposal required the cooperation of both the Trading and Markets and Investment Management Divisions of the SEC. There is even a parallel rule proposed for investment advisers (proposed Rule 211h-1). This shows that the SEC is taking a more comprehensive view of the SEC's authority over the use of leverage in securities trading. Although we find this non-compartmentalized approach heartening, we think that more could be done to fully deploy the SEC's powers in this area. We even dare to suggest that, having avoided silos within itself, the SEC might try to work with the Fed to better rationalize regulation of leverage in the financial system.

What Are Leveraged/Inverse Investment Vehicles?

Proposed Rules 15l-2 and 211h-1 would define a "leveraged/inverse investment vehicle" (I'm guessing "LIVs" will become the acronym) as:

a registered investment company ... , or commodity- or currency-based trust or fund, that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship, to the performance of a market index, over a predetermined period of time."

For example, a fund might seek to provide twice the total return of the S&P 500 Index each day; if the S&P500 increases 1%, the fund would seek to produce a return of 2%. Similarly, a fund may be designed to provide twice the inverse of the S&P 500 Index; if the S&P 500 Index fell 1%, that fund would seek to produce a positive 2% return. Proposed Rule 18-4(c)(4), and a conforming change to the new exchange traded fund ("ETF") rule ([Rule 6c-11](#)), would permit an open-end or closed-end investment company (other than a money market fund) that is a leveraged/inverse investment vehicle to seek a return not to exceed 300% of the return (or inverse of the return) of its market index. This is consistent with [exemptive orders](#) previously granted to several ETFs. Unlike these exemptive orders, the proposal also would allow ordinary index mutual funds and closed-end funds to offer multiple or inverse returns.

With Greater Leverage Comes Greater Responsibility

Having fully opened the door for retail investors to use leveraged index investing, the SEC would require broker/dealers and investment advisers to increase their vigilance over who comes through that door. Trading in leveraged/inverse investment vehicles would be prohibited for accounts of a natural person unless they believe "that the client has such knowledge and experience in financial matters that he or she may reasonably be expected to be capable of evaluating the risks of buying and selling leveraged/inverse investment vehicles." The broker/dealer or adviser "must exercise due diligence to ascertain the essential facts," including, "at a minimum:"

1. Investment objectives and time horizon;
2. Employment status;

3. Annual income;
4. Net worth (exclusive of family residence);
5. Liquid net worth;
6. Percentage of liquid net worth targeted for investment in leveraged/inverse investment vehicles; and
7. Investment experience and knowledge (e.g., number of years, size, frequency and type of transactions) regarding leveraged/inverse investment vehicles, options, stocks, bonds, commodities, and other financial instruments.

Trading approval for an account must be documented and retained for six years. Proposed Rules 15c-2 and 211h-1 were modeled on FINRA's [suitability requirements for accounts using options](#), so broker/dealers may already have compliance procedures they could extend to accounts using leveraged/inverse investment vehicles. In my next post, we will point out some incongruities in the regulation of leveraged trading that the SEC and Federal Reserve Board may want to address.

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