Leveraged ETFs: The Trojan Horse Has Passed the Margin-Rule Gates

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> "When you combine ignorance and leverage, you get some pretty interesting results."
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> -Warren Buffet[1]

I. INTRODUCTION

What do the Great Depression, the Great Recession,[2] and the demise of Lehman Brothers and Bear Sterns all have in common? One word: leverage.[3] The misuse of leverage, in all its forms, contributed greatly to all of these events.[4] Yet even today, common investors can purchase a leveraged exchange-traded fund (leveraged ETF), a complex product that uses leverage to increase returns,[5] without triggering applicable laws designed to regulate the use of leverage.

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1. Ron DeLegge, *Should You Use Leverage?*, ETFGUIDE.COM (Dec. 19, 2009), http://www.etfguide.com/commentary/651/Should-You-Use-Leverage?/.

2. Courtney Schlisserman, *'Great Recession' Gets Recognition as Entry in AP Stylebook*, BLOOMBERG.COM (Feb. 23, 2010), http://www.bloomberg.com/apps/news?pid=20601103&sid=ayojB2KWQG4k; *see also* Chris Isidore, *The Great Recession*, CNNMONEY.COM (Mar. 25, 2009), http://money.cnn.com/2009/03/25/news/economy/depression_comparisons/index.htm.

3. *Black's Law Dictionary* defines leverage as "1. Positional advantage; effectiveness. 2. The use of credit or borrowed funds (such as buying on margin) to improve one's speculative ability and to increase an investment's rate of return. 3. The advantage obtained from using credit or borrowed funds rather than equity capital." BLACK'S LAW DICTIONARY 990 (9th ed. 2009).

4. *See* DeLegge, *supra* note 1; *see generally* MICHAEL G. CROUHY, ROBERT A. JARROW & STUART M. TURNBULL, PRESENTATION AT THE 8TH ANNUAL BANK RESEARCH CONFERENCE: THE SUBPRIME CREDIT CRISIS OF 2007, FDIC (2007), http://www.fdic.gov/bank/analytical/cfr/bank_research_conference/annual_8th/Turnbull_Jarrow.pdf.

5. *See infra* Part II.

Leverage is "[t]he use of a small initial investment, credit, or borrowed funds to gain a very high return in relation to one's investment . . . ."[6] Investing on margin (i.e., borrowing to purchase securities and pledging those securities as collateral for the loan) is a traditional form of leverage.[7] The U.S. Securities and Exchange Commission (SEC) declares that the Great Crash of 1929 laid its foundation: "Tempted by promises of 'rags to riches' transformations and easy credit, most investors gave little thought to the systematic risk that arose from widespread use of margin financing . . . ."[8] The Great Depression followed and Congress set out to identify ways to solve the problems created by investing on margin.

Since the 1930s, investing on margin has not ceased but, at least in the stock market, has been regulated by the margin rules (a set of rules created in the 1930s designed to prevent the same mistakes leading to the Great Depression). But the underlying principle learned from the Great Depression of exercising caution when using and providing leverage such as margin loans has faded, with drastic results. "Bear Stearns and Lehman Brothers, two former Wall Street powerhouses, no longer exist because they overleveraged themselves out of business. These companies became so addicted to leverage—they destroyed themselves and nearly the entire global financial system."[9]

In addition, a desire for yield enhancement[10] and greater access to leverage caused the credit crisis of 2007, whether through subprime mortgages[11] for individuals or collateralized debt obligations[12] for institu-

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6. THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1106 (2d ed. 1987).

7. FRANK K. REILLY & KEITH C. BROWN, INVESTMENT ANALYSIS & PORTFOLIO MANAGEMENT 127 (Mike Reynolds ed., Thomson S.-W. 7th ed. 2003). Normally, you buy stock X at $100 with your own money, it goes up to $150, and you sell stock X for a 50% profit. When investing on margin, however, you buy stock X at $100 with $50 of your own money and $50 borrowed from a broker. If the stock goes up $150, you have made a 100% profit (minus loan fees). If the stock goes down to $50, you have lost 100% (and you still have to pay loan fees).

8. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. AND EXCH. COMM'N (SEC), http://www.sec.gov/about/whatwedo.shtml (last modified May 3, 2010).

9. DeLegge, *supra* note 1.

10. Yield means "the income produced by a financial investment," and enhance means "to raise to a higher degree." RANDOM HOUSE WEBSTER'S COLLEGE DICTIONARY 444, 1546 (1996). Therefore, yield enhancement means to increase one's income produced by a financial investment to a greater level than previously obtained.

11. Subprime mortgages are mortgages offered to individuals with higher risks of default than the typical qualified or "prime" lender. In other words, subprime mortgages are home loans for people generally ineligible for loans.

12. Collateralized debt obligations (CDOs) "are financial vehicles that bundle different kinds of debt—ranging from corporate bonds, to securities underpinned by mortgages, to debt backed by money owed on credit cards—and cut it into slices. These slices are sold to investors in the form of bonds." David Reilly, *Center of a Storm: How CDOs Work*, WALL ST. J., June 23, 2007, at B1.

tions.[13] Relying on the expected increase in value, individuals took advantage of greater access to credit to purchase homes they could not afford.[14] Financial institutions and companies created and purchased securities with values based on these home loans because of a desire for better returns than they could normally obtain.

Recently, leveraged ETFs became available to provide access to leverage and, consequently, higher returns without the restrictions such as the rules that limit investing on margin (margin rules). Leveraged ETFs are controversial because they are complex, lightly regulated, and provide embedded leverage.[15] Based on the prior consequences of easy leverage and greedy desires for higher yields without limiting regulation, should leveraged ETFs be available and, if so, to what extent?

This Comment articulates the basics surrounding the functions and operations of leveraged ETFs and margin rules in order to assess the compatibility of the two. I argue that leveraged ETFs should be limited or prohibited because they contravene the purposes of the long-established margin rules set in place to protect the market and investors.

Part II explains ETFs and leveraged ETFs. Part III describes margin and the margin regulations, including the history behind their introduction and the policy concerns they address. Part IV analyzes how the basic functions and characteristics of leveraged ETFs flout the policy considerations underlying the margin rules (preventing excess use of credit, protecting investors from too thin a margin, and protecting the market from excess volatility), as well as the rules themselves. Part V proposes limitations on leveraged ETFs that would honor margin rule policies. Part VI concludes the Comment with the resolution that leveraged ETFs defy the margin rules and, therefore, should be limited if not prohibited.

II. BASICS OF ETFS

ETFs provide investors the ability to mirror the performance of groups of securities or indices with an investment vehicle that trades like a stock and has lower expense ratios than the average mutual fund.[16]

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13. *See* CROUHY, JARROW & TURNBULL, *supra* note 4.

14. *See id.* at 6.

15. *See* FIN. INDUS. REGULATORY AUTH. (FINRA), REGULATORY NOTICE 09-31, NON-TRADITIONAL ETFS: FINRA REMINDS FIRMS OF SALES PRACTICE OBLIGATIONS RELATING TO LEVERAGED AND INVERSE EXCHANGE-TRADED FUNDS (June 2009), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118952.pdf.; *see also* Chuck Jaffe, *Leveraged EFTs [sic] Are Like Power Tools; They're Best for Pros*, THE NEWS TRIB., Aug. 26, 2010, http://www.thenewstribune.com/2009/08/26/856917/leveraged-efts-are-like-power.html.

16. *What Are ETFs?*, NASDAQ, http://www.nasdaq.com/investing/etfs/what-are-ETFs.aspx (last visited Apr. 2, 2010) [hereinafter NASDAQ, *What Are ETFs?*]; *see also* REILLY & BROWN,

ETFs were introduced to the United States' financial markets in 1993 with the release of the S&P Depository Receipts Trust 1, or SPDRs, (pronounced "spiders").[17] SPDRs tracks the Standard & Poor's 500 Index[18] and continues to be the largest and most popular ETF as noted by its total net asset value—total assets minus liabilities divided by the number of shares outstanding—of $70.6 billion on November 5, 2009.[19] Since the introduction of the SPDRs fund, hundreds of ETFs have been introduced and different varieties have developed.[20]

A. Traditional ETFs

Generally, ETFs track market indices or other groups of securities.[21] For example, some ETFs track indices such as the Standard & Poor's 500, the NASDAQ 100, or the Dow Jones Industrial Average.[22] Others track a wide variety of securities including stocks, bonds, commodities, and even real estate.[23] ETFs invest in either all of the securities that comprise a particular index or a representative sample.[24] Basically, ETFs emulate the return of a given index.[25]

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supra note 7, at 87, 660 (ETFs are traded like stocks and have lower expense ratios than most mutual funds.).

17. *History of ETFs: From Institutions to Individuals*, THE WALL ST. J. ONLINE, http://online.wsj.com/ad/focusonetfs/history.html (last visited Apr. 3, 2010).

18. The Standard & Poor's 500 Index aims to measure the performance of the broad U.S. market and economy through changes in the values of 500 of the leading U.S. companies from all major industries. The index moves up and down in value as the values of the 500 largest companies in the U.S. change. It is regarded as the benchmark for U.S. stock performance. *S&P 500*, STANDARD & POOR'S, http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf—p-us-l— (last visited Apr. 2, 2010).

19. *SPDR S&P 500 ETF (SPY)*, STATE ST. GLOBAL ADVISORS, https://www.spdrs.com/product/fund.seam?ticker=SPY (last visited Mar. 17, 2010); *see also Popular ETFs*, YAHOO! FIN., http://finance.yahoo.com/etf/education/04 (last visited Mar. 17, 2010).

20. *A Focus on ETFs*, THE WALL ST. J. ONLINE, http://online.wsj.com/ad/focusonetfs/focus.html (last visited Apr. 3, 2010).

21. NASDAQ, *What Are ETFs?*, *supra* note 16; *see also NASDAQ ETF Family*, NASDAQ, http://www.nasdaq.com/Structuredeq/nasdaq_etf_family.stm (last visited Mar. 17, 2010); *see also Market Indices*, SEC, http://www.sec.gov/answers/indices.htm (last modified June 26, 2007) ("If you open the financial pages of many newspapers, you will find a number of major market indices listed. Each of the indices tracks the performance of a specific 'basket' of stocks considered to represent a particular market or sector of the U.S. stock market or the economy.").

22. NASDAQ, *What Are ETFs?*, *supra* note 16.

23. *All ETF Types*, ETFDB, http://etfdb.com/types/ (last visited Mar. 17, 2010) (The site includes hyperlinks to a variety of different types of ETFs based on the underlying assets.).

24. *Exchange-Traded Funds (ETFs)*, SEC, http://www.sec.gov/answers/etf.htm (last modified Mar. 18, 2010) [hereinafter SEC, *Exchange-Traded Funds*].

25. NASDAQ, *What Are ETFs?*, *supra* note 16. When buying shares in an ETF, the investor basically purchases shares of a "portfolio that tracks the yield of its native index." *Id.*

ETFs are priced and sold like stocks because of the way they are formed and the way they function.[26] ETFs are formed by a fund manager who submits a detailed plan of how the fund will operate to the SEC for approval.[27] After ETFs are approved and formed, the fund sells large blocks of shares (e.g., 50,000 shares) called "Creation Units" to large institutional investors[28] rather than directly to individual investors like you or me.[29] Usually, these Creation Units are purchased by institutional investors with an assortment of securities that parallel the ETF's portfolio (i.e., the index it intends to track).[30] The holder of the ETF's shares (the large institutional investor) then sells the individual shares that make up the Creation Units to individual investors in the secondary market.[31] Only Creation Units can be sold back to the ETF,[32] so large institutional investors buy up shares in the secondary market and redeem Creation Units.[33] The buying and selling of Creation Units back to the ETF creates arbitrage,[34] which allows the ETF to operate like a stock because it keeps the value of the ETF consistent with the value of the underlying securities.[35] If ETF share prices on the secondary market increase above the value of the underlying securities, institutional investors buy more Creation Units and sell the individual shares of the ETFs on the secondary market for more than the per-share cost of the Creation Units.[36] The opposite is true when ETF share prices are lower than the value of the underlying securities.[37]

Because of the manner in which ETFs are formed and function, investors gain attractive benefits.[38] First, ETFs generally have lower costs than mutual funds because they are traditionally passively managed,

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26. *See How ETFs Work*, ETFZONE.COM (Jan. 5, 2001), http://www.etfzone.com/?template=viewarticle&article_id=138.

27. *Id.*

28. *See* REILLY & BROWN, *supra* note 7, at 63. Institutional investors are just that, institutions that invest. *See id.* Examples include insurance companies, hedge funds, and pension funds. *Id.*; Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 881 (2010). Because institutional investors must invest large sums of money, they have the financial ability to buy Creation Units from ETFs.

29. SEC, *Exchange-Traded Funds*, *supra* note 24.

30. *Id.*

31. *Id.*

32. *Id.*

33. ETFZONE.COM, *supra* note 26.

34. RANDOM HOUSE WEBSTER'S COLLEGE DICTIONARY 70 (1996) ("1. the simultaneous sale of a security or commodity in different markets to profit from unequal prices.").

35. *See* ETFZONE.COM, *supra* note 26.

36. *Id.*

37. *Id.*

38. *How to Choose an Exchange-Traded Fund (ETF)*, THE WALL ST. J. ONLINE, http://guides.wsj.com/personal-finance/investing/how-to-choose-an-exchange-traded-fund-etf/ (last visited Apr. 2, 2010).

meaning the only changes made in an ETF's portfolio are to adjust it to assure the portfolio matches the underlying index or other securities.[39] Generally, ETFs are not actively traded like a mutual fund trying to gain the highest return for investors.[40] ETFs do not try to outperform the index, but rather seek to mirror it.[41] The reduced trading frequency and volume characteristics of ETFs allow for lower transaction and administrative costs, while also reducing the amount of potential capital-gain distributions.[42]

Second, investors are provided portfolio diversification without betting on the talents of fund managers.[43] Because ETFs provide returns nearly identical to a replicated index, investors are exposed to the diversified holdings of the index and "harness[] the power of the market itself" rather than the risky knowledge and skill of an active fund manager.[44]

Lastly, and perhaps most importantly, ETFs are traded like stock, providing the investor with flexibility.[45] Unlike mutual funds, which are purchased for the price of the fund at the close of the previous day (net asset value), ETFs are priced and traded continuously.[46] The price is based on the market value of the underlying index of the ETF.[47] In addition, they can be bought on margin, sold short, or held for long periods.[48]

B. Leveraged ETFs

Leveraged ETFs are almost identical to traditional ETFs except for one significant distinguishing feature: leverage.[49] Unlike traditional ETFs, leveraged ETFs seek to achieve multiplied returns based on the performance of the ETF's underlying index, group of securities, or other

39. NASDAQ, *What Are ETFs?*, *supra* note 16.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* "ETF shares trade exactly like stocks. . . . ETFs enjoy the additional benefits of . . . greater flexibility that goes with investing in entire markets, sectors, regions, or asset types." *Id.*

46. *Id.* ("Unlike index mutual funds, which are priced only after market closing, ETFs are priced and traded continuously throughout the trading day.").

47. *Id.*; *see also Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors*, SEC, http://sec.gov/investor/pubs/leveragedetfs-alert.htm (last modified Aug. 18, 2009) [hereinafter SEC, *Leveraged and Inverse ETFs*].

48. NASDAQ, *What Are ETFs?*, *supra* note 16.

49. *See* NYSE INFORMED INVESTOR: WHAT YOU SHOULD KNOW ABOUT EXCHANGE TRADED FUNDS, N.Y. STOCK EXCH., 4 (2009), http://www.nyse.com/pdfs/what_you_should_know_about_etfs.pdf [hereinafter NYSE INFORMED INVESTOR].

asset group.[50] For example, a leveraged ETF would seek to achieve as much as two (200%) or three (300%) times the performance of a traditional ETF that uses the same underlying index or benchmark.[51]

Leveraged ETFs achieve multiplied performance through derivative[52] investments.[53] Rather than simply holding the stocks, bonds, commodities, or other securities in a ratio similar to the underlying index like traditional ETFs, leveraged ETFs use derivative instruments to create leverage.[54] "Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security or index. For example, a stock option is a derivative because its value changes in relation to the price movement of the underlying stock."[55] While understanding the specific mechanics of derivatives exceeds the scope of this Comment, one must understand that a leveraged ETF does not achieve multiple returns through holding the same assets in the same proportion as the benchmarked group of assets.[56] Some other type of investment instrument must multiply the return, or in other words, produce leverage.[57]

Most leveraged ETFs reset daily.[58] This means that leveraged ETFs achieve their multiplied performance objectives daily.[59] Thus, the return

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50. *Id.*; *see also* Press Release, FINRA, SEC Warns Retail Investors About Investing in Leveraged or Inverse ETFs (Aug. 18, 2009), http://www.finra.org/Newsroom/NewsReleases/2009/P119820.

51. NYSE INFORMED INVESTOR, *supra* note 49; *see also* SEC, *Leveraged and Inverse ETFs*, *supra* note 47. In addition, both traditional ETFs and leveraged ETFs can be purchased in an inverse form called "inverse ETFs" or "inverse leveraged ETFs." *Id.* Inverse ETFs simply seek the opposite performance of the underlying index or benchmark. *Id.*

52. A derivative is "an instrument whose market value ultimately depends upon, or derives from, the value of a more fundamental investment vehicle called the underlying asset or security." REILLY & BROWN, *supra* note 7 at G-5; *see also* Kelli A. Alces, *Revisiting Berle and Rethinking the Corporate Structure,* 33 SEATTLE U. L. REV. 787, 799 (2010).

53. Swaps are a type of derivative frequently used by leveraged ETFs to achieve their investment objectives. Minder Cheng & Ananth Madhavan, *The Dynamics of Leveraged and Inverse Exchange-Traded Funds*, 7 J. INVESTMENT MGMT. 43 (2009). Swaps have been scrutinized by governments, however, for their risk. *See* Stephen Fidler, Gregory Zuckerman & Brian Baskin, *Swaps Come Under Fire: U.S. Regulators, European Leaders Seek More Oversight on Trades in Derivatives*, WALL ST. J., Mar. 10, 2010, at A1. A part of the Dodd-Frank Wall Street Reform and Consumer Protection Act deals with the regulation of these swaps and derivative markets in general. Pub. L. No. 111-203, §§ 701–54, 124 Stat. 1376, 1654–1754 (2010).

54. Cheng & Madhavan, *supra* note 53, § 2.1.

55. *Derivatives*, SEC, http://www.sec.gov/answers/derivative.htm (last modified May 25, 2000).

56. *See* SEC, *Leveraged and Inverse ETFs*, *supra* note 47.

57. Cheng & Madhavan, *supra* note 53, § 2.1. "[L]everaged returns cannot be created out of thin air . . . ." *Id.*

58. FINRA, REGULATORY NOTICE 09-31, *supra* note 15. In other words, leveraged ETFs proved daily returns based on a multiple of the underlying benchmark. *See id.* The fund adjusts its assets and exposure so that it can provide the stated multiplied return each day, which effectively compounds the gains or losses over periods of time. *See id.*

on the leveraged ETF can differ significantly from that of the underlying asset group over a period of time.[60] This trait has caused the SEC and the Financial Industry Regulatory Authority (FINRA) to issue warnings about the risk to investors of losing money over a period of time even though the index or benchmark actually increased over that period.[61] For example, between December 1, 2008, and April 30, 2009, the Dow Jones U.S. Oil & Gas Index gained 2% while a 200% leveraged ETF fell 6% and a 200% inverse leveraged ETF fell by 26%.[62]

Despite these risks, leveraged ETFs remain popular.[63] Like traditional ETFs, leveraged ETFs are similar to stock because investors can buy and sell them throughout the trading day or purchase them on margin.[64] However, unlike stocks and traditional ETFs, leveraged ETFs derive their appeal from their use of leverage.[65] Leveraged ETFs remain popular because of their opportunity for multiplied returns, despite the risk that they will not perfectly mirror the underlying benchmark[66] and despite the higher costs caused by the need for active management to create and maintain the leverage.[67]

ETFs remain popular and useful because of their opportunity for diversified, flexible, and low-cost investing.[68] Leveraged ETFs provide similar advantages but add a new level of complexity and risk through leverage.[69] Traditionally, leverage has been obtained by investing on margin—borrowing funds from a broker to purchase stock. Therefore, in order to fully understand ETFs, it is important to understand the history

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59. *Id.*

60. *Id.* For a good example of how the resetting can create differences in returns over a period of time, see *Understanding the Impact of Changing Market Exposure on Leveraged ETFs*, DIREXIONSHARES, http://direxionshares.com/pdfs/Compounding_Article_ETFs.pdf (last visited Apr. 3, 2010).

61. FINRA, REGULATORY NOTICE 09-31, *supra* note 15; *see also* Press Release, *supra* note 50. FINRA provided the following example of the risk of leveraged ETFs over the long term:

> For example, between December 1, 2008, and April 30, 2009, a leveraged ETF seeking to deliver three times the daily return of the Russell 1000 Financial Services Index fell 53 percent, while the underlying index actually gained approximately 8 percent. A leveraged inverse ETF seeking to deliver three times the inverse of the Russell 1000 Financial Services Index's daily return declined by 90 percent over the same period.

Id.

62. *Id.*

63. Jason Zweig, *The Intelligent Investor: Will Leveraged ETFs Put Cracks in Market Close?*, WALL ST. J., Apr. 18, 2009, at B1.

64. FINRA, REGULATORY NOTICE 09-31, *supra* note 15.

65. *See id.*

66. *See* Zweig, *supra* note 63.

67. Tristan Yates, *Dissecting Leveraged ETF Returns*, INVESTOPEDIA, http://www.investopedia.com/articles/exchangetradedfunds/07/leveraged-etf.asp (last visited Apr. 3, 2010).

68. NASDAQ, *What Are ETFs?*, *supra* note 16.

69. *See* FINRA, REGULATORY NOTICE 09-31, *supra* note 15.

surrounding margin, the basics of its operation, and the rules that regulate its use.

III. INVESTING ON MARGIN AND MARGIN REGULATIONS

Investing on margin allows investors to gain leverage by using borrowed funds to purchase stock.[70] To facilitate a better understanding of margin, this Part discusses the basic mechanics and history of margin as well as the rules that currently govern it. In addition, I will present the underlying policies supporting the enactment of margin rules.

A. Investing on Margin

Investing on margin means "borrowing money from your broker to buy a stock and using your investment as collateral."[71] Investing on margin allows investors to buy more stock for less money, creating leverage.[72] Similar to the power of a crowbar to pry out embedded nails because of its extended length, the enlarged amount of money gained from borrowing amplifies the returns that an investor can produce when investing on margin. Although leverage increases the potential for greater returns, it also increases the potential for greater losses.[73]

For example, if a broker allows an investor to borrow 75% of the market value of a security, then the investor need only provide 25% of the market value.[74] Therefore, an investor could purchase $4,000 worth of stock on a $1,000 investment.[75] If the stock goes up, leverage creates an obvious advantage: A 10% increase in the value of the stock produces a $400, or 40%, return because of the leverage that the margin loan allows.[76] But leverage creates an equally astounding risk if the stock value

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70. *See* 5 THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 14.9[4] (6th ed. 2009 & Supp. 2010) ("A margin purchase gives the security holder (investor) leverage, and thus, while significantly increasing the risk of investment, also increases the potential gain.").

71. *Margin: Borrowing Money to Pay for Stocks*, SEC, http://www.sec.gov/investor/pubs/margin.htm (last modified Apr. 17, 2009).

72. *Id.*

73. *Id.*; Christie Ford & Carol Liao, *Power Without Property, Still: Unger, Berle, and the Derivatives Revolution*, 33 SEATTLE U.L. REV. 889, 913–14 (2010).

74. *See* SEC, *Margin: Borrowing Money to Pay for Stocks*, *supra* note 71; *see also* REILLY & BROWN, *supra* note 7, at 128–29.

75. Stock worth $4,000 multiplied by the 25% hypothetical initial margin percentage—the portion of the purchase price that the investor has to deposit—equals a $1,000 required deposit by the investor in order to purchase the stock under this hypothetical.

76. The initial value of the stock was $4,000. An increase of 10%, or $4,000 times 10%, equals $400. The initial amount of cash the investor had to deposit was only $1,000, so the return on the investment is the increase of $400 divided by the cash investment of $1,000, or 40%. However, the opposite is true if the stock value decreases by 10%. The $400 loss is divided by the $1,000 initial investment, creating a 40% loss. Additionally, the equity is reduced to $600 because the margin loan of $3,000 ($4,000 purchase price less the $1,000 initial cash investment by the investor)

goes down. A 10% decrease in the value of the stock generates a negative 40% return, leaving the investor with stock valued at $3,600 and a debt of the initial $3,000 borrowed.[77] Therefore, the investor holds only $600 in equity, not counting the interest due on the loan.[78] The events that caused the Great Depression readily evidence the possible catastrophic effects of margin.[79]

B. The Origin of Margin Rules and Their Policies

Buying stock on margin was prominent in the 1920s.[80] The post-World War I U.S. economy flourished, and a wide array of people, companies, and trusts invested in the stock market.[81] Since the government did not regulate buying on margin,[82] brokers controlled margin requirements based on concerns for their own well-being.[83] In the late 1920s, the average broker margin requirement was 50%, but by October 1929, investors purchased some stocks with only 25% of the initial price paid.[84] Additionally, interest rates decreased and the number of broker loans increased because of the easy access to "cheap" loans.[85] Because of their expanded buying power, investors drove up stock prices and became more vulnerable to stock price declines.[86] Moreover, lenders became increasingly vulnerable because they depended on the value of stocks as collateral.[87] Therefore, as stock prices plummeted in late October 1929,

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has not changed, but the value has decreased by $400. Therefore, if the stock was sold today for the reduced $3,600 value ($4,000 less the $400 loss), then the investor would only be left with $600 ($3,600 new value less the $3,000 loan).

77. *See supra* note 76.

78. *Id.*

79. *See infra* Part III.B.

80. Harold Bierman, Jr., *The 1929 Stock Market Crash*, EH.NET ENCYCLOPEDIA (Feb. 5, 2010), http://eh.net/encyclopedia/article/Bierman.Crash.

81. *See* H.R. Rep. No. 73-1383, at 3 (1934) ("Since the war the interest of the public at large in the ownership of corporate enterprise has grown bigger, the size of the corporate unit has increased, the diffusion of corporate ownership has widened, all correlatively.").

82. Bierman, *supra* note 80.

83. *Id.*

84. *Id.*

85. *Id.* (Interest rates declined making it easier for brokerage firms to obtain money to loan to investors and making it less expensive for investors to borrow.).

86. *Id.*

87. *See* H.R. Rep. No. 73-1383, at 4 (1934).

> A rise in the security markets stimulates economic activity in all lines of business, a fall in the market precipitates a decline. If the rise in the market is occasioned by an excessive use of credit, a decline in the market loosens a process of deflation which feeds on itself and ruins not only security prices but all business as well. Between 1922 and 1929 brokers' loans increased from 1 1/2 billion dollars to 8 1/2 billion dollars. Five billion dollars of this increase took place in 3 years, 1 1/2 billion dollars in the last 3 months. In the crash of 1929 the same loans declined 3 billion dollars in the first 10 days and 8 billion dollars in the next 3 years. These figures alone will enable the economic historian of the

investors either sold quickly to minimize losses, thereby exacerbating the price declines, or were left owing more than the stock's value and ultimately defaulted on their margin loans.[88] Although other factors contributed, the Great Depression followed.[89]

In response to the 1929 stock market crash and subsequent Great Depression, Congress enacted margin rules.[90] Section 7 of the Securities Exchange Act of 1934 ('34 Act) set forth rules regulating the purchase of securities on margin.[91] The margin rules therein, which are discussed in the next section, were established based on three basic underlying policy considerations: (1) to "prevent[] the excessive use of credit for the purchase or carrying of securities";[92] (2) "to protect the margin purchaser by making it impossible for him to buy securities on too thin a margin";[93] and (3) to "prevent undue market fluctuations and help stabilize the economy generally . . . ."[94] In short, margin rules were created to protect individual investors, the market, and the economy as a whole.[95] The me-

> future to describe the unhealthy prosperity of 1929 and the inevitable grief and suffering that followed in the succeeding years—grief and suffering that overwhelmed and carried away not merely the speculative gains of those who participated in the speculative debauch, not merely the savings of the most frugal and most thrifty invested in securities, but eventually the operating profits of every business in the country no matter how unrelated to stock exchanges.

Id.

88. *See* Bierman, *supra* note 80.

89. *See supra* note 87.

90. *See* H.R. Rep. No. 73-1383, at 3 (1934).

> The [Securities & Exchange Act of 1934] is conceived in a spirit of the truest conservatism. It attempts to change the practices of exchanges and the relationships between listed corporations and the investing public to fit modern conditions, for the very purpose that they may endure as essential elements of our economic system. The lesson of 1921–29 is that without changes they cannot endure.

Id.

91. Securities Exchange Act of 1934, 15 U.S.C. § 78g (2009).

92. *Id*. § 78g(a); s*ee also* 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3225 (3d ed. 2003 & Supp. 2010); H.R. Rep. No. 73-1383, at 5 (1934). ("The causes of dangerous speculation in the securities markets go far deeper than defects and abuses in stock-exchange machinery alone. They include inadequate central control of a national credit system that too easily provides for speculation funds which the national welfare much more requires in local commerce, industry, and agriculture.").

93. 7 LOSS & SELIGMAN, *supra* note 92, at 3225, n.261.; s*ee also* H.R. Rep. No. 73-1383, at 1 (1934) (President Roosevelt stated, "In my message to you last March proposing legislation for Federal supervision of national traffic in investment securities I said: 'This is but one step in our broad purpose of protecting investors and depositors.'" He went on to say, "There remains the fact, however, that outside the field of legitimate investment naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.").

94. 7 LOSS & SELIGMAN, *supra* note 92, at 3228; s*ee also* H.R. Rep. No. 73-1383, at 5 (1934) ("Increasing margins—i.e., decreasing the amounts which brokers or banks may lend for the speculative purchase and carrying of stocks—is the most direct and the most effective method of discouraging an abnormal attraction of funds into the stock market.")

95. *See supra* notes 92–94 and accompanying text.

chanics of the margin rules set out below reflect the efforts of legislators and regulators to achieve these policy goals.

C. Margin Rules

Congress promulgated the margin rules in order to limit the amount an investor can borrow to purchase securities.[96] Although investors may salivate at the chance to borrow 100% of their investment by putting up as collateral the very assets they are borrowing money to purchase, the margin rules do not allow investors to borrow all of the cost of a security to purchase that security.[97]

The margin rules originate in '34 Act § 7(a), which establishes a complicated system of regulations regarding the extension of credit to buy securities.[98] Although the '34 Act itself sets a ceiling for the initial loan amount to purchase securities at 55% of the market value,[99] '34 Act § 7(a) delegates to the Federal Reserve Board (FRB) the power to set regulations regarding the extension of credit for purchasing securities where the securities are collateral for the loan.[100] The FRB uses this grant of authority to adopt a slightly more conservative limit, requiring margin of 50%, or "the percentage set by the regulatory authority where the trade occurs, whichever is greater."[101] These regulations apply to ETFs and leveraged ETFs because they are treated like stock.[102]

The FRB requires that designated margin accounts be used when investing on margin.[103] The broker who manages the account must give the customer a margin disclosure statement when the account is opened and once a year thereafter.[104] Failure to comply with these disclosure requirements can result in broker liability for the losses of the customer.[105]

The margin requirements mentioned above, however, apply only to the initial purchase of securities.[106] They do not address the amount re-

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96. *See supra* Part III.B.

97. 15 U.S.C. § 78g(a) (2009).

98. THOMAS LEE HAZEN, BROKER-DEALER REGULATION: IN A NUTSHELL 83 (2003).

99. 15 U.S.C. § 78g(a)(1) (2009).

100. *See id.* § 78g(b).

101. Regulation T, 12 C.F.R. § 220.12 (2009).

102. Regulation T, 12 C.F.R. § 220 (2009), by default, applies to all securities traded on a national securities exchange or actively traded over-the counter. 5 HAZEN, *supra* note 70, § 14.9[2]. In addition, "[t]he Federal Reserve Board now provides for the automatic marginability of stocks that are part of the Nasdaq's National Market System." *Id.*

103. Regulation T, 12 C.F.R. § 220.4(a) (2009).

104. 5 HAZEN, *supra* note 70.

105. *Id.*

106. Under §7(a) of the Securities Exchange Act of 1934 codified at 15 U.S.C. § 78g (2009), Congress gave the Federal Reserve Board the power to impose regulations regarding maintenance margin requirements, but the Federal Reserve Board has never exercised this authority. *See* 5

quired to be maintained in the margin account as collateral for the loan.[107] Because securities inherently involve more risk and volatility than other investments (e.g., homes, electronics, or cars), rules exist requiring investors to maintain a certain amount of equity in the account as collateral to cover the potential decline in value of the securities—i.e., maintenance margin requirements.[108] FINRA sets forth these maintenance margin requirements.[109]

FINRA's current maintenance margin requirement for stock, and therefore ETFs, is 25% of the current market value.[110] If an investor's equity in the margin account falls below the maintenance margin requirement, then a margin call is issued.[111] This means the investor must deposit more funds or securities in the margin account or the brokerage firm can sell securities in the account until the equity percentage exceeds the maintenance margin requirement.[112] Thus, the requirement protects the lender and the investor by requiring equity in the margin account above a certain percentage of the market value and by informing the in-

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HAZEN, *supra* note 70, § 14.9[1]. Therefore, maintenance margin requirements are left to the exchanges and other self-regulatory bodies (e.g. NYSE, NASDAQ, and FINRA). *Id.*

107. 5 HAZEN, *supra* note 70, § 14.9[3].

108. *See id.* § 14.9[1].

109. *See About the Financial Industry Regulatory Authority*, FINRA, http://www.finra.org/AboutFINRA/index.htm (last visited Apr. 3, 2010). In July 2007, the National Association of Securities Dealers (NASD) was consolidated with the regulatory functions of the New York Stock Exchange to create the Financial Industry Regulatory Authority (FINRA). *Id.* "It also performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange." *Id.*; *see also* SEC, *Margin: Borrowing Money to Pay for Stocks*, *supra* note 71 ("FINRA requires you to keep a minimum amount of equity in your margin account.").

110. FINRA MANUAL: NASD RULES § 2520(C) (2010), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3668. ETFs are included in the NASD maintenance margin rules just like any other stock because the rule regulates the margin accounts and not the type of security. *See id.* Also, FINRA has incorporated the NYSE rules relating to margin requirements. *See* FINRA MANUAL: INCORPORATED NYSE RULES § 431 (2010), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6461.

111. 5 HAZEN, *supra* note 70, § 14.9[1]. For example, with a maintenance margin requirement of 25% an investor must have equity (i.e., difference between the market value of the stock and the loan amount) of 25% times the current market value of the stock. Therefore, if $50,000 worth of stock is purchased with an initial margin of 50%, the investor has a loan of $25,000. If the market value of the stock drops to $30,000, the equity is only $5,000 ($30,000 minus $25,000) and the maintenance margin requirement is 25% multiplied by the market value, or $7,500 ($30,000 multiplied by 25%). Thus, a margin call for the difference between the equity of $5,000 and the maintenance margin requirement of $7,500, or $2,500, will be received by the investor. A margin call allows the broker to demand that the investor deposit more cash or more securities or the broker can sell the investor's stock so that the investor's account is again above the maintenance margin requirement level.

112. *Investing with Borrowed Funds: No "Margin" for Error*, FINRA, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MarginAndBorrowing/P005973 (last updated Oct. 6, 2008).

vestor, through a margin call, of the dangerously low value of the securities. Notwithstanding this general rule, FINRA recently changed the maintenance margin requirement for leveraged ETFs.[113]

In response to mounting pressure to tighten the regulations on leveraged ETFs because of their risk and exposure, FINRA recently approved a more stringent maintenance margin requirement for leveraged ETFs.[114] The new requirement will increase the former 25% requirements by the amount of leverage on the ETF, but not to exceed 100%.[115] Therefore, a 200% leveraged ETF will now have a maintenance margin requirement of 50% (25% multiplied by 200%). In explaining the reason for this change, FINRA states: "In view of the increased volatility of leveraged ETFs compared to their non-leveraged counterparts, FINRA believes higher margin levels are necessary."[116]

FINRA's newly increased maintenance margin requirement is just one acknowledgement of the problems and impact leveraged ETFs create through their main feature—leverage. While Congress created margin rules to regulate leveraged investing (e.g., margin), leveraged ETFs have been allowed to sneak past their application, with potentially harmful results.[117] The next Part discusses how leveraged ETFs flout the margin rules and why this exploitation is inappropriate and dangerous.

IV. How Leveraged ETFs Imitate Investing on Margin and Flout the Margin Rules

While leveraged ETFs produce strikingly similar returns to traditional margin trading[118] and use leverage,[119] they are not limited by the same margin rules. As such, leveraged ETFs exploit a gaping hole in the margin rules. This exploitation allows for synthetic margin,[120] exponentially larger exposure to risk,[121] access to otherwise prohibited leverage in retirement accounts,[122] and access to investment mechanisms other-

113. FINRA, REGULATORY NOTICE 09-53, NON-TRADITIONAL ETFS: INCREASED MARGIN REQUIREMENTS FOR LEVERAGED EXCHANGE-TRADED FUNDS AND ASSOCIATED UNCOVERED OPTIONS (Aug. 2009), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119906.pdf.

114. *Id.*

115. *Id.*

116. *Id.*

117. *See infra* Part IV.

118. *Compare supra* Part III.C (explains that the purpose of investing on margin is to allow investors to have greater purchasing power in order to increase possible returns), *with supra* Part II.B (explains that leveraged ETFs provide exponential returns compared to an underlying asset group so that investors can reap greater returns than if the investor just purchased the underlying asset group).

119. *See supra* Part III.C.

120. *See infra* Part IV.A.

121. *See infra* Part IV.C.

122. *See infra* Part IV.B.1.

wise not available. Leveraged ETFs should fall within the reach of the margin rules because of their similarities to investing on margin. The effects of leveraged ETFs mirror those of investing on margin and implicate the same policy issues.[123]

A. Simulated or Synthetic Margin Borrowing

The purpose of leveraged ETFs is to provide leverage (access to greater returns relative to initial investment) to investors.[124] Obvious from their name, companies promoting leveraged ETFs make this purpose clear in the prospectuses filed with the SEC. For example, the "ProShares UltraPro S&P500 (the 'Fund') seeks leveraged investment results . . . . The Fund is different from most exchange-traded funds in that it seeks leveraged returns . . . ."[125] Leveraged ETFs have "'leverage' explicitly embedded as part of their product design."[126] Therefore, leveraged ETFs and investing on margin have the same purpose—to provide greater potential returns through leverage.[127]

To solidify the similarities between the two techniques, compare investing $1,000 on a 50% margin in the famous SPDRs[128] traditional ETF that tracks the S&P 500 stock market index[129] to investing $1,000 in the ProShare Ultra S&P 500 leveraged ETF that tracks the same index but with a 200% leverage multiple.[130] Excluding the small costs from interest, fees, and expenses from investing in these two ETFs, the returns from each would be the same in a single day. If the S&P 500 stock market index rose by 1%, each of these investments would generate a 2% return. Both achieve twice the return than that of the underlying index. Thus, leveraged ETFs create multiplied returns and losses similar to investing on margin and, ultimately, seek to achieve the same results.[131] "[L]everaged . . . ETFs can be viewed as pre-packaged margin products, albeit without any restrictions on margin eligibility."[132]

Unlike traditional margin trading, however, the investor purchasing leveraged ETFs need not borrow money to access the leverage. The funds themselves create leverage through borrowing and derivatives,[133]

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123. *See infra* Part IV.D.
124. Cheng & Madhavan, *supra* note 53.
125. ULTRAPRO S&P 500: SUMMARY PROSPECTUS, PROSHARES 3 (2009), *available at* http://media.proshares.com/funds/prospectus.html?ticker=upro.
126. Cheng & Madhavan, *supra* note 53.
127. *See* Tom Eidelman, *One-Day Wonders*, BARRON'S, Jan. 12, 2009, at L8.
128. *See supra* Part II and notes 16–17 and accompanying text.
129. STATE ST. GLOBAL ADVISORS, *supra* note 19.
130. PROSHARES, *supra* note 125.
131. *See* Eidelman, *supra* note 127.
132. Cheng & Madhavan, *supra* note 53, § 2.1.
133. *See id.*

allowing the investor to "synthetically" invest on margin.[134] Since the fund accomplishes the leverage rather than the investor, leveraged ETFs do not fall within the margin rules.[135] This creates detrimental consequences that the margin rules try to prevent but, as currently constructed, cannot.[136]

B. Differences and Their Consequences

Although investors need not borrow to purchase leveraged ETFs,[137] the leverage gained through purchasing a leveraged ETF creates problems otherwise evaded by the margin rules.[138] The investor does not pay interest on a loan[139] and limits any loss to that of the investment.[140] But leveraged-ETF fees act similarly to interest costs of investing on margin and are used by leveraged ETFs to recoup the costs incurred in creating leverage.[141] Furthermore, leveraged ETFs and investing on margin inherently carry enhanced volatility risks because of the leverage they provide.[142] Safeguards such as maintenance margin requirements and eligibility requirements in order to use margin accounts, however, protect the investor purchasing on margin. For example, retirement accounts are protected from the risks inherent from investing on margin because of the requirements surrounding the use of margin accounts, but leveraged ETFs can be purchased in cash accounts.[143] Unfortunately, many of the protective mechanisms used to limit margin trading do not apply to leveraged ETFs. These include maintenance margin requirements and the prohibition on investing on margin in retirement accounts.

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134. THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1356 (2d ed. 1987) ("3. not real or genuine; artificial; feigned").

135. *Cf.* Scott Rothbort, *How Leveraged ETFs Flout Margin Requirements*, REALMONEY SILVER (Mar. 4, 2009), http://www.thefinanceprofessor.com/ArticleFiles/16how%20etfs%20flout%20margin%20rules.pdf (approval for leveraged ETFs comes from the SEC and the Federal Reserve Board has no say over the matter). In addition, investors do not purchase the leveraged ETFs with borrowed funds, so technically traditional margin rules do not extend to leveraged ETFs. *See supra* Part II.B.

136. *See* Rothbort, *supra* note 135.

137. *See* Cheng & Madhavan, *supra* note 53, § 1.

138. *See* Rothbort, *supra* note 135.

139. Because the investor does not have to borrow money to purchase a leveraged ETF, there will be no direct interest charged as there would be on a loan.

140. *See* Cheng & Madhavan, *supra* note 53, § 1.

141. *See id.* § 2.1 (implementing a leveraged strategy may implicate financing costs).

142. *See* Eidelman, *supra* note 127.

143. A cash account is an account with a broker where the investor is required to purchase securities up front without borrowed funds. *What to Expect When You Open a Brokerage Account*, FINRA, http://www.finra.org/Investors/SmartInvesting/GettingStarted/OpeningaBrokerageAccount/index.htm (last visited July 5, 2010).

1. Maintenance Margin Requirements

Leveraged ETFs provide synthetic margin without the protections of the margin call discussed in Part III.[144] Although only the initial investment in a leveraged ETF can be lost (if not purchased on margin), there is no safeguard to slow down a decline. Unlike investing on margin, when underlying assets decline in value and the leveraged ETF multiplies the decline by its leverage ratio, the leveraged-ETF investor receives no warning of the drastic decrease in value of the investment.[145] Therefore, if an investor does not monitor the leveraged ETF frequently, the investor can quickly lose most of the investment with no warning or safeguard.

Notwithstanding the lack of safeguards against drastic and swift losses, retirement accounts are currently allowed to be exposed to these risks through the use of leveraged ETFs even though they are prohibited from investing on margin.[146]

2. Retirement Accounts Allowed Access to Otherwise Prohibited Leverage

Individual retirement accounts (IRAs) are not allowed to be invested on margin[147] because IRAs cannot be pledged as collateral.[148] As discussed above in Part II, investors must use a margin account with their broker, not a traditional cash account, in order to invest on margin, and margin accounts require the account to be pledged as collateral for the margin loans given by the broker.[149] The tax advantages provided to IRAs are lost, however, if the IRA is pledged as security because pledging the IRA, or a portion thereof, is considered a distribution and subject to taxes and penalties.[150]

Congress prohibited the use of these accounts as collateral because the tax advantages given to IRAs are meant to help individuals save for

144. *See* Rothbort, *supra* note 135.

145. When investing on margin, the maintenance margin rules might protect the investor from total loss. *See supra* Part III.C.

146. *See infra* Part IV.B.2.

147. *See* 26 U.S.C. § 408(e)(4) (2009); *see also* 26 C.F.R. § 1.408-1(c)(4) (2009). Investing on margin must be done through a margin account, which requires the account to be collateral for any loans. 5 HAZEN, *supra* note 70, § 14.9[1]. An individual retirement account cannot be pledged as security for loan or that portion is deemed distributed and the tax advantages are lost. 26 U.S.C. § 408(e)(4) (2009). Therefore, because the individual retirement account in a margin account would have to be pledged as security for a margin loan, the tax advantages would be lost.

148. 26 U.S.C. § 408(e)(4) (2009).

149. FINRA, *What to Expect When You Open a Brokerage Account*, *supra* note 143.

150. *See* 26 U.S.C. § 408(e)(4) (2009).

retirement.[151] Preventing IRAs from investing on margin reduces the risk of losing retirement savings and protects the government from providing support to individuals later in life.[152] Unfortunately, under the current regulatory scheme, an IRA can purchase leveraged ETFs.[153] Leveraged ETFs are treated like a stock,[154] and IRAs are allowed to invest in stock through cash accounts. Therefore, although people cannot invest IRAs on margin to leverage the purchasing power,[155] retirement accounts can purchase leveraged ETFs and gain exposure to the leverage offered.

The government's goal of mitigating undue risk when investing retirement savings seems reasonable and worthwhile.[156] The government will forgo tax revenue in return for increased savings and responsible investing.[157] The opportunity for multiplied gains is forfeited, but the corresponding risk of losing retirement savings, earmarked for the future when the person generates little or no income,[158] outweighs the possible benefit. Increased gains may allow for the individual to live better during retirement, but substantial losses may require the American populous to make up the loss.

The ability to purchase leveraged ETFs in IRAs does not comport with the policies behind safeguarding tax-advantaged retirement savings from the undue risk just discussed.[159] IRAs are subject to restrictions on pledging the accounts as collateral for a loan to avoid unnecessary risk of loss.[160] As discussed above, the purpose of leveraged ETFs is to provide the opportunity to garner large gains, which is accompanied by the corresponding risk of suffering large losses.[161] Allowing individuals to expose themselves to increased risk of loss through a new and complex

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151. 5 WEST'S ENCYCLOPEDIA OF AMERICAN LAW 385 (2d ed. 2004) ("To help people prepare for retirement, Congress in 1974 established individual retirement accounts [IRAs] . . . .") [hereinafter WEST ENCYCLOPEDIA].

152. *See id.* "[A] substantial number of politicians, economists, and scholars contend that the Social Security fund is being drained faster than it is being filled, and that it will go broke in a number of years, leaving retirees to survive without government assistance." *Id.*

153. *See* Rothbort, *supra* note 135.

154. *See supra* Part II.B.

155. *See supra* notes 147–50 and accompanying text.

156. *See supra* notes 151–52 and accompanying text.

157. WEST ENCYCLOPEDIA, *supra* note 151, at 388 ("The goal of ERTA [Economic Recovery Tax Act] was to promote an increased level of personal retirement savings through uniform discretionary savings arrangements.").

158. *Id.* Because of the increase in the average life span and the decline in the number of employers that offer retirement plans, individuals may need more retirement savings than their ancestors. *Id.*

159. *See supra* notes 151–52 and accompanying text.

160. *See id.*

161. *See* SEC, *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors*, *supra* note 47.

investment vehicle (leveraged ETF), while prohibiting the same risk exposure through traditional and simple borrowing, defies logic and reason.

C. Margin Times Leverage Equals "Super Margin"

In addition to the built-in leverage, leveraged ETFs can be purchased on margin themselves.[162] Thus, an investor can purchase a leveraged ETF, created to provide embedded leverage, on margin. This creates "super margin."[163] For example, if an investor purchases a 200% leveraged ETF with a margin requirement of 50%, the resulting exposure is 400%, or 4-to-1. Furthermore, if a triple-leveraged ETF is purchased on the same margin, then the leverage is truly 600%, or 6-to-1.[164]

Because Congress and regulating agencies, through the '34 Act and Regulation T,[165] set margin requirements that cap the total possible leverage exposure to approximately two times the investment,[166] how can leveraged ETFs be allowed to provide leverage of six times an investment? The answer is unclear. Nonetheless, access to this amount of leverage seems to blatantly defy the policies underlying the margin rules.[167] These policies, and how leveraged ETFs contradict them, are discussed below.

D. Contradiction of Margin-Rule Policies through Leveraged ETFs

Leveraged ETFs leave the margin rules partially ineffective in achieving their underlying policy initiatives of protecting individual investors, the market, and the economy as a whole. How each of these three policies is undermined by leveraged ETFs deserves discussion.

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162. *See* FINRA, REGULATORY NOTICE 09-53, *supra* note 113.

163. The term "super margin" is not a term of art or a term readily used in the investment community. However, I will use this term to indicate the ability to combine the embedded leverage of a leveraged ETF with the leverage obtained through buying a leveraged ETF on margin.

164. *See* Rothbort, *supra* note 135.

165. Regulation T is another name for the regulations found in 12 C.F.R. § 220 (2009).

> Regulation T (this part) is issued by the Board of Governors of the Federal Reserve System (the Board) pursuant to the Securities Exchange Act of 1934 (the Act) (15 U.S.C.78a et seq.). Its principal purpose is to regulate extensions of credit by brokers and dealers; it also covers related transactions within the Board's authority under the Act. It imposes, among other obligations, initial margin requirements and payment rules on certain securities transactions.

12 C.F.R. § 220.1 (2009).

166. *See supra* Part III.C.

167. *See* Rothbort, *supra* note 135.

1. Excessive Use of Credit to Purchase Securities

How leveraged ETFs contradict the first policy consideration, the prevention of the overuse of credit to purchase securities,[168] is not immediately obvious. The policy is grounded in the risk of committing too much of the nation's resources into the stock market and out of the hands of normal loan transactions.[169] Leveraged ETFs contradict this policy because the underlying mechanics of leveraged ETFs cause the same result as if numerous investors borrowed funds to generate leverage in the traditional sense. Thus, the funds absorb a large amount of resources that could be put to other productive uses.[170] As two employees of Barclays Global Investors stated, "[L]everaged returns cannot be created out of thin air . . . ."[171] Therefore, committing too much of the nation's resources to the stock market simply shifts the party committing the resources from the final investor up the chain to the leveraged ETF.

2. Protect Investors from Buying on Too Thin of Margin

During the enactment of the '34 Act, the chairman of the House Commerce Committee stated that "[a] reasonably high margin requirement is essential so that a person cannot get in the market on a shoe string one day and be one of the sheared lambs when he wakes up the next morning."[172] In other words, an investor should be protected from too much risk.

As indicated in the discussion thus far, leveraged ETFs have the same effects as investing on margin but lack many of the same safeguards.[173] Leveraged ETFs provide synthetic margin,[174] allow for "super margin" when purchased on margin themselves,[175] and even allow retirement accounts access to leverage previously unobtainable.[176] These characteristics, coupled with the investor's ability to purchase leveraged ETFs and gain a multiple of two or three times the normal returns of the underlying assets, demonstrate that leveraged ETFs allow everyday in-

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168. *See supra* Part III.B.

169. 7 LOSS & SELIGMAN, *supra* note 92.

170. *See* H.R. Rep. No. 73-1383, at 5 (1934) (The House was concerned about the use of credit to supply resources to the stock market and not to "local commerce, industry, and agriculture.").

171. Cheng & Madhavan, *supra* note 53, § 3.1. Leveraged ETFs generally rely on total return swaps, futures, or even trading on margin to create the leverage they promise. *Id.* Defining and discussing these types of complex derivative investments is beyond the scope of this Comment, but it is sufficient to state that these derivatives require actual loans or loan-like contracts that expose the leveraged ETF to margin risks.

172. 7 LOSS & SELIGMAN, *supra* note 92, at 3226.

173. *See supra* Part IV.B.1.

174. *See supra* Part IV.A.

175. *See supra* Part IV.C.

176. *See supra* Part IV.B.2.

vestors exposure to heightened risk.[177] This is precisely what the legislature aimed to avoid.

3. Protect Market Stability

Congress's third goal was to avoid excessive market fluctuations and stabilize the economy by use of margin rules.[178] The underlying assumption is that volatility increases with the untamed use of margin.[179] Margin rules protect this policy by limiting initial margin so that investors cannot impact market prices significantly more than their own buying power would allow.[180] In addition, maintenance margin requirements ensure that brokers can sell the collateral (stock) before the collateral is worth less than the loan given, thereby limiting the risk of lender volatility.[181] In order for leveraged ETFs to negatively impact this policy concern, however, they must substantially contribute to market volatility.

Leveraged ETFs have been accused of being a major driving force in market volatility, especially at the end of the trading day.[182] The most likely explanation is the rebalancing of leverage, which occurs at the end of the day. Leveraged ETFs rebalance their leverage so that they can reset and provide the desired leverage the following trading day. Rebalancing requires the purchase or sale of large amounts of shares.[183] The idea is that for a leveraged ETF to honor its multiple (e.g., 200%) return promised, it must buy or sell in the last few minutes of the day to realign its leverage scheme.[184] For example, if a leveraged ETF seeks a 200% return and has $100 million dollars of assets at the beginning of the day it must have started with market exposure of $200 million in order to achieve 200% leverage. If the fund then increases by $10 million during the day, it must increase its exposure to $220 million.[185] Therefore, $20 million of buy orders will be processed at the end of the day in order to readjust the leverage exposure to obtain the desired double return.

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177. *See* Eric Uhlfelder, *Do You Really Need All That Risk?*, BARRON'S, Oct. 12, 2009, at L10.

178. 7 LOSS & SELIGMAN, *supra* note 92, at 3228.

179. Roberta S. Karmel, *The Rashomon Effect in the After-The-Crash Studies*, 21 REV. SEC. & COMMODITIES REG. 101, 106 (1988), *available at* http://www.sec.gov/news/speech/1988/092188grundfest.pdf.

180. *See* 15 U.S.C. § 78g (2009).

181. *See* 5 HAZEN, *supra* note 70, § 14.9[1], n.7.

182. Zweig, *supra* note 63.

183. *Id.*

184. *Id.*

185. The increase to $220 million would be necessary because in order to achieve a 2-to-1 return, the amount of exposure the fund has must be double that of its assets. In this example the fund started with $100 million in assets so its exposure would need to be double that, or $200 million. After a return of $10 million the fund would have $110 million in assets and would need exposure of double that, or $220 million.

Although there is continuing debate about whether rebalancing at the end of the trading day drives market volatility,[186] the fact that two or three times the number of shares have to be purchased in order to maintain the leverage increases the power of leveraged ETFs to affect prices in the market.

Even if leveraged ETFs do not substantially contribute to market volatility due to releveraging, they do substantially contravene the other two policy grounds for the margin rules: (1) reducing excessive use of funds to buy securities so that funds are available for other areas of national growth and (2) protecting investors from losing too much too fast.[187] Additionally, leveraged ETFs serve substantially the same purpose and create substantially the same result as investing on margin.[188] Therefore, because leveraged ETFs look the same as investing on margin, act the same as investing on margin, and provoke the same policy concerns as investing on margin, they should not be allowed to skirt around laws designed to control and regulate leverage—i.e., margin rules.

V. PROPOSALS

Numerous solutions exists, some more drastic than others, for solving the problem of leveraged ETFs defying the margin rules.[189] Although prohibiting leveraged ETFs altogether would resolve concerns, this solution ignores the current large-scale use of leveraged ETFs and the possible benefits for sophisticated investors.[190] Instead, a balanced solution to align leveraged ETFs with the margin rules is appropriate.[191] As a result, multiple changes in combination should be instigated to create broad and effective change.[192]

First, the FRB should add leveraged ETFs to the list of non-marginable securities.[193] The problem of combining the embedded leve-

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186. *See supra* note 185.

187. *See supra* Part IV.D.1-2.

188. *See supra* Part IV.A.

189. *See* Rothbort, *supra* note 135.

190. *See* Uhlfelder, *supra* note 177 ("Leveraged ETFs are best left to professional investors who understand their nuances and are prepared to trade them daily." However, Mr. Uhlfelder goes on to opine that "futures, options and margin accounts are cheaper.").

191. *See* Rothbort, *supra* note 135; *see also* Cheng & Madhavan, *supra* note 53, § 5 (proposes better margin restrictions).

192. *See* Rothbort, *supra* note 135 (lists multiple changes to address the problems of leveraged ETFs flouting the margin rules); *see also* Tamar Frankel, *The New Financial Assets: Separating Ownership from Control*, 33 SEATTLE U. L. REV. 931, 953–60 (2010) (lists multiple suggestions to strengthen the regulation of derivative over-the-counter markets).

193. *Id.*; *see also* Regulation T, 12 C.F.R. § 220.11(f). The Federal Reserve Board has the ability to use its discretion to "omit or remove from the list of marginable OTC [over-the-counter]

rage in leveraged ETFs with the leverage created through margin[194] would be solved by simply barring leveraged ETFs from being purchased on margin. Six-to-one leverage would no longer be available.[195] Adding leveraged ETFs to the list of nonmarginable securities, however, does not stop retirement accounts from accessing leverage[196] and does not address many of the policy critiques noted in Part IV.D. Therefore, more needs to be done.

Second, IRAs should be barred from using leveraged ETFs.[197] This could easily be accomplished by requiring brokers to prohibit retirement accounts (like IRAs) from buying leveraged ETFs.[198] Because investing is trending dramatically toward the use of online computer trading systems,[199] the broker could presumably create a program tool to block retirement accounts from accessing trades for leveraged ETFs.[200] But, like the first alternative above, this solution only addresses some of the problems.[201]

Third, leveraged ETFs could be capped at 200% of the underlying asset group. Such a cap would effectively limit exposure to roughly the same leverage allowed by current margin rules, which allow 50% initial margin.[202] Capping the leverage ratio alone does not address the issues of super margin[203] and retirement account access to leverage.[204] Combined with the alternatives above, however, it would substantially reinforce the original policy goals of the margin rules.[205]

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stocks, . . . if in the judgment of the Board, such action is necessary or appropriate in the public interest." *Id.*

194. *See supra* Part IV.C.

195. *Id.*

196. *See supra* Part IV.B.2.

197. *See* Rothbort, *supra* note 135; *see supra* Part IV.B.2.

198. The FRB could modify Regulation T (12 C.F.R. § 220) to disallow the purchase of a leveraged security in a cash account designated as an "individual retirement account" as per 26 U.S.C. § 408(a) (2009). This could be accomplished through specifically modifying Regulation T, 12 C.F.R. § 220.8(a) (2009), which outlines the permissible transactions in a cash account.

199. *See* Daniel Trotta, *RPT-Small Investors Shun Big Brokers, Do It Themselves*, REUTERS, Jan. 22, 2009, http://www.reuters.com/article/idUSN2150549120090122.

200. *Cf. New Limits on Net Trades,* CNNMONEY, Feb. 2, 1999, http://money.cnn.com/1999/02/02/technology/online/ (discussing the limits that online brokers place on the number of internet stocks investors can buy on margin).

201. For example, restricting the purchase of leveraged ETFs with retirement account proceeds alone would not solve the problems with excessive risk and margin available to normal investors. *See supra* Part IV.A & C.

202. Rothbort, *supra* note 135.

203. *See supra* Part IV.C.

204. *See supra* Part IV.B.2.

205. *See supra* Part IV.D.1–3.

Fourth, investor eligibility requirements to invest in leveraged ETFs should be imposed.[206] These requirements could range from mandated training courses[207] to separate agreements with a brokerage firm in order to assure that investors acquire a general understanding of the risks.[208] Investors purchasing leveraged ETFs normally do not understand[209] or have access to the types of derivatives that these funds use to achieve their purposes; therefore, investors should be made aware of the complexity and risks involved before purchasing. In addition, by requiring additional action, investors uninterested in or insufficiently educated on the existence or workings of leveraged ETFs would be less likely to go through the steps required to gain access to leveraged ETFs. Just as the freedom of individuals to take risks and use their assets as they wish in a gambling setting requires reasonable regulation and limitation, access to leveraged ETFs demands more limitation as well.

Each of the proposed solutions herein possesses independent benefits. But collectively, the changes would bring effective solutions to the problems created by leverage going unchecked by the margin rules. Taking action to limit access to and use of leveraged ETFs reaffirms a commitment to the original policy considerations of the margin rules.

VI. CONCLUSION

Leveraged ETFs are prepackaged margin products that provide multiplied returns similar to investing on margin but without all the protections of the margin rules. The margin rules were adopted to protect investors, reduce the amount of resources injected in the stock market, and secure market stability. But leveraged ETFs are not regulated to ensure these policies are upheld. For example, although leveraged ETFs provide multiplied returns similar to investing on margin, they are not

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206. Rothbort, *supra* note 135. In FINRA Regulatory Notice 09-31, issued in June of 2009, FINRA emphasized the importance of understanding the terms and features of leveraged ETFs by the firms selling the products, which implies that if an investor is going to purchase a leveraged ETF without consultation he or she should also have a sound understanding of the terms and features. FINRA, REGULATORY NOTICE 09-31, *supra* note 15.

207. Many professionals in the investment community do not fully understand the features and potential consequences of leveraged ETFs, and investors have already shown that they do not understand the risks and features of the leveraged ETF outlined in the prospectuses filed with SEC for these funds. Cheng & Madhavan, *supra* note 53, §§ 1, 5. As such, Minder Cheng and Ananth Madhava suggest the following as possible solutions: "Better education, margin restrictions, and tighter requirements on investor eligibility are possible options regulators could consider." *Id.* at 23.

208. Before a margin account is available for use by an investor, the investor must sign an agreement with the broker-dealer and the broker-dealer must disclose the risk of investing on margin. 5 HAZEN, *supra* note 70. Therefore, because leveraged ETFs are analogous to investing on margin, it seems appropriate to require similar disclosures and agreements related to leveraged ETFs. *See id.* § 14.9[4]–[5].

209. *See* Cheng & Madhavan, *supra* note 53, § 5.

limited to the same leverage exposure as those investing on margin. Tax-advantaged retirement accounts are denied access to margin to safeguard against undue risk of retirement savings losses but are allowed to purchase leveraged ETFs that offer similar volatility, risk, and leverage. Furthermore, Congress limited initial margin to a 2-to-1 leverage ratio, but leveraged ETFs provide up to 3-to-1 leverage ratio and even higher when purchased on margin.

Access to and use of leveraged ETFs must be limited in order to retain the policies of the margin rules originating from lessons of the Great Depression and other financial disasters. By prohibiting leveraged ETFs from being purchased on margin, from being available through retirement accounts, from being offered at more than a 2-to-1 leverage ratio, and from being purchased without prior knowledge of the complexity and risks involved, investors, the market, and the economy will be stronger and safer.