

Draft as of June 16, 2023

To be discussed at the June 22, 2023 SEC Investor Advisory Committee Meeting

**Recommendation of the Market Structure Subcommittee of the SEC Investor Advisory Committee on Single Stock ETFs and Leveraged ETFs**

**Background**

In 2019, the Commission adopted Rule 6c-11, which permits ETFs that satisfy certain conditions to come directly to market without the cost and delay of obtaining an exemptive order from the Commission. The exemptive relief in SEC Rule 6c-11 also applies to leveraged and inverse ETFs.<sup>1</sup>

While the streamlined process for listing ETFs has benefitted several issuers, those same changes also opened the door for a new investment product available to retail investors called a Single Stock Exchange Traded Fund (single stock ETF). Single stock ETFs are complex investment products with enhanced risks that pay positive or negative multiples of the market performance of the single underlying security. A single stock ETF differs from a more traditional ETF that combines multiple securities into a single fund to give an investor exposure to a market segment or asset class. Instead of reflecting a basket of stocks, single stock ETFs only track the performance of a single underlying security. The value of a single stock ETF resets daily and can diverge significantly from the underlying stock, especially if it is leveraged or inversely leveraged. Because of this type of volatility, single stock ETFs are meant to be actively traded and not meant to be held over long periods of time. Single stock ETFs may also be allowing self-directed investors access to leverage that they would otherwise need approval from their brokers for via margin accounts or options trading.<sup>2</sup>

Single stock ETFs typically use derivatives such as total return swaps to replicate the daily returns of a single stock. In some cases, single stock ETFs may also offer investors the inverse, 2.0x, or 3.0x those daily returns. For example, suppose that Fleetza Pizza, Inc. is a company that trades on a national stock exchange, and an ETF issuer offers two different Single Stock ETFs based on Fleetza's stock price. The first single stock ETF is a 2x leveraged fund, and the second is a 2x inverse leveraged fund. On Monday, Fleetza is trading at \$100 per share and it goes up ten percent to \$110 per share at close. The 2x leveraged single stock ETF would earn 20% (or double the increase in price of the underlying stock), and go to \$120 per share, while the 2x inverse single stock ETF would lose 20 percent, thus dropping to \$80 per share. On Tuesday, the Single Stock ETFs reset their respective prices, and begin trading again. Fleetza's

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<sup>1</sup> Securities and Exchange Commission. Release No. IC-34084. File No. 27-24-15. RIN 3235-AL60. Use of Derivatives by Registered Investment Companies and Business Development Companies. Dec 21, 2020. <https://www.sec.gov/rules/final/2020/ic-34084.pdf>

<sup>2</sup> Securities and Exchange Commission. Statement on Single-Stock ETFs. Jul 11, 2022. <https://www.sec.gov/news/statement/crenshaw-single-stock-etfs-20220711>

stock then drops by an additional 50 percent that day,<sup>3</sup> closing the day at \$55 per share. The 2x leveraged single stock ETF would fall towards \$0 (doubling the 50% loss that day), while the 2x inverse leveraged single stock ETF would now be worth \$160 (doubling the day's starting ETF share price of \$80).<sup>4</sup>

## **Findings**

On December 8, 2022, the SEC Investor Advisory Committee hosted a panel discussion on Rule 6c-11 from 2019 and the rise of single stock Exchange Traded Funds (ETFs). Panelists included smaller and newer ETF issuers who touted the benefits of the exemptive relief from Rule 6c-11. However, panelists also recognized that single stock ETFs and leveraged ETFs are “running afoul of the general spirit of ETFs” given that they do not offer a diverse basket of securities<sup>5</sup> and are a way for retail investors to effectively conduct “regulatory arbitrage” and access leverage without margin accounts or options trading permission.<sup>6</sup>

Retail investors are predominantly the largest holders of single stock ETFs. As of January 31, 2023, retail accounts made up 92% of the holders across 26 of the most popular single stock ETFs, according to data provided by one proxy service provider.

Aside from the inherent risk of holding such concentrated exposure to one stock, many buy-and-hold retail investors do not understand the potential effects of compounding and daily rebalancing of the 2.0x or 3.0x leveraged or inverse ETFs on the daily returns of a stock, such that the performance significantly diverges from the underlying stock when held over a longer period of time.<sup>7</sup>

## **IAC Recommendations**

The Investor Advisory Committee therefore recommends the Commission consider the following:

The panelists as well as other market participants have made clear how Rule 6c-11, despite allowing single stock ETFs to come to market more easily, have vastly improved the issuance process and lowered the costs for the entire ETF industry.

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<sup>3</sup> If this were to happen, the ETF sponsor would likely choose to intercede (or be required to intercede by the terms of the ETF fund's prospectus) before the share price literally reached \$0.00 by closing the fund and redeeming all outstanding ETF shares at some minimal price valuation.

<sup>4</sup> <https://www.nasaa.org/66400/informed-investor-advisory-single-stock-etfs/?qoid=investor-advisories> and <https://www.sec.gov/news/statement/schock-statement-single-stock-levered-and-or-inverse-etfs-071122>.

<sup>5</sup> Bloomberg Government. U.S. Securities and Exchange Commission Investor Advisory Committee Transcript. Dec 8, 2022.

<sup>6</sup> Isenberg, David. Ignites. SEC urged to rein in single-stock leveraged and inverse ETFs. Dec 15, 2022. <https://www.ft.com/content/1d57b241-15ea-4b1b-9576-ac1b6c453ec9>

<sup>7</sup> Commissioner Caroline Crenshaw. Statement on Single-Stock ETFs. Jul 11, 2022. <https://www.sec.gov/news/statement/crenshaw-single-stock-etfs-20220711>

However, the Commission should consider future amendments to Rule 6c-11 to clarify which ETFs and other Exchange Traded Products (ETPs) should qualify for exemptive relief and which should require approval from the Commission.

In addition to changes to Rule 6c-11, the Commission should also consider the following:

- Propose amendments requiring Single Stock, Leveraged ETFs, and other ETPs are renamed to more accurately convey their unique features and risks which materially differ from ETFs
- Continue to bring enforcement cases against investment advisers who solicit, and broker-dealers who make unsuitable sales of, single stock ETFs and other exchange traded products (ETPs) that are inappropriate for their clients
- Require broker-dealers to provide a visual point of sale disclosure clearly showing performance of a single stock/leveraged ETF versus the underlying asset in such a way that the inherent divergence over time is understandable to unsophisticated self-directed investors

**Consider a more consistent naming convention for leveraged ETFs, inverse ETFs, and other Exchange Traded Products (ETPs) that more accurately describe their distinct features and risks**

As multiple panelists noted, single stock ETFs are inconsistent with the original spirit of the exemptive relief for traditional ETFs, which offered investors a lower cost and transparent way to invest in a diversified portfolio of assets. In contrast to basic traditional ETFs, single stock ETFs are expensive,<sup>8</sup> complex, opaque (due to their reliance on derivatives), and not diversified.

The Commission should consider whether single stock/leveraged ETFs, and other exchange traded products (ETPs) should be renamed given the complexity and misunderstood impact of the daily rebalancing which produces returns differing materially from the longer-term performance of the reference assets.<sup>9</sup>

As the SEC staff acknowledged in 2020, some investors may be holding on to leveraged/inverse ETFs for a long period of time, incurring significant losses as a result of failing to understand how the ETFs function.<sup>10</sup>

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<sup>8</sup> Duggan, Wayne. U.S. News. What Are Single-Stock ETFs? New Funds Add Leverage, Risk. Jul 21, 2022. <https://money.usnews.com/investing/stock-market-news/articles/what-are-single-stock-etfs-new-funds-add-leverage-risk>

<sup>9</sup> Guedj, Ilan and Li, Guohua and McCann, Craig. Securities Litigation & Consulting Group. Leveraged ETFs, Holdings Periods and Investment Shortfalls. Aug 30, 2010. <https://www.slcg.com/files/research-papers/Leveraged%20ETFs,%20Holding%20Periods%20and%20Investment%20Shortfalls.pdf>

<sup>10</sup> Securities and Exchange Commission. Release No. IC-34084: File No. S7-24-15. Use of Derivatives by Registered Investment Companies and Business Development Companies. Dec 21, 2020. <https://www.sec.gov/rules/final/2020/ic-34084.pdf>

The Fixed Income Market Structure Advisory Committee in October 2018 called for “truth in labeling” to ensure that both self-directed investors and financial advisors are not misled by single stock and leveraged ETFs as well as other exchange traded products being associated with other ETFs, given they are functionally not the same product.<sup>11</sup> The Commission should therefore establish a clearer naming convention around different types of ETPs, but ones that do not use the nomenclature of “Exchange Traded” and risk being confused for ETFs that invest in an unleveraged, diversified portfolio of assets.<sup>12</sup>

The lack of a clearer naming convention around Exchange Traded Products, which include Single Stock ETFs, Leveraged ETFs, and other ETNs, has led to investor confusion and unnecessary loss of capital from self-directed investors failing to understand the payouts and risks, due in part to their close association with more standard, diversified products.

Properly naming ETPs is also important due to the personal trading policies of organizations that treat ETFs differently from individual stocks. Already, concerns have been raised about ETFs more broadly and how in some cases they may be used to disguise insider trading based on material nonpublic information.<sup>13</sup> Yet, a glaring gap is created by single stock ETFs since company executives and government officials are restricted from actively transacting in shares of specific companies, but are allowed to transact or exclude from their disclosures ETF transactions.<sup>14</sup> Justification for such exemptions are premised on ETFs being a diversified portfolio of investments that allow a holder passive exposure to a broad market index or a diverse basket of securities that make it difficult to profit from MNPI.<sup>15</sup> Single stock ETFs however are clearly not diversified and meant to be actively traded, therefore raising the question over whether they deserve to benefit from the same treatment in the personal trading policies of organizations as a diversified portfolio or index ETF, and who otherwise would restrict ownership or transacting in the underlying stock.

Clearer naming conventions around ETPs would also help corporate and governmental personal trading policies to better differentiate how ETPs, especially those of single stock ETFs, should be treated differently from more standard ETFs.

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<sup>11</sup> Fixed Income Market Structure Advisory Committee. Recommendation for an Exchange-Traded Product Classification Scheme. Oct 29, 2018. <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-etp-naming-convention-recommendation.pdf>

<sup>12</sup> See, <https://www.sec.gov/rules/final/2020/ic-34084.pdf> at fn 566.

<sup>13</sup> Eglite, Elza and Staermans, Dans and Patel, Vinay and Putnins, Talis J. Using ETFs to conceal insider trading. January 2023. [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4343579](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4343579)

<sup>14</sup> U.S. House of Representatives. Ethics in Government Act Periodic Transaction Report. June 10, 2020. <https://ethics.house.gov/sites/ethics.house.gov/files/documents/Periodic%20Transaction%20Report%20%28PTR%29%20Form%20CY%202020%201.pdf>

<sup>15</sup> Office of Government Ethics. Legal Entities that Hold Assets. Oct 8, 2021. [https://www.oge.gov/web/oge.nsf/0/7A3DB2F1691E9E42852585B6005A1F8F/\\$FILE/Legal%20Entities%20that%20Hold%20Assets.pdf](https://www.oge.gov/web/oge.nsf/0/7A3DB2F1691E9E42852585B6005A1F8F/$FILE/Legal%20Entities%20that%20Hold%20Assets.pdf)

**Continue to bring enforcement cases against investment advisers who solicit and broker-dealers who make unsuitable sales of, single stock ETFs and other exchange traded products (ETPs) that are inappropriate for their clients**

The Commission and FINRA should reinforce existing investor protection laws by continuing to bring enforcement cases against investment advisers and broker-dealers who violate their fiduciary and Regulation Best Interest obligations by offering single stock ETFs and other Exchange Traded Products (which broadly encompass other complex products with unintuitive risks and payouts such as Exchange Traded Notes and Exchange Traded Instruments) that are inappropriate for their clients.<sup>16</sup>

The prospectuses of these ETFs often state that such ETFs are only meant to be held for a single day and that the long-term performance of the ETF will differ from the reference asset over a period of time.

The Commission recently brought enforcement action against an investment adviser for putting hundreds of advisory clients into leveraged ETFs without evaluating whether they were in the clients' best interest to do so, failing to monitor the products performance, and failing to develop policies and procedures to prevent violations of the Investment Advisers Act of 1940.<sup>17</sup>

The Commission and FINRA should similarly continue to bring enforcement cases against other investment advisers and broker-dealers who are inappropriately investing clients in leveraged and/or single stock ETFs to reinforce the consequences of their staff failing to understand complex, leveraged ETPs.

**Require single stock and leveraged ETFs to show a graph of the divergent long-term performance of the ETF versus the underlying reference asset at point of sale**

However, neither Reg BI nor the fiduciary duties cover the problems around self-directed investors who purchase these products and whose risks and payouts they may not fully understand.

Panelists and market participants have suggested that ETF issuers should be required to clearly disclose the periodic performance of single stock and leveraged ETFs against their reference assets to show that these ETFs are only meant for short-term holdings and not over the long term.

As an additional safeguard, the SEC and FINRA should require brokers to display at point of sale, a graph showing both the divergent longer-term performance of the single stock/leveraged ETF and the underlying asset before being able to purchase them. Studies have already shown that

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<sup>16</sup> See Joint Statement Regarding Complex Financial Products and Retail Investors (October 28, 2020).

<sup>17</sup> Securities and Exchange Commission. In the Matter of Classic Asset Management. May 4, 2023.

<https://www.sec.gov/litigation/admin/2023/34-97427.pdf>

leveraged ETFs on single-stocks have seen -95% returns or worse when looking at their performance from December 31, 2021 through August 16, 2022.<sup>18</sup>

Panelists clearly demonstrated the highly inconsistent practices various brokers have in place for allowing self-directed retail investors to access leveraged and inverse ETFs. One long standing brokerage firm employing thousands of investment advisers does not allow its investors to access leveraged and inverse ETFs, while another brokerage, popular with retail investors, and without any investment advisers, allowed investors to transact in such ETFs without any questions, notices, or warnings.

By requiring a clear visual point of sale display of performance, the SEC and FINRA can add an additional safeguard for self-directed investors, many of whom are also increasingly trading via mobile apps,<sup>19</sup> so that they can see a clear divergence in long term performance before trading any one of these products.

# DRAFT

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<sup>18</sup> Crouse, Matthew S. Westminster College Gore School of Business. Averting Disaster: Leverage Limits for Single-Stock Leveraged ETFs. Nov 2022. <https://doi.org/10.4236/jmf.2022.124033>

<sup>19</sup> Kennesaw State University. Stock Investment Industry Augmented by Mobile Technology. Mar 21, 2023. <http://www.americanscholarspress.us/journals/IMR/pdf/IMR-1-2023/IMRV19N1-Art6.pdf>