HARVEST
Transparent Investment Valuations

August 18, 2015

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609
Transmitted via email: rule-comments@sec.gov

Re. SEC Request for Public Comment
on Exchange Traded Products (ETP)
File S7-11-15

Dear Members of the Securities and Exchange Commission:

Thank you for the opportunity to comment on the SEC Request for Public Comment on Exchange Traded Products (ETP), File number S7-08-15. Harvest Investments, Ltd. welcomes the Commission's efforts to improve portfolio transparency in order to maintain stability within this important sector of the financial system. In what follows, we first outline our understanding of the Commission's Request and its context, addressing the interplay of regulatory strategy/approach and investor aims/behavior. Then, we turn directly to issues of valuation and the informational environments within which it circulates, relying as we do so on our expertise and experience as an independent securities valuation specialist.

The Commission's request for comment poses important questions on two key topics: first, the nature of the ETP approval process and the regulatory space resulting from it; second, whether broker-dealers are adequately informing investors of the risks that attend involvement in ETPs. On both counts, the present Request for Public Comment can profitably be read alongside Commissioner Kara Stein's June, 2015 speech "Mutual Funds: The Next 75 Years."[1] Stein situates the rise of ETPs historically in the context of the Investment Act of 1940 and argues for the importance of revisiting the Act in order to modernize it. She also outlines significant social risks posed by certain mutual funds and ETFs[2] because of the large numbers of retail investors, particularly retirees, who have invested in them. The low fees and tax advantages of ETPs appeal to such investors, who are seeking higher yields in a difficult market. Stein's profile of investor demographics underscores the high stakes involved with the Commission's general efforts to update and revise the rules governing ETPs. As a securities valuation specialist, we are particularly concerned here with underlying portfolio valuation, especially when complex securities are significantly involved. Accurate reporting of portfolio valuation is basic to achieving transparency

[1] Kara Stein,"Mutual Funds, the Next 75 Years," speech delivered at Brookings (6/15/15): https://www.sec.gov/news/speech/mutual-funds-the-next-75-years-stein.html

[2] In what follows, we will generally use the general designation "ETP" unless we are referring to a document that specifically uses "ETF"

for regulators, asset managers, and investors, and it resonates across both key topics addressed in the Commission's Request.

As with the Commission's Request for Public Comment on the proposed modernization of financial reporting for alternative mutual funds and ETFs (File S7-08-15), questions of portfolio valuation are addressed tangentially in S7-11-15 even though they are basic to the operation of ETPs. In its proposal for Form N-PORT, the Commission assumed that financial reporting conformed to the guidance provided in ASC 820.[3] This assumption appeared largely consequent to the explicit priority given to the collection and standardization of large amounts of data. Within the present Request, however, the lack of attention to valuation of the underlying portfolios seems to mirror tendencies that are also evident in much of the academic literature on ETPs, in which ETPs are treated as closed systems. This literature generally proceeds in one of three main directions: 1) testing whether or not ETPs perform as they claim to (in other words, compiling and assessing data on variances between share prices and NAV); 2) assigning various functions to ETPs (such as price discovery); or 3) defining effects of ETP activity (e.g., price volatility in the underlying assets triggered through arbitrage activity). What these approaches have in common is the recapitulation within the analysis of an internal perspective on these entities:[4] profit is made through the arbitrage of shares based on the NAV of an underlying portfolio of securities, and the underlying or reference portfolio is just that. Even so, some academic literature has lately shifted away from this type of internally-oriented approach to consider ETP vulnerabilities to general market turbulence.[5] Many recent commentators point to the heavy involvement of retail investors with ETFs as a particular problem because as a group, they appear inclined to head for the door in periods of market turbulence.[6] This concern

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[3] Harvest took issue with that assumption in its comments on S7-08-15, pointing out significant problems with input calculations and also issues of variance: see https://www.sec.gov/comments/s7-08-15/s70815-281.pdf

[4] See Commissioner Michael Piwowar, "Remarks at the 2015 Mutual Funds and Investment Management Conference" (3/16/15) http://www.sec.gov/news/speech/031615-spch-cmsp.html. The central arguments in Commissioner Piwowar's talk reference Ivan T. Ivanov and Stephen L. Lenkey, "Are Concerns About Leveraged ETFs Overblown?", Federal Reserve Working Paper 2014-106 (Nov. 19, 2014), available at http://www.federalreserve.gov/econresdata/feds/2014/files/2014106pap.pdf. This paper illustrates the approach indicated above: it separates ETFs from their underlying portfolios and any valuation problems, and focuses on the mechanisms that constitute ETFs; it concludes that these mechanisms do what they're supposed to do. For a survey of academic literature on ETFs through 2012 that discriminates between the approaches noted above, see Narat Charupat Peter Miu, (2013),"Recent developments in exchange-traded fund literature" in *Managerial Finance*, Vol. 39 no. 5 pp. 427 – 443.

[5] See for example: Ben-David, Franzoni & Moussawi, "ETFs Arbitrage & Contagion" LSE PWC Conference Presentation, June 2012 http://www.lse.ac.uk/fmg/events/conferences/past-conferences/2012/PWC-Conference_7-8June/Papers-and-slides/Francesco_Franzoni_paper.pdf; Bae, Kang & Wang, "The Costs of ETF Membership: Valuation Effect of ETFs on Underlying Firms" Conference Presentation, August 2012 http://www.apjfs.org/conference/2012/cafmFile/3-2.pdf; Ben-David et al, "ETFs, Arbitrage, and Shock Propagation" (September 2012) http://www.mfsociety.org/modules/modDashboard/uploadFiles/conferences/MC20~142~p17eag52oj1ue4p203rknkv18s4.pdf.

[6] This is a recurrent theme in warnings for heavy-hitter investors about the "illusion of liquidity" that ETFs generate. See for example, with reference to the wave of concerns about illiquidity in the bond market, Howard Marks' Oaktree Newsletter reproduced in Zerohedge on 3/26/2015: "What Would Happen is ETF Holders All Sold At Once: Howard Marks Explains" http://www.zerohedge.com/news/2015-03-26/what-would-happen-if-etf-holders-sold-all-once-howard-marks-explains. See also coverage of the confrontation between Carl Icahn and Blackrock's Larry Fink, such as this WSJ piece from 7/15/2015: http://www.wsj.com/articles/icahn-flips-script-on-blackrocks-fink-a-longtime-critic-1437002297.

dovetails with the approach to systemic risk developed by Feroli et al in a recent working paper that takes "market tantrums" as its point of departure and poses the question of whether previous work on systemic risk has over-emphasized the role of leverage (an endogenous factor) at the expense of considering the behaviors of different types of investors and the impact of high-frequency trading.[7]

Our general unease regarding the neglect of valuation with respect to reference portfolios runs parallel to the shift in analytic literature away from exclusive focus on the interior workings of ETPs.[8] As we mentioned above, it seems that the Commission is assuming that reference portfolios are being valued in conformity with the guidance provided in ASC 820 on pricing and fair value leveling. We believe this assumption to be mistaken, since we observe frequent nonconformity with the guidance provided by ASC 820 as well as substantial variances.[9] Accordingly, we caution the Commission against a neglect of valuation issues with respect to the underlying portfolios.

Our concerns about valuation relate to the Commission's Questions 16 and 17, which take up the basic machinery of the ETP and its functionality under conditions of market stress and disruption. Matrix pricing services are a key element within that machinery: without them, the arbitrage mechanisms and the calculation of NAV would be impossible. In line with our claim that both leveling and ASC 820 compliance remain problematic, however, we respectfully draw the Commission's attention to three interrelated issues of valuation that we believe should be addressed: 1) reliance on matrix pricing and its limitations; 2) the lack of transparency regarding the underlying portfolio constitution; 3) the derivative structure that is built into the ETP model.

The systemic weaknesses associated with dependence on proprietary matrix pricing services became clear in the recent financial crisis, when inaccurate but nevertheless rapidly relayed pricing and valuation information contributed to exposing investors to enormous risks. The opacity of underlying portfolios served further to obscure the actual extent of the risk exposure until it was simply too late. With investor participation in the market having risen exponentially over the past thirty years, far more people are now exposed to far more risks. When returns remain steady and markets are reasonably calm, a tendency simply to trust that underlying assets are being competently

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[7] Feroli, Kashyap, Schoenholz and Shin, "Market Tantrums and Monetary Policy" Chicago Booth Research Paper 14-09 available here: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2409092

[8] This sense of unease is hardly diminished by the cavalier treatment that valuation has received, for example, in coverage of the SEC's actions against Pimco. In a Financial Times piece on this matter from last year (Chris Flood, "Media is 'Making a Meal' of SEC's investigation into Pimco ETF" *Financial Times*, 5 October 2014 http://www.ft.com/intl/cms/s/0/e5bbf464-48b3-11e4-9f63-00144feab7de.html#axzz3j7FRx7EX), the following points were made:

> If illiquid conditions meant that transaction-based prices were not readily available, then the ETF's prospectus allowed Pimco to mark the bond holdings "at fair value". Paul Amery, a longstanding ETF industry commentator, says: "This practice may strike outside observers as lax, but it is how the mutual fund business has long worked." Peter Sleep, a senior portfolio manager at 7IM, who uses both ETFs and index trackers, says odd lots tend to transact at discounts to large deal sizes and that accurate bond prices can be difficult to ascertain due to the limited liquidity of some parts of the fixed income market. "It is like trying to trade a second-hand car. Pricing is not always as clear as you might like," he says.

Harvest makes no claims regarding the specifics of this case, but we would like to point out that valuation, while challenging, is hardly as arbitrary a process as it might seem from this quote. Subjective aspects and/or unobservable inputs do not equal arbitrariness, but rather interpretive and methodological challenges, as is made plain within the relevant guidance on leveling.

[9] For more, please see https://www.sec.gov/comments/s7-08-15/s70815-281.pdf

evaluated and managed is perhaps understandable. But it is important to underscore that such a perception is far more dependent on context and happenstance than it is on a clear understanding of the constitution of the portfolios that underlie ETPs. Matrix pricing, as essential as it may be for ETP structure, simply does not and cannot accurately value complex and/or illiquid securities. In addition, both the inputs and methods of such pricing systems are proprietary, which means that investors who look at underlying portfolio valuations have no idea of the quality of the inputs, the methods used to construct prices, or the accuracy of the fair value leveling.[10] Consequently, one of the main sources of information for assessment of position and risk is therefore unreliable at best; at worst, we think it would contribute to a significant escalation in systemic risk.

This situation obtains in part because of the sheer size and diversity of the underlying holdings, and its problematic aspects are compounded by the way ETPs operate: NAV is struck and moves throughout the day based on market interest and other factors, regardless of any market conditions that might affect the underlying assets. For example, in the current and somewhat anomalous low interest rate environment, an underlying portfolio might include significant numbers of bond securities. One can imagine positions assuming that the values of these assets will move with the market, even as that market has been and remains stagnant; however, current asset valuations do not necessarily reflect this, and shares can move opposite to what one would expect, were the identity of the underlying securities made clear. At the same time, accurate valuation of these assets would complicate aligning NAV with expectations. The result is a low information environment in which low information investors (who may not understand themselves as such) are heavily invested in pursuit of higher returns. Significant market stress could abruptly reveal the magnitude of the problem if a redemption run is triggered. Referring again to Commissioner Stein's characterization of retirees as the retail investor demographic most involved with ETPs, the consequences of such a run could be both socially and politically detrimental.

We would also like to call the Commission's attention to the ways in which ETPs operate like derivatives: their value is dependent on complex underlying portfolios, shares of which are traded as if they were equities. These portfolios may be fixed-income, in which case one is confronting a case of mismatched assets. In other words, and despite the present scale of investment in ETPs, these are not "plain vanilla" securities but complex, risk-laden instruments, whose composition renders them challenging to value. The three interrelated issues of valuation we have just outlined indicate that regulation of ETPs should be approached with proper attention to the accuracy of valuation information as transmitted via the ETP structure. Investor confidence in these products at present reflects a certain faith that the underlying assets are being correctly managed; nevertheless, both the management and valuation of the underlying assets remains opaque.

By linking the Commission's Request for Comments to the basic situation outlined in Kara Stein's speech, we hoped to underscore the Janus-faced nature of the dilemma the Commission faces. Commissioner Stein argues that the social risks entailed by the large numbers of retail investors is contextually driven, shaped by problems of retirement benefits and pension funds. These contexts are in turn shaped by others, as suggested by the Bank of International Settlements recent annual

[10] By contrast, Harvest applies a consistent, documented approach, so that all inputs as well as the reasoning behind all inputs are clearly available to our clients for review. In this way, our methods and results constitute an open rather than proprietary book, with clear documentation of and rationale for each input.

report.[11] A redemption run would negatively affect many of these investors. The Commission attempts to address this social risk - along with the systemic risks that follow from heavy involvement of low-information retail investors - by asking whether broker-dealers are relaying adequate information to investors about the risks involved with ETPs. In doing so, the Commission uses its regulatory reach to confront a situation that is both internal and external to it. The Commission's concern about broker-dealer activities and what might be done to improve them in order to protect investors is interior to its regulatory space. But the main problems remain social (i.e., the composition of the retail investor demographic and the conditions that have made ETPs attractive to that demographic) and as such involve macroprudential considerations that are largely external to the Commission's institutional and/or regulatory space.

We regard the lack of attention to the correct valuation of ETP underlying portfolios as contributing to an unnecessarily low-information environment, one that significantly increases risks for investors not least because the normal operation of ETPs obscures both the presence and the implications of the problem. We do not believe that investors are aware that matrix pricing does not work with illiquid securities (Question 49). We also do not think that investors are aware that asset mismatches are characteristic of how ETPs operate (Question 45), or that they think about ETPs themselves as a type of derivative (Question 48). In short, the radical expansion of ETPs over the past decade and their availability for retail investors has expanded the pool of low-information investors who are at risk, often without knowing it. A reasonable response to this problem is to increase transparency. But the category of "transparency" entails more than one outcome, since it is always a question of transparency for whom. For the Commission, transparency is defined through regulation and procedures. Financial reporting by market participants is done with respect to those definitions and procedures and is therefore SEC-facing. It is not obvious how much of that reporting retail investors are in a position to decipher or to use effectively in evaluating their exposure to risk, especially if they lack specialized knowledge. Because of the trust placed in the sources of that reporting, it is even less likely that these same retail investors will be able to recognize inadequacies in the data reported and draw from that the appropriate conclusions.

We are far from alone in raising these issues.[12] Risks that attend the heavy involvement of low-information investors include exacerbated tendencies to herding that can result under conditions of market turbulence in redemption runs.[13] The redemption run would entail fire sales of assets that

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[11] This echoes central points made in the Bank of International Settlements Annual Report released on June 25, 2015 (available here: http://www.bis.org/publ/arpdf/ar2015e.htm). BIS warns that an unprecedented period of very low interest rates may produce anomalous situations in which investors will be willing to take on considerable risks in the search for higher yields in a context shaped by outmoded policy logics and inadequate attention to macroprudential considerations.

[12] On the massive expansion of mutual funds broadly construed and an analysis of the types of systemic risk that follow from scale, see IMF's April, 2015 "Global Financial Stability Report, Chapter 3: Asset Management Industry and Financial Stability" http://www.imf.org/External/Pubs/FT/GFSR/2015/01/index.htm. See also Douglas Elliot, "Systemic Risk and the Asset Management Industry." Economic Studies at Brookings, Brookings Institution, Washington http://www.brookings.edu/~/media/research/files/papers/2014/05/systemic%20risk%20asset%20management%20elliott/systemic_risk_asset_management_elliott.pdf and Office of Financial Research's September 2013 report "Asset Management Industry and Financial Stability" http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf.

[13] On this, see Feroli et al, "Market Tantrums and Monetary Policy," *op cit.*

would be particularly damaging for investors whose holdings included ETPs heavily involved with securities that were illiquid at the time. The scale on which this could possibly happen would transmit this shock across the market. So while we applaud the Commission's efforts to increase stability and mitigate systemic and social risks by focusing on the question of whether broker-dealers are providing retail investors with adequate information about the risks involved with ETPs, we wonder whether the problems of having multitudes of low-information investors operating in a low-information environment is one that Commission itself can fully address, because it seems a macroprudential matter that may require strategies formulated on a proactive rather than reactive basis.

Even so, we recommend that the Commission resist treating ETPs as closed systems, and directly address the complex valuation issues presented by them. One possible strategy would be the inclusion of a requirement that pricing and valuation periodically be undertaken outside of the exclusive fame of the matrix pricing services, so that a greater degree of transparency and accuracy would begin to circulate regarding these funds. We recognize that the sheer size and diversity of the underlying holdings presents significant challenges for accurate valuation. Even so, we strongly recommend that the Commission consider incorporating measures that would more critically assess the positions held within and the valuation of ETP underlying portfolios, so that the assumption of trustworthiness and the pursuit of profits do not conspire to expose vast numbers of investors to significant risks.

We appreciate this opportunity to comment on the Commission's proposal, as well as its attention to our arguments and concerns. If the Commission would be interested in discussing any of our points in more detail, we are at its disposal: please contact Susan DuRoss at 312-823-7051.

With best regards,

Harvest Investments, Ltd.