



SCHOOL OF LAW
THE UNIVERSITY OF TEXAS AT AUSTIN

727 East Dean Keeton Street • Austin, Texas 78705 • (512) 471-5151 • Facsimile (512) 471-6988

August 27, 2018

BY E-MAIL: RULE-COMMENTS@SEC.GOV

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-15-18 – Request for Public Comment on Proposed Rule re Exchange-Traded Funds -- Release No. 33-10515; IC-33140; File No. S7-15-18

Ladies and Gentlemen:

This letter is submitted with respect to File No. S7-15-18, the proposed rule relating to Exchange-Traded Funds voted on by the Securities and Exchange Commission (the “Commission”) on June 28, 2018. In particular, we are responding to the Commission’s invitation for public comment. We appreciate this opportunity.

We are the authors of the first academic work to show the need for, or to offer, a regulatory framework for ETFs. We posted two drafts of the work on the Social Science Research Network in March 2018 (one on March 9 and one on March 18), and we just posted a more recent draft on August 16, 2018. This latest August 16 draft is available at:

Henry T. C. Hu and John D. Morley, *A Regulatory Framework for Exchange-Traded Funds*, 91 SOUTHERN CALIFORNIA LAW REVIEW – (forthcoming 2018) (draft of August 16, 2018), <http://ssrn.com/abstract=3137918>

We much appreciate the earlier March drafts of the article being cited in the Commission’s June 28, 2018 release, Commissioner Robert J. Jackson, Jr.’s June 28, 2018 statement on *Proposed Rules Regarding Exchange Traded Funds*, <https://www.sec.gov/news/public-statement/statement-jackson-exchange-traded-funds-062818>, and Commissioner Hester Peirce’s March 19, 2018 speech, *Looking at Funds through the Right Glasses*, <https://www.sec.gov/news/speech/peirce-looking-funds-through-right-glasses>. The March 18 draft was the basis for an April 23, 2018 FINANCIAL TIMES op-ed: Henry T. C. Hu, *The \$5tn ETF Market Balances Precariously on Outdated Rules*, FIN. TIMES (Apr. 23, 2018), <https://www.ft.com/content/08cc83b8-38e0-11e8-b161-65936015ebc3>.

One of us (Hu) holds the Allan Shivers Chair in the Law of Banking and Finance at the University of Texas Law School and was the inaugural Director of the Commission’s Division of Economic and Risk Analysis (initially “Division of Risk, Strategy, and Financial Innovation”) (2009-2011). The other (Morley) is Professor of Law at Yale Law School.

We commend the Commission for its June 28 proposal. Moving towards a more rules-based approach with respect to certain ETFs is a step in the right direction. We also welcome the Commission’s indicated openness to reconsidering the matter of better disclosures relating to the

arbitrage mechanism and other distinctive aspects of ETFs, one of the core themes in our article. However, we believe that much more would need to be done to achieve a comprehensive regulatory framework for ETFs.

The Commission's June 28 proposal was voted on just prior to our article's scheduled publication in the July issue of the SOUTHERN CALIFORNIA LAW REVIEW. The August 16 draft of our article offers a brief descriptive summary of major aspects of the Commission's June 28 proposal in the Appendix (as will the soon-to-be-published version). However, we do not attempt to contrast that proposal with ours, in either the Appendix or the main body of our article. We will, however, offer an analysis of the June 28 Commission proposal and related matters in a forthcoming issue of the same law review.

For your convenience, an Abstract of our article is set out below:

This is the first academic work to show the need for, or to offer, a regulatory framework for exchange-traded funds ("ETFs"). The economic significance of this financial innovation is enormous. U.S.-listed ETFs now hold more than \$3.2 trillion in assets and comprise seven of the country's ten most actively traded securities. ETFs also possess an array of unique characteristics raising distinctive concerns. They offer what we here conceptualize as a nearly frictionless portal to a bewildering, continually expanding universe of plain vanilla and arcane asset classes, passive and active investment strategies, and long, short, and leveraged exposures. And we argue that ETFs are defined by a novel, model-driven device that we refer to as the "arbitrage mechanism," a device that has sometimes failed catastrophically. These new products and the underlying innovation process create special risks for investors and the financial system.

Despite their economic significance and distinctive risks, ETFs remain a regulatory backwater. The United States has neither a dedicated system of ETF regulation nor even a workable, comprehensive conception of what an ETF is. A motley group of statutes divide similar ETFs into a plethora of different regulatory cubbyholes that were originally intended for very different vehicles such as mutual funds, commodity pools, and operating companies. Other regulatory constraints center on a process of discretionary review that generally allows the Securities and Exchange Commission ("SEC") to assess the merits of each proposed ETF on an ad hoc, individualized basis. This process of review is opaque and unfocused. It is also inconsistent over time, with the effect that older funds often operate under lighter regulation than newer ones. And because it has its roots in statutes originally designed for other kinds of vehicles, the regulation of ETFs fails to address the ETF's distinctive characteristics. Rooted in a disclosure system largely designed for mutual funds, the SEC's disclosure mandates for ETFs fail to comprehend the significance and complexities of the arbitrage mechanism and often require no public disclosure of major breakdowns in the mechanism's workings.

Our proposal contemplates a single regulatory framework for all ETFs. The treatment of all ETFs would be unified. This systematic approach, rooted in the arbitrage mechanism common to all ETFs, would largely displace the hodge-podge of regulatory regimes that vary widely across both the different ETF regulatory cubbyholes in use today and different ETFs within each such cubbyhole. The functional elements of the framework would streamline and rationalize the creation, substantive operations, and disclosure of all ETFs. Such elements would include a shift away from ETF-by-ETF discretionary review and toward written rules of general applicability. In terms of the creation of ETFs, we would narrow the range of ETFs subject to close substantive scrutiny while retaining some discretion for the SEC to address concerns related to the arbitrage mechanism or related structural engineering issues, risky or

complex ETFs not adequately addressed by suitability rules and investor education, and large negative externalities. In terms of disclosure, we contemplate quantitative and qualitative information addressing what we here call “trading price frictions,” such as those relating to the performance of the arbitrage mechanism and related engineering during the trading day, model-related complexities, and evolving understandings and conditions.

We appreciate the opportunity to share our views. We would be honored to discuss any questions the Commissioners or the staff may have with respect to any of the foregoing matters.

Thank you.

Sincerely,

/s/ Henry T. C. Hu

/s/ John D. Morley

Henry T. C. Hu and
Allan Shivers Chair in the
Law of Banking and Finance
University of Texas Law School

John D. Morley
Professor of Law
Yale Law School

cc:

The Hon. Jay Clayton, Chair

The Hon. Kara M. Stein, Commissioner

The Hon. Robert J. Jackson, Jr., Commissioner

The Hon. Hester M. Peirce, Commissioner

Ms. Stephanie Avakian, Co-Director, Division of Enforcement

Dr. Chyhe Becker, Acting Director, Division of Economic and Risk Analysis

Ms. Dalia Blass, Director, Division of Investment Management

Mr. William Hinman, Esq., Director, Division of Corporation Finance

Mr. Steven Peikin, Co-Director, Division of Enforcement

Mr. Brett Redfearn, Director, Division of Trading and Markets

Mr. Robert B. Stebbins, General Counsel