MEMORANDUM

To: File No. S7-15-18

From: Joel Cavanaugh
Division of Investment Management

Date: April 11, 2019

Re: Meeting with Representatives of Innovator Capital Management, LLC

On April 11 2019, representatives of the Securities and Exchange Commission ("SEC") participated in a meeting with representatives of Innovator Capital Management, LLC ("Innovator"). The SEC representatives present in-person were Sarah ten Siethoff, David Bartels, Brian Johnson, Melissa Gainor, Jacob Krawitz, Daniele Marchesani, Kay-Mario Vobis, Joel Cavanaugh, Kimberly Browning, and Alexander Schiller. The Innovator representatives present in-person were Bruce Bond and John Southard of Innovator, and Morrison Warren, Barry Pershkow, and Walter Draney of Chapman and Cutler.

The participants discussed, among other things, the SEC's proposal relating to exchange-traded funds.

Information provided by Innovator in connection with this meeting is set forth in Annex A.

Annex A

INNOVATOR
exchange-traded funds

Innovator Capital Management, LLC

DISCUSSION WITH THE STAFF OF THE SECURITIES AND EXCHANGE COMMISSION REGARDING PROPOSED RULE 6C-11 UNDER THE INVESTMENT COMPANY ACT OF 1940

April 11, 2019

Proposed Rule 6c-11(c)(4)

- Rule 6c-11 would "permit ETFs that satisfy certain conditions to operate without the expense and delay of obtaining an exemptive order."
- One condition is set forth in proposed Rule 6c-11(c)(4):

  "The [ETF] may not seek, directly or indirectly, to provide returns that exceed the performance of a market index by a specified multiple, or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time."

Proposed Change to Rule 6c-11(c)(4)

- Innovator Capital Management, LLC ("*Innovator*") advocates for the following revision to Rule 6c-11(c)(4):

  "The [ETF] may not seek, directly or indirectly, to provide returns that exceed the performance of a market index by a specified multiple, or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time **<u>of less than one year</u>**."

The History of the Leveraged ETF Moratorium

- **2008 –** Informally, the Staff adopts the position that it would not recommend that the Commission approve leveraged/inverse ETF ("*Leveraged ETF*") exemptive applications.
- **2010 –** The Commission issues a press release stating that it would be deferring consideration of exemptive requests for funds that would make significant use of derivatives, including actively managed and Leveraged ETFs.
- **2011 –** The Commission issues a derivatives concept release.
- **2012 –** Norm Champ, in a speech at the 2012 ALI CLE Conference, announces that the SEC is lifting the moratorium on actively managed ETFs that use derivatives but maintaining Leveraged ETF application moratorium "because of concerns regarding Leveraged ETFs…."

Underlying Concerns Regarding Leveraged ETF Moratorium

- The specific concerns underlying the moratorium were never publicly articulated by the Commission or its staff, until Rule 6c-11 was proposed.
- In the Proposing Release for Rule 6c-11, the Commission noted that:

> "[A Leveraged ETF] also typically seeks to deliver the targeted return over a *short period of time, such as a day*. This means that investors holding shares over periods longer than that the targeted period may experience performance that is different, and at some times substantially different, from the target returns… The strategy that [Leveraged ETFs] pursue requires them to rebalance their portfolios on a daily basis in order to maintain a constant leverage ratio."

Underlying Concerns Regarding Leveraged ETF Moratorium

- The Commission further noted that:

  "This daily reset, and the effects of compounding, can result in performance that differs significantly from some investors' expectations of how index investing generally works. This effect can be more pronounced in volatile markets. As a result, buy-and-hold investors in a Leveraged ETF with an intermediate or long-term time horizon—who may not evaluate their portfolios frequently—may experience large and unexpected losses."

- Thus, the underlying concerns of permitting additional Leveraged ETF entrants appear to be:

  1. the effect of compounding on leveraged returns; and
  2. the perceived inability of retail, buy and hold investors to understand these related fund performance erosion characteristics and risks.

Underlying Concerns Not Present in ETFs with Long Reset Periods

- Innovator is not seeking to dispute these concerns, but rather to suggest that they are inapplicable to ETFs with outcome periods of one year or greater.
- Innovator's suggested revision to Rule 6c-11(c)(4) maintains codification of the moratorium on those ETFs with characteristics causing concern: ETFs with single-day or short reset periods.

Compounding Concern — Not Present

- To maintain their leveraged investment objectives, Leveraged ETFs rebalance their exposure to their benchmark each day by adding to, or subtracting from, their positions. When fund shares are held beyond the single-day reset period, the laws of compounding can cause the investor's performance experience to deviate from that which the investor might expect. It is thus very possible (particularly in volatile markets) that an investor will have an unexpected outcome over any extended period of time despite the Leveraged ETF meeting its objective each day.

Compounding Concern — Not Present

- While it is intuitive that a Leveraged ETF that rebalances annually versus daily will not experience compounding on an intra-year basis, academics have essentially made that point by examining the effect that the length of time between rebalances has on a Leveraged ETFs tracking error.[1]
- They found the following:
  - "In general, longer times between rebalances decreases the ETF's tracking error to the underlying index [on a leveraged basis]."

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1. Tim Dulaney, Tim Husson, and Craig McCann, *Leveraged, Inverse, and Futures-Based ETFs*, Vol. 19, PIABA Bar Journal, No. 1 (2012) (available at https://ssrn.com/abstract=2163122).

Compounding Concern — Not Present

- ETFs that utilize outcome periods of at least one year, will not expose investors to the detriments of daily or other short-term compounding. The returns received will match the return of the annual (or greater) outcome period. We believe that when fund rebalances occur no more frequently than annually, the impact of compounding is significantly diminished, if not completely eliminated.

Investor Expectation Concerns — Not Present

- While critiquing Leveraged ETFs, both the Proposing Release and FINRA Regulatory Notice 09-31 specifically articulate concerns as they relate to the expectations of the "buy-and-hold" investor.
- *Proposing Release Release* (pg. 30)
  - "As a result, buy-and-hold investors in a leveraged ETF with an intermediate or long-term time horizon—who may not evaluate their portfolios frequently—may experience large and unexpected losses."
- *FINRA Regulatory Notice 09-31* (pg. 3)
  - "While the customer-specific suitability analysis depends on the investor's particular circumstances, inverse and leveraged ETFs typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets."

Investor Expectation Concerns — Not Present

- ETFs with longer reset periods are *specifically designed* to be purchased by all types of investors, including buy-and-hold investors. They are designed to provide outcomes for shareholders who hold shares of the ETF for an entire year.
- Unlike regular Leveraged ETFs in the market, an investor in an ETF with a yearly reset period are not likely to be be surprised by performance results over periods longer than the daily reset period.

Summary

- In setting the condition outlined in (c)(4), the Commission expanded the nature of the Leveraged ETF moratorium, from one that contemplated Leveraged ETFs with single day or short rebalance periods to one that applied to Leveraged ETFs with nearly infinite rebalance periods.

- While the Commission requested comment on the topic (e.g., Does the Proposed Rule's use of "a fixed period of time" effectively describe the daily reset mechanism in leveraged ETFs? Are there other descriptions we should use?), the Commission offered no data and engaged in no statistical or economic analysis supporting a nearly infinite period.

- We believe that a rebalancing period set at less than one year is more than adequate to ensure that the Leveraged ETF moratorium captures only those funds that exhibit the performance characteristics that gave rise to the concerns underlying the moratorium in the first place.

How Innovator ETFs Would Utilize Longer Reset Periods

- Innovator Capital Management, LLC serves as the investment adviser to the suite of Defined Outcome ETFs comprising the Innovator ETFs Trust.
- Defined Outcome ETFs are funds that utilize an option strategy designed to produce predetermined investment outcomes over a fixed time period of one-year based upon the performance of a benchmark index.
  - Innovator ETFs Trust has launched twelve series that each allows shareholders to participate in any gains experienced by the S&P 500 over the course of the one-year period, up to a cap, and a pre-determined buffer (9%, 15%, 30%) against S&P 500 losses experienced during the period.

How Innovator ETFs Would Utilize Longer Reset Periods

- Using the same principles, Innovator has designed strategies that, over at least a one-year time period (meaning that the fund's exposure to the index would reset only once a year), would allow shareholders to experience gains exceeding those experienced by a multiple of an underlying benchmark, up to a cap, over a one-year time period.
  - Such funds are currently being offered to retail investors in mutual funds[2] and in structured notes.
  - Innovator currently contemplates two strategies that would utilize reset periods of one year:
    - ETFs that allow investors to participate in 3x the upside (up to a cap) of any S&P 500 gains while maintaining 1-to-1 exposure to any S&P 500 losses, over the one-year period.
    - ETFs that allow investors to participate in 2x the upside (up to a cap) of any S&P 500 gains and providing a buffer against 10% of S&P 500 losses, over the one-year period.
  - Illustrations of how these ETFs can be expected to perform in various market conditions are included in future slides.

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2. *Please see* Cboe Vest S&P 500 Enhanced Growth Strategy Fund and Catalyst/Exceed Defined Risk Fund.

How Innovator ETFs Would Utilize Longer Reset Periods

- If Rule 6c-11 is approved as currently drafted, these contemplated funds cannot be brought in an ETF without additional exemptive relief as they do not comply with the condition set forth in Rule 6c-11(c)(4):
  - "The [ETF] may not seek, directly or indirectly, to provide returns that exceed the performance of a market index by a specified multiple, or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time"
- Innovator contends that this condition is overly broad as it includes funds that do not pose the risks contemplated by the SEC in the drafting of the ETF Rule and imposition of the moratorium on Leveraged ETF exemptive relief.

Return Experience – Innovator S&P 500 Power Buffer ETF –July

AUGUST 7, 2018 (INCEPTION) THROUGH DECEMBER 31, 2018

Range 08/07/2018 - 12/31/2018 Period Daily No. of Period 146 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	PJUL US Equity	USD	-4.84%	-4.84%	7.46%	-11.68%
2)	SPX Index	USD	-12.30%	-12.30%	--	-27.97%
3)						
4)						
5)						
6)						

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y

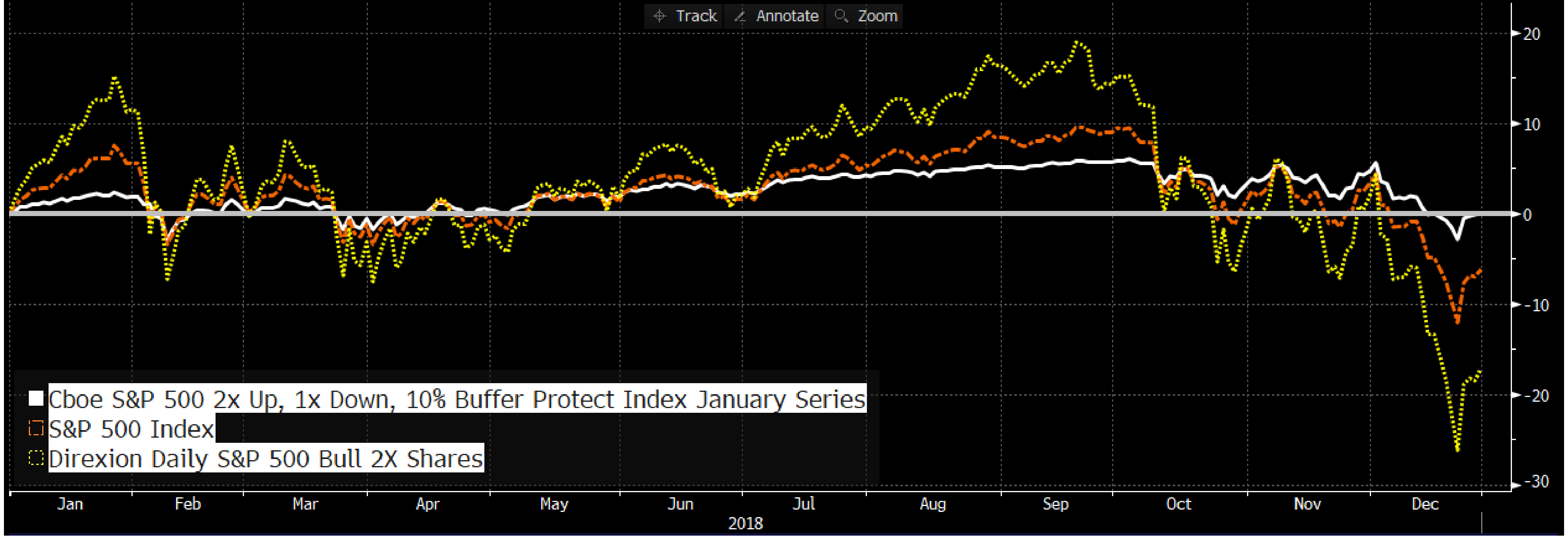
Return Experience – Innovator 2x Up, 10% Buffer vs. 2x Leveraged ETF

DECEMBER 29, 2017 THROUGH DECEMBER 31, 2018

Range 12/29/2017 - 12/31/2018 Period Daily No. of Period 367 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SPEB-01 Index	USD	.00%	.00%	6.24%	.00%
2)	SPX Index	USD	-6.24%	-6.24%	--	-6.20%
3)	SPUU US Equity	USD	-17.12%	-17.12%	-10.88%	-17.03%
4)						
5)						
6)						

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y



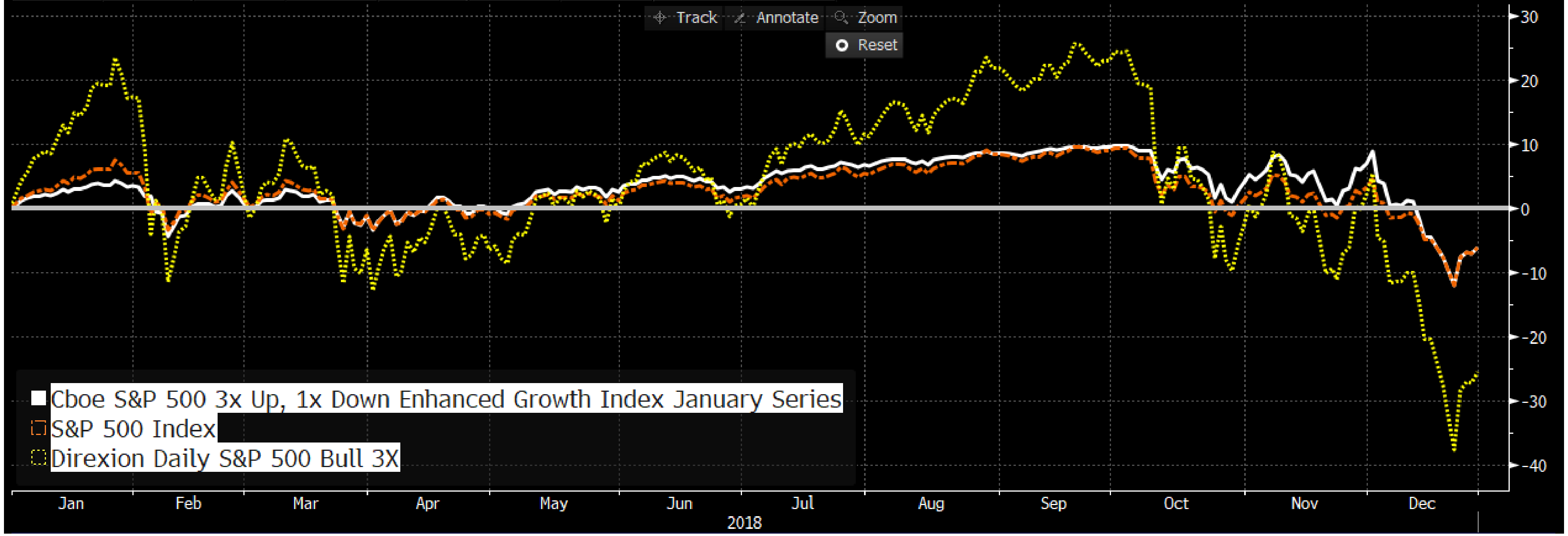
Return Experience – Innovator 3x Up, 1x Down vs. 3x Leveraged ETF

DECEMBER 29, 2017 THROUGH DECEMBER 31, 2018

Range 12/29/2017 - 12/31/2018 Period Daily No. of Period 367 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SPEG-01 Index	USD	-6.24%	-6.24%	-.00%	-6.20%
2)	SPX Index	USD	-6.24%	-6.24%	--	-6.20%
3)	SPXL US Equity	USD	-25.52%	-25.52%	-19.28%	-25.40%
4)						
5)						
6)						

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y



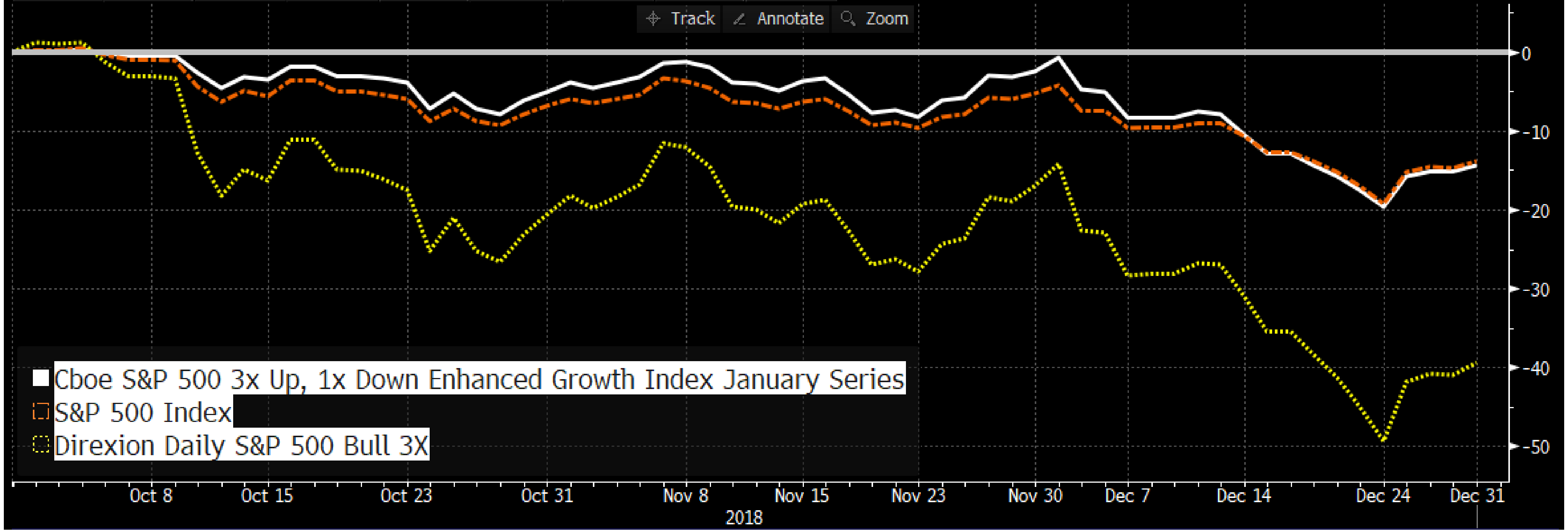
Return Experience – Innovator 3x Up, 1x Down vs. 3x Leveraged ETF

SEPTEMBER 28, 2018 THROUGH DECEMBER 31, 2018

Range 09/28/2018 - 12/31/2018 Period Daily No. of Period 94 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SPEG-01 Index	USD	-14.43%	-14.43%	-.45%	-45.39%
2)	SPX Index	USD	-13.97%	-13.97%	--	-44.25%
3)	SPXL US Equity	USD	-39.48%	-39.48%	-25.50%	-85.77%
4)						
5)						
6)						

1M 3M 6M YTD 1Y 2Y 3Y 5Y 10Y

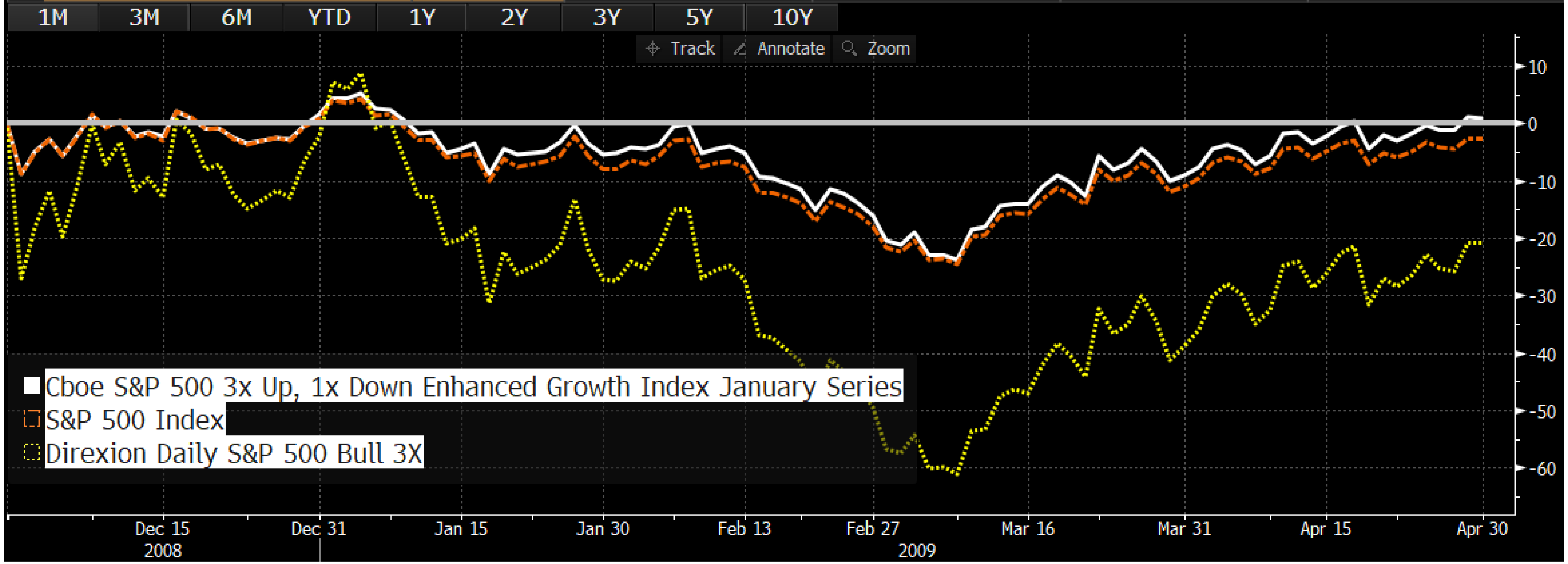


Return Experience – Innovator 3x Up, 1x Down vs. 3x Leveraged ETF

NOVEMBER 28, 2008 THROUGH APRIL 30, 2009 (high volatility period referenced in FINRA Regulatory Notice 09-31)

Range 11/28/2008 - 04/30/2009 Period Daily No. of Period 153 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	SPEG-01 Index	USD	.74%	.74%	3.36%	1.78%
2)	SPX Index	USD	-2.61%	-2.61%	--	-6.12%
3)	SPXL US Equity	USD	-20.85%	-20.85%	-18.23%	-42.75%
4)						
5)						
6)						



Thank you.

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