

Statement

Statement on Single-Stock ETFs



Commissioner Caroline A. Crenshaw

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Last year, Commissioner Lee and I called for improvements to the regulatory framework for complex exchange-traded products to address concerns about investor protection and potential risks to the financial system.^[1] A new type of complex product will arrive on the market shortly: so-called “single-stock ETFs.”

These newly engineered offerings provide leveraged, inverse or other complex exposure to one single security rather than the typical portfolio of multiple, more diversified securities. While I have expressed concern about leveraged and inverse ETFs before, I worry that these single-stock ETFs pose yet another, perhaps greater, risk for investors and the markets.

In 2019, the Commission adopted Rule 6c-11 under the Investment Company Act of 1940.^[2] In combination with changes to the listing standards at stock exchanges, that rule created a framework that allowed exchange-traded funds (ETFs) meeting certain criteria to come directly to market without first obtaining permission, through what is called an exemptive order, from the SEC.^[3]

Nowhere in Rule 6c-11 is there a discussion of single-stock ETFs; there is no indication that the rule contemplated such products. However, single-stock ETFs are nonetheless coming to market under the auspices of that rule. And, in addition to presenting a high level of risk by virtue of their leveraged and inverse exposure to a single stock, these ETFs^[4] rebalance on a daily basis, like most existing leveraged and inverse ETFs. The daily rebalancing and effects of compounding may cause returns to diverge quite substantially from the performance of the, in this case, *one* underlying stock, especially if these products are held over multiple days or more.^[5]

In other words, investors’ returns over a longer period of time might be significantly lower than they would expect based on the performance of the underlying stock. These effects are likely to be especially pronounced in volatile markets. And as Commissioner Lee and I previously noted, in addition to presenting significant investor protection issues,^[6] in periods of market stress or volatility, leveraged and inverse products can act in unexpected ways and potentially contribute to broader systemic risks.^[7]

Because of the features of these products and their associated risks, it would likely be challenging for an investment professional to recommend such a product to a retail investor while also honoring his or her fiduciary obligations or obligations under Regulation Best Interest.^[8] However, retail investors can and do access leveraged and inverse exchange-traded products through self-directed trading. While investors can gain similar upside and downside exposures to an equity security through the use of options and other derivatives, single-stock ETFs are likely to be uniquely accessible and convenient for self-directed retail investors, in particular.

As I have noted before, a comprehensive and consistent approach to the review of complex exchange-traded products is long overdue. I appreciate that the Chair has expressed a willingness to work on these issues,^[9] and I am encouraged by the steps FINRA has taken toward updating its complex products framework.^[10]

However, I am disappointed that, months after Commissioner Lee and I called for improvements to the rules for complex exchange-traded products, we have not updated our regulatory framework to better address the risks these products pose to investors and the markets. Further, with respect to single-stock ETFs in particular, I am disappointed that the Commission has thus far failed to make use of the tools it does have, such as rulemaking under the Investment Company Act of 1940 and/or the Securities Exchange Act of 1934, to grapple with the question of whether these products are appropriate in the public interest and consistent with the protection of investors. I strongly encourage my colleagues to consider rulemaking in this case.

As with other complex exchange-traded products, single-stock ETFs may be useful to certain investors who understand their unique features. However, they are risky products for investors and potentially for the markets, as well. The arrival and proliferation of these products on the market underscores the importance of addressing the investor protection concerns and market risks that these and other exchange-traded products can entail.

[1] Commissioner Allison Herren Lee and Commissioner Caroline Crenshaw, [Statement on Complex Exchange-Traded Products](#) (Oct. 4, 2021).

[2] [Exchange-Traded Funds](#), Release Nos. 33-10695; IC-33646 (December 23, 2019). See also [Use of Derivatives by Registered Investment Companies and Business Development Companies](#), Release No. IC-34084, (Oct. 28, 2020) (amending Rule 6c-11 to allow leveraged and inverse ETFs that satisfy the rule's conditions to operate without an exemptive order).

[3] [Exchange-Traded Funds](#), Release Nos. 33-10695; IC-33646 (December 23, 2019). Prior to the passage of Rule 6c-11, exchange-traded funds had to meet certain listing criteria established by rules at the relevant exchanges. Single-stock ETFs would not have satisfied the criteria established by those rules, and therefore could not have come directly to market. However, after the passage of Rule 6c-11, the exchanges established generic listing standards for ETFs that are permitted to operate in reliance on Rule 6c-11. See, e.g., [NYSE Arca, Inc.; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 2, to Adopt NYSE Arca Rule 5.2-E\(j\)\(8\) Governing the Listing and Trading of Exchange Traded Fund Shares](#), Release No. 34-88625 (April 13, 2020). Other exchanges made similar rule changes. Speaking generally, many complex products do not qualify for listing under exchanges' generic listing rules. Rather, depending on the product, the listing exchange may be required to adopt a specific listing rule for the relevant product, which requires Commission approval. This process gives the Commission and the public an opportunity to evaluate, among other things, the product and its likely impact on investors and the markets. The Commission then must approve the proposed rule change if it finds after the period of notice and comment that it is consistent with the applicable requirements of the Exchange Act, and it must disapprove the filing if it does not make such a finding. See, e.g., [Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, to List and Trade Shares of Grayscale Bitcoin Trust under NYSE Arca Rule 8.201-E \(Commodity-Based Trust Shares\)](#), Release No. 34-95180 (June 29, 2022). In contrast, products qualifying as "exchange-traded funds" under Commission Rule 6c-11 automatically qualify for listing under exchanges' generic listing rules—without a corresponding opportunity for public notice and comment—despite the fact that leveraged and inverse products qualifying under that rule may present many of the same risks to investors and the markets. In other words, because of the operation of Rule 6c-11, these single-stock ETF products can come to market without any specific Commission vote or approval, and without public notice and comment.

[4] Single-stock ETFs have been introduced in certain other jurisdictions. However, those jurisdictions have different regulatory frameworks and markets.

[5] See Office of Investor Education and Advocacy, [Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors](#) (Aug. 1, 2009). The Commission's Office of Investor Education and Advocacy has received complaints from investors expressing concerns that, while certain leveraged/inverse products may have operated in accordance with their terms, the pricing and trading dynamics of these products during periods of market volatility was not consistent with investor expectations.

[6] Commissioner Allison Herren Lee and Commissioner Caroline Crenshaw, [Statement on Complex Exchange-Traded Products](#) (Oct. 4, 2021) (describing investor protection concerns). See also Jay Clayton, Dalia Blass, William Hinman, Brett Redfearn, Joint Statement Regarding Complex Financial Products and Retail Investors (October 28, 2020) (“[L]everaged/inverse products and other complex products may present investor protection issues—particularly for retail investors who may not fully appreciate the particular characteristics or risks of such investments, including the risks that holding such products may pose to their investment goals.”)

[7] See, e.g., Luke Kawa, Bloomberg, [The Day The VIX Doubled: Tales of “Volmageddon”](#) (Feb. 6, 2019).

[8] As the Commission stated at the time of Regulation Best Interest’s adoption, leveraged and inverse exchange-traded products are “highly complex financial instruments” and the fact that they reset daily means such products are unlikely to be “suitable for, and as a consequence also not in the best interest of, retail customers who plan to hold them for longer than one trading session, particularly in volatile markets.”

[Regulation Best Interest: The Broker-Dealer Standard of Conduct](#), Release No. 34-86031 (June 5, 2019) at 263-264. The Commission explained further that these products are unlikely to be in the best interest of a retail investor absent an identified, short-term, customer-specific trading objective. Id. at 264.

[9] Chair Gary Gensler, [Statement on Complex Exchange-Traded Products](#) (Oct. 4, 2021).

[10] See FINRA, [Regulatory Notice 22-08: FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements](#) (Mar. 8, 2022).