INVESTMENT COMPANY INSTITUTE®

1401 H Street, NW, Washington, DC 20005-2148, USA
202-326-5800 www.ici.org

September 21, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Exchange-Traded Funds, File No. S7-15-18

Dear Mr. Fields:

The Investment Company Institute[1] is pleased to express its strong support for the Securities and Exchange Commission's proposed new rule intended to modernize the regulations for ETFs by establishing a clear and consistent framework for most ETFs operating today.[2] The SEC's new rule would allow ETFs that satisfy certain conditions to be able to operate within the scope of the Investment Company Act of 1940 without applying for individual exemptive orders. The Commission also proposes certain disclosure amendments intended to provide investors who purchase and sell ETF shares in the secondary market with additional information to help them understand ETF trading costs.

ETFs have been one of the most successful financial innovations in recent years. Since the introduction of ETFs in the early 1990s, demand for these funds has grown markedly in the United States, as investors increasingly have found their features appealing. As of July 2018,

---

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$22.4 trillion in the United States, serving more than 100 million US shareholders, and US$7.3 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *See* Investment Company Act Release No. 33140 (June 28, 2018) (the "Release"), available at https://www.sec.gov/rules/proposed/2018/33-10515.pdf. The SEC proposed, but never adopted, an ETF rule in 2008. *See* Investment Company Act Release No. 28193 (March 11, 2008), 73 FR 14618 (March 18, 2008) ("2008 ETF proposal"). ICI filed a comment letter that strongly supported the 2008 proposal. *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, Securities and Exchange Commission, dated May 19, 2008 ("2008 ICI comment letter").

there were over 1,900 ETFs on the market with more than $3.6 trillion in assets, and year-to-date net inflows to ETFs were nearly $147 billion.

Over the last quarter century, the Commission has issued over 300 exemptive orders to ETFs and their sponsors leading to some variations in the regulatory structure for existing ETFs. To this end, the Commission acknowledges that given its lengthy experience regulating ETFs, the types of ETFs covered by the proposed rule are investment products that no longer require individualized exemptive relief. Proposed Rule 6c-11 includes several conditions designed to address the concerns underlying the relevant statutory provisions and support a Commission finding that the exemptions necessary to allow ETFs to operate are in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act. Building on its experience regulating this product and the comments the Commission received on its 2008 ETF proposal, the proposed rule therefore seeks to bring greater consistency, transparency, and efficiency to the regulatory framework for ETFs.

Summary of Comments and Recommendations

In summary, ICI's comments and recommendations include the following:

<u>Scope of Proposed Rule 6c-11</u>

- We strongly agree with the Commission that permitting index-based and actively managed open-end ETFs to operate under the proposed rule subject to the same conditions would provide a level playing field among those market participants.

<u>Exemptive Relief Under Proposed Rule 6c-11</u>

- We strongly support the Commission's proposal to deem an equity security issued by an ETF covered by the rule to be a "redeemable security" for purposes of Section 2(a)(32) of the Investment Company Act. We also recommend the SEC extend this same treatment to the shares of ETFs registered under the Investment Company Act that are not permitted to rely on the proposed rule.
- We agree with the Commission that exemptive relief from Section 22(d) of the Investment Company Act and Rule 22c-1 thereunder is appropriate for ETFs permitted under the proposed rule.
- We support the proposed relief from Sections 17(a)(1) and (2) to permit in-kind creation and redemption transactions involving persons who are affiliates of an ETF by reason of holding with the power to vote 5 percent or more of (i) the ETF's shares; or (ii) any investment company that is an affiliated person of the ETF. We also recommend that this relief be expanded to encompass other affiliates, including broker-dealers that are affiliated with an ETF's adviser.
- We support the proposed relief for postponement of payment of redemption proceeds when a foreign holiday prevents timely delivery of a foreign security included in an

ETF's redemption basket, but we request a change or clarification to the definition of "foreign investment," as to the requirement that the security have "no established United States public trading market." We also do not believe a 10-year sunset provision for this exemption is necessary.

<u>Conditions for Reliance on Proposed Rule 6c-11</u>

- We strongly support the proposed definition of "creation unit," which does not incorporate a minimum creation unit size, and, as such, gives an ETF flexibility to set its creation unit size at an amount that the ETF believes to be appropriate.
- We believe the proposed definition of "authorized participant" is appropriate.
- We support the Commission's proposal to require that ETF shares be listed on a national securities exchange, but we urge the Commission to clarify (either in the final rule or release) that a trading halt or suspension will not disqualify an ETF from relying on the rule.
- We strongly support the Commission's decision not to require the dissemination of an intraday estimate of an ETF's net asset value (NAV per share as a condition of the proposed rule.
- We support the Commission's determination not to include a marketing disclosure requirement in Rule 6c-11.

Basket Policies and Procedures

- We support the requirement under proposed Rule 6c-11 that each ETF relying on the rule adopt and implement written policies and procedures governing the construction of baskets and the process that would be used for the acceptance of baskets. An ETF's basket policies and procedures (including its custom basket policies and procedures discussed below) should be covered by the ETF's compliance program and other requirements under Rule 38a-1 under the Investment Company Act.

Custom Baskets

- We strongly support the Commission's proposal to give all ETFs the flexibility to use "custom baskets." We have long argued that basket flexibility benefits investors by helping the ETF meet its investment objective more efficiently, improving its tradability and thereby allowing its investors to enjoy lower costs and better tax treatment. We therefore commend the Commission for recognizing these benefits and incorporating custom basket flexibility into the proposed rule.
- We generally support the proposed requirement that an ETF using custom baskets adopt policies and procedures setting forth detailed parameters for the construction and acceptance of custom baskets.
- We question why the definition of custom baskets should include cash substitutions. A cash substitution does not raise the same potential conflicts of interest as a security

substitution and therefore should only be governed by an ETF's regular basket policies and procedures rather than be subject to the proposed heightened processing requirements of custom baskets.

Portfolio Holdings and Basket Website Disclosure

- *T-1 Orders*: As proposed, an ETF's basket and portfolio holdings must be published on its website before it accepts creation and redemption orders. This requirement would seem to preclude an ETF from accepting creation and redemption orders shortly after the US market closes (4:00 pm ET) but before the basket holdings are published ("T-1 orders")—a practice that is quite common and beneficial for certain ETFs and their investors. We strongly urge the Commission to reconsider this requirement and change the proposed rule so that T-1 orders can be accepted.
- *Regulation S-X*: Although we appreciate the Commission's desire to standardize the manner in which portfolio holdings and baskets are presented on the ETF's website, presenting this information consistent with Article 12 of Regulation S-X as proposed is problematic. We are concerned that certain requirements in Article 12 may prove overly burdensome for purposes of daily disclosure. Instead, we recommend that the Commission specify formats for the portfolio disclosure and basket disclosure similar to that required by the exchange listing standards. If the Commission still determines to standardize the format of website portfolio holdings and baskets consistent with Regulation S-X, we recommend that certain required data elements within the Article 12 schedules be omitted because such information is not necessary to achieve the Commission's stated rationale for requiring the disclosure (*i.e*., to facilitate the arbitrage process).
- *Basket Disclosure*: We urge the Commission to reconsider the proposed requirement that ETFs disclose baskets on their websites. Unlike portfolio holdings, the contents of an ETF's basket are simply not relevant for most secondary market investors, and, in fact, may be confusing for investors who mistake the basket (which, for some ETFs, may only be a representative sample of the entire portfolio) for the ETF's portfolio holdings.
- Under the proposal, an ETF would publish a basket that it would accept if presented by any authorized participant in exchange for creation units (or presented to an authorized participant redeeming creation units). We request that the Commission clarify that even if an ETF does not publish a custom basket at the beginning of the trading day, it can still use custom baskets in addition to the published (*e.g., pro rata*) basket.
- We would not support a requirement that an ETF post every basket it accepts from or presents to an authorized participant after the close of trading on each business day. We agree with the Commission's preliminary belief that such a requirement would be unnecessarily burdensome and costly to implement.
- *NAV, Market Price, and Premium or Discount Website Disclosure*: We do not object to the proposed requirement that would require ETFs to disclose: (i) the ETF's NAV per

share, market price, and premium or discount, each as of the end of the prior business day; and (ii) historical information regarding premiums and discounts.

- We oppose disclosure that would require any ETF whose premium or discount was greater than 2 percent for more than seven consecutive trading days to post that information on its website, along with a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount. For certain ETFs, especially those investing in international markets, the proposed disclosure requirement may be triggered more frequently, leading to disclosure that is unnecessary (given the asset class) or repetitive. It also may be difficult for an ETF to accurately identify the material factors that caused the deviation before the ETF must post the information and provide the narrative discussion of factors. An investor interested in information about the extent and frequency with which an ETF's market prices have tracked its NAV would still have access to the daily and historical premium/discount information proposed above.

Recordkeeping

- We support the Commission's proposal to require that ETFs preserve and maintain copies of authorized participant agreements. We also support the Commission's proposal to require that ETFs maintain information regarding the baskets exchanged with authorized participants.

Effect of Proposed Rule 6c-11 on Prior Orders

- We do not object to the SEC's proposal to amend and rescind (one year following the effective date of any final rule) the exemptive relief it has issued to ETFs that would be permitted to rely on the proposed rule.
- We also strongly agree with the SEC's proposal to retain the exemptive relief of ETFs that would not be permitted to rely on the proposed rule.

Amendments to Form N-1A

- We generally support the Commission's approach of revising Form N-1A to better serve the information needs of retail investors and we agree that it is appropriate to distinguish between those who purchase in the secondary market and authorized participants who transact directly with the fund.
- *Changes that Affect Mutual Funds and ETFs*: We support the Commission's proposal to add disclosure that would clarify that, in addition to the current disclosures relating to investors who buy or hold shares, the fees and expenses reflected in Item 3 may be higher for investors if they sell shares of the fund. We also support the Commission's proposal to require a statement that investors may be subject to other fees not reflected in the table, such as brokerage commissions and fees to financial intermediaries.

- *Changes that Affect ETFs*: We have serious concerns with the proposed new section in Item 3 that would add a series of question and answers that would require disclosure of certain ETF trading information and trading costs. Although we support narrative disclosure that would highlight the transaction fees and costs for ETFs that are not reflected in the fee table, we do not believe ETFs should be required to calculate and disclose their bid-ask spread costs. Unlike an ETF's other quantitative disclosure responsibilities, an ETF does not control bid-ask spread costs and must either purchase market data to calculate it or rely on third party vendors for this information. To demonstrate how costs attributable to bid-ask spreads can affect an investor's total costs of investing in an ETF, we recommend the Commission add a hypothetical example using standard inputs, like the current prospectus fee example.
- Although we appreciate the Commission's desire to provide investors with a tool relating to the total costs of trading ETFs in the secondary market, we do not believe ETFs should be required to add an interactive calculator on their websites. Not only is historical bid-ask spread data not necessarily predictive of an investor's future spread costs, the proposed bid-ask spread disclosure and the interactive calculator add additional vendor and licensing fees to a growing list of SEC-mandated disclosures for registered funds. If the Commission still wishes to move forward with an interactive calculator for investors despite our concerns, we recommend that it utilize the advanced market metrics available on the SEC's website. This way there would be a single data source and methodology for the calculator allowing investors to assess these costs in one place and in a comparable manner.

Amendments to Form N-8B-2

- Subject to our comments regarding the amendments to Form N-1A, we generally support the Commission's proposal to amend Form N-8B-2 to require UIT ETFs to provide disclosures that mirror certain of the proposed disclosure changes in Form N-1A.

Amendments to Form N-CEN

- We support the Commission's proposal to add to Form N-CEN a requirement that ETFs report if they are relying on Rule 6c-11.

Regulation of ETFs Under the Securities Exchange Act of 1934

- We recommend the Commission consider ways to streamline the regulation of ETFs under both the Investment Company Act and the Securities Exchange Act of 1934. We also urge the SEC to consider ways the Divisions of Investment Management and

Trading and Markets can work together to establish a single process for all ETF approvals.

<u>Exemptions for Investment Companies Investing in ETFs</u>

- We strongly support a proposal to permit investment companies to invest in ETFs to a greater extent than currently permitted by the Investment Company Act and commend the Commission for including a proposed rule addressing "fund of funds" arrangements on its rulemaking agenda for next year.

We will discuss each of these items in greater detail below.

I. Scope of Proposed Rule 6c-11: Index-Based and Actively Managed Open-End ETFs

Proposed Rule 6c-11 under the Investment Company Act would allow most ETFs organized as open-end management companies to operate without individual exemptive relief and would not distinguish between index-based ETFs and actively managed ETFs.[3] We strongly agree with the Commission that permitting index-based and actively managed open-end ETFs to operate under the proposed rule subject to the same conditions would provide a level playing field among those market participants. Regulations for other types of funds do not distinguish between funds that track an index or are actively managed. More importantly, the distinction between index-based and actively managed ETFs is not obvious or meaningful.

II. Exemptive Relief Under Proposed Rule 6c-11

Proposed Rule 6c-11 would provide ETFs within the scope of the rule with exemptions from certain provisions of the Investment Company Act that are necessary to allow ETFs to operate. These exemptions are generally consistent with the relief the SEC has given to ETFs under their current exemptive orders. Like other registered funds, ETFs would remain subject to all other relevant provisions of the Investment Company Act.

A. Treatment of ETF Shares as "Redeemable" Securities

We strongly support the Commission's proposal to deem an equity security issued by an ETF covered by the rule to be a "redeemable security" for purposes of Section 2(a)(32) of the Investment Company Act.[4] The Act defines a redeemable security as one that can be presented to the issuer in exchange for approximately the holder's proportionate share of the issuer's

---

[3] Rule 6c-11 would not be available to ETFs organized as UITs, ETFs structured as a share class of a multi-class fund, and leveraged or inverse ETFs. Instead, these ETFs would continue to rely on their existing exemptive orders.

[4] This is consistent with the 2008 ETF proposal and, in contrast to the exemptive orders, which provide an exemption from the definition of "redeemable security" in Section 2(a)(32) or from the definition of "open-end company" in Section 5(a)(1) of the Investment Company Act.

current net assets. As the Release notes, the arbitrage mechanism is central to the operation of an ETF and serves to keep the market price of ETF shares at or close to the ETF's NAV per share. As a result, even though only authorized participants may redeem creation units directly from the ETF at NAV per share, investors are able to sell their ETF shares in the secondary market at or close to NAV, similar to investors in mutual funds that redeem their shares directly from the fund at NAV per share next calculated after their order is received. We note that this also is true for ETFs that are not permitted to rely on the proposed rule. We therefore recommend the SEC extend this same treatment to the shares of all ETFs registered under the Investment Company Act.

Furthermore, and as discussed below IX. Regulation of ETFs Under the Securities Exchange Act of 1934 , the proposed classification allows ETFs to benefit from certain exceptions from rules under the Securities Exchange Act that apply to redeemable securities and/or open-end funds. This is an important first step to establishing a single process within the Commission for ETF and related approvals.

B. Trading of ETF Shares at Market-Determined Prices

The Investment Company Act and its rules require redeemable securities to be sold at NAV. Consistent with the SEC's exemptive orders, proposed Rule 6c-11 would provide exemptions from Section 22(d) and Rule 22c-1 to permit trading of shares in the secondary market at market-determined prices that may be different than the ETF's current NAV.

We agree with the Commission that exemptive relief from Section 22(d) of the Investment Company Act and Rule 22c-1 thereunder is appropriate for ETFs permitted under the proposed rule. As noted above, the arbitrage mechanism has kept the deviation between the market price of ETFs and NAV per share, calculated as of the close of trading each day, generally relatively small. We therefore believe the proposed rule provides the necessary relief and suitable limitations.

C. Affiliated Transactions

Section 17(a) of the Investment Company Act generally prohibits an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security or other property to or purchasing any security from the company. Purchases and redemptions of ETF creation units are typically effected in kind, and Section 17(a) prohibits these in-kind purchases and redemptions by affiliated persons of the ETF.

Proposed Rule 6c-11 would provide exemptions from Sections 17(a)(1) and (a)(2) of the Investment Company Act with regard to the deposit and receipt of baskets to a person who is an affiliated person of an ETF (or who is an affiliated person of such a person) solely by reason of: (i) holding with the power to vote 5 percent or more of an ETF's shares ("first-tier affiliates"); or (ii) holding with the power to vote 5 percent or more of any investment company that is an affiliated person of the ETF ("second-tier affiliates" . This relief is necessary to facilitate the efficient functioning of the arbitrage mechanism. Without it, an authorized participant or other market participant that becomes an affiliated person of the ETF due to its holdings would be prevented from engaging in arbitrage using an in-kind basket. This, in turn, could have the adverse effect of limiting the pool of market participants that could engage in arbitrage. As the Release explains, relief for this category of affiliates has been granted in previous exemptive orders because such affiliates are not treated differently from non-affiliates when engaging in purchases and redemptions of creation units, and there is no opportunity for them to engage in transactions that could be detrimental to other shareholders. Specifically, all purchases and redemptions of creation units are at an ETF's next-calculated NAV pursuant to Rule 22c-1. Also, the assets deposited or delivered upon redemption are valued in the same manner, and under the same terms, as those assets are valued for purposes of calculating the ETF's NAV per share.

As such, we support the proposed relief from Sections 17(a)(1) and (2) to permit in-kind creation and redemption transactions involving persons who are first- or second-tier affiliates of an ETF by reason of holding with the power to vote 5 percent or more of (i) the ETF's shares; or (ii) any investment company that is an affiliated person of the ETF. Although the Release does not suggest the Commission intends to limit the scope of the proposed exemption to exclude control affiliates, the proposed rule differs somewhat from current exemptive orders because it does not specifically state that the exemption from Sections 17(a)(1) and (2) would apply to first- or second-tier affiliates of an ETF by reason of holding with the power to vote in excess of 25 percent of the ETF's shares or an affiliated fund's shares.[5] We therefore request that the Commission clarify that the exemption also would include control affiliates (*e.g*., affiliates that own more than 25 percent of an ETF's shares).

The Release also notes that the SEC preliminarily does not believe that it is appropriate to expand the scope of affiliated persons covered by the exemption at the same time that it is permitting additional flexibility with respect to custom baskets. Despite these misgivings, we recommend that this relief be expanded to encompass other affiliates, including broker-dealers that are affiliated with an ETF's adviser. We note that similar to affiliated persons covered by the proposed rule, other affiliates would purchase and redeem creation units in accordance with the fund's basket and custom basket policies and procedures (as described below). Any attempt to do otherwise, could not only be a violation of these policies and procedures, but a violation of federal securities laws and regulations prohibiting manipulative practices in connection with securities trading, as well as a misuse of non-public information.

Registered advisers and broker-dealers also should have policies and procedures, and related information barriers, in place to prevent such violations, including policies and procedures designed to prevent the use or disclosure of material non-public information and

---

[5] Section 2(a) 9) of the Investment Company Act defines "control" to include presumptively any person who owns beneficially more than 25 percent of the voting securities of a company.

employees from attempting to manipulate the market for securities in which the broker-dealer transacts.

Moreover, ETFs and their shareholders stand to benefit from increasing the pool of authorized participants by permitting, for example, affiliated broker-dealers to act as authorized participants in their shares. As discussed throughout the Release, the arbitrage mechanism is a critical element of the functioning and success of all ETFs and would only stand to be improved by increasing the number of market participants willing to create or redeem shares. We therefore also recommend that this relief be expanded to encompass other affiliates, including broker-dealers that are affiliated with an ETF's adviser.

D. Additional Time for Delivering Redemption Proceeds

Section 22 e) of the Investment Company Act generally prohibits a registered open-end management investment company from postponing the date of satisfaction of redemption requests for more than seven days after the tender of a security for redemption. The Release notes that this prohibition can cause operational difficulties for ETFs that hold foreign investments and exchange in-kind baskets for creation units. For example, local market delivery cycles for transferring foreign investments to redeeming investors, together with local market holiday schedules, can sometimes require a delivery process in excess of seven days.

Rule 6c-11 would grant relief from Section 22(e) to permit an ETF to delay satisfaction of a redemption request for more than seven days if a local market holiday, or series of consecutive holidays, the extended delivery cycles for transferring foreign investments to redeeming authorized participants, or the combination thereof prevents timely delivery of the foreign investment included in the ETF's basket. To rely on this exemption, an ETF would be required to deliver foreign investments as soon as practicable, but in no event later than 15 days after tender to the ETF. This proposed exemption thus would permit a delay in the delivery of foreign investments only if the foreign investment is being transferred in kind as part of the basket. In addition, given the continued movement toward shorter settlement times in markets around the world, the Commission believes that the relief from Section 22(e) does not need to be permanent. Accordingly, Rule 6c-11 would include a sunset provision that would expire ten years from the rule's effective date.[6]

---

[6] The 2008 ETF proposal would have allowed up to 12 days to deliver redemption proceeds without an offsetting requirement to deliver as soon as practicable and without a sunset provision. The 2008 ETF proposal also would have required an ETF to disclose in its registration statement the foreign holidays it expects may prevent timely delivery of foreign securities, and the maximum number of days that it anticipates it will need to deliver the foreign securities. We agree with the Commission's belief that this disclosure is not relevant to investors who purchase ETF shares in the secondary market because the settlement of these investors' ETF trades would be unaffected by the potential delay and such delays are typically covered by the authorized participant agreement.

ICI members that currently have such relief through their exemptive orders agree that it provides additional assurance that they will not be out of compliance due to circumstances beyond their control. Members generally agree that it is appropriate to limit the exemption to the particular foreign investment and not the entire basket (as permitted by current exemptive relief) and that 15 calendar days is sufficient. Members have expressed concern, however, regarding the definition of "foreign investment."[7] Although many foreign issuers wishing to access the US capital markets will offer and sell securities in the United States (*e.g*., using Forms F-1, F-3), ETFs often hold the foreign security rather than its US-traded equivalent. This is because (i) the underlying international indexes (*e.g.,* MSCI) typically include the foreign security in the index, and ii) the foreign security is more liquid (*e.g*., has a higher trading volume) than the foreign issuer's US-traded security. We therefore recommend that the SEC either eliminate the "no established United States public trading market" restriction in the proposed definition of foreign investment or clarify that Section 22(e) relief under proposed Rule 6c-11 would still be available for ETFs that invest in a foreign security even if a US market exists.[8]

We also question the rationale for including a 10-year sunset provision. Although many established global markets have moved to shorter settlement times, there are newer frontier markets or countries that may in the future become available for international investment that may move slower. These countries also tend to have more failed trades than developed markets, as settlement processes may be less standardized, less automated, and more prone to errors. To the extent that global settlement times continue to shorten, however, we note that local market holidays do not change. Finally, the "as soon as practicable" language included in the proposed exemption is designed to minimize any unnecessary settlement delays. As noted in the Release, if the foreign investment settles in less than 15 days, the ETF would be required to deliver it pursuant to the standard settlement time of the local market where the investment trades. A sunset provision is therefore not necessary.

III. Conditions for Reliance on Proposed Rule 6c-11

Proposed Rule 6c-11 would require ETFs to comply with certain conditions that would allow them to operate within the scope of the Investment Company Act, and that are designed to protect investors and to be consistent with the purposes fairly intended by the policy and provisions of the Act. These conditions are generally consistent with the SEC's exemptive order conditions. Based on the SEC's vast experience regulating ETFs, the proposed conditions

---

[7] Under proposed Rule 6c-11, "foreign investment" is defined as any security, asset or other position of the ETF issued by a foreign issuer (as defined by Rule 3b-4 under the Securities Exchange Act), and for which there is no established United States public trading market (as that term is used in Item 201 of Regulation S-K under the Securities Act of 1933).

[8] We note that if the Commission does not change the proposed definition of foreign investment, ETF sponsors will need to build compliance systems to monitor foreign issuers trading in the United States even if the ETF does not intend to invest in the US security.

also reflect certain changes from the exemptive order conditions, which the Commission believes will improve the overall regulatory framework for ETFs.

A. Definition of Exchange-Traded Fund

Under proposed Rule 6c-11, an "exchange-traded fund" would be defined as a registered open-end company that (i) issues (and redeems *creation units* to (and from *authorized participants* in exchange for a basket and a balancing amount (if any); and (ii) issues shares that are *listed on a national securities exchange* and traded at market-determined prices. The Release notes that the proposed rule seeks to preserve the existing ETF structure, reflected in the SEC's exemptive orders, whereby only an authorized participant of an ETF may purchase creation units from (or sell creation units to) the ETF.

1. Definitions of Creation Unit and Authorized Participant

We strongly support the proposed definition of "creation unit," which does not incorporate a minimum creation unit size, and, as such, gives an ETF flexibility to set its creation unit size at an amount that the ETF believes to be appropriate based on its investment strategy, type and availability of basket assets, and the authorized participants (and other market participants) that are expected to engage in creation and redemption transactions with the ETF. Indeed, maximum or minimum thresholds are not necessary because it is in the ETF's interest to establish a creation unit size that facilitates trading. We also believe the proposed definition of "authorized participant" is appropriate.

2. Listing on a National Securities Exchange

We support the Commission's proposal to require that ETF shares be listed on a national securities exchange. The Release requests comment on whether the rule should make allowance for shares that are delisted for a short time, or for halts or suspensions in trading. We believe it should.

National securities exchanges require all listed companies, including ETFs, to meet certain listing standards to keep their shares trading on the exchange. If a listed company fails to continuously meet these listing standards, the exchange may take various actions relating to the company's shares. For example, an exchange may suspend trading in or commence delisting procedures until the non-compliance is cured.[9] Additionally, for a variety of other reasons (typically relating to trading activity or issuer events), an exchange (and sometimes the SEC)

---

[9] *See e.g.*, NYSE Arca Equities Rule 5.5-E(g)(2); NYSE Regulation (December 11, 2017), available at https://www.nyse.com/publicdocs/nyse/regulation/nyse-arca/NYSE_Arca_Continued_Listing_Standards_FAQ.pdf; Bats, Frequently Asked Question—New Continued Listing Rules, available at http://cdn.batstrading.com/resources/listings/FAQs%20-%20New%20Cont%20List%20Standards%20FINAL.pdf; Nasdaq, Listing Exchange-Traded Products (January 1, 2018 , available at https://listingcenter.nasdaq.com/assets/ETP_Listing_Guide.pdf.

may halt or suspend trading of an issuer's shares.[10] Although we took a different position in response to the 2008 ETF proposal,[11] we now believe that the potential repercussions on an ETF of not being able to rely on the rule during any trading halt or suspension may create difficult practical issues (*e.g.,* must the ETF at that point accept non-creation unit redemption requests that warrant an exception. Given the uncertainty of an ETF's status under proposed Rule 6c-11 under these circumstances, we therefore urge the Commission to clarify (either in the final rule or release) that a trading halt or suspension will not disqualify an ETF from relying on the rule.

B. Intraday Indicative Value and Marketing

We strongly support the Commission's decision not to require the dissemination of an intraday estimate of an ETF's NAV per shares "IIV") as a condition of the proposed rule. Indeed, as noted in the Release, market makers typically calculate their own intraday value of an ETF's portfolio with proprietary algorithms that use the ETF's daily basket and/or portfolio disclosure and available pricing information about the ETF's basket or portfolio assets. This is because an ETF's current value changes every time the value of any underlying component of the ETF portfolio changes. In fast-moving markets, the IIV's 15 second dissemination lag may therefore not reflect the actual value of the ETF. Similarly, for an ETF that holds securities that do not trade frequently or an ETF with foreign securities, the IIV can be stale or inaccurate.

We also support the Commission's determination not to include a marketing disclosure requirement in Rule 6c-11.[12] As noted in the Release, this condition is no longer necessary because the market has developed a familiarity with ETFs over the last quarter century.

C. Basket Policies and Procedures

We support the requirement under proposed Rule 6c-11 that each ETF relying on the rule adopt and implement written policies and procedures governing the construction of baskets and the process that would be used for the acceptance of baskets. Specifically, the

---

[10] *See e.g.*, SEC, Office of Investor Education and Advocacy, Investor Bulletin: Trading Suspensions (May 2012), available at https://www.sec.gov/investor/alerts/tradingsuspensions.pdf; Finra, Investor Alert, When Trading Halts: What You Need to Know About Halts, Suspensions and Other Interruptions (February 7, 2013), available at http://www.finra.org/investors/alerts/when-trading-stops-halts-suspensions-other-interruptions.

[11] In the 2008 ICI comment letter, we expressed our belief that it would be difficult to craft an exception that would, in practice, appropriately capture all of the necessary circumstances for shares that are temporarily delisted or suspended.

[12] Current exemptive orders include a condition requiring each ETF to identify itself in any sales literature as an ETF that does not sell or redeem individual shares and to explain that investors may purchase or sell individual ETF shares through a broker via a national securities exchange. This condition was designed to help prevent retail investors from confusing ETFs with mutual funds.

policies and procedures would cover the methodology that an ETF would use to construct baskets, including for example, the circumstances when the basket may omit positions that are not operationally feasible to transfer in kind, when the ETF would use representative sampling of its portfolio to create its basket, and how the ETF would sample in those circumstances.

We also think it is appropriate that an ETF's basket policies and procedures (including its custom basket policies and procedures discussed below) should be covered by the ETF's compliance program and other requirements under Rule 38a-1 under the Investment Company Act.[13] For example, an ETF would be required to preserve the basket policies and procedures pursuant to the requirements of Rule 38a-1(d)(1). The SEC believes that oversight by the ETF's board of directors of the ETF's compliance policies and procedures, as well as their general oversight of the ETF, would provide an additional layer of protection for an ETF's use of custom baskets.

D. Custom Baskets

We strongly support the Commission's proposal to give all ETFs the flexibility to use "custom baskets."[14] We have long argued that basket flexibility benefits investors by helping ETFs manage their portfolios and meet investment objectives (*e.g.,* with respect to an index-based ETF, facilitating better index tracking) at a lower cost.[15] For example, an investment adviser to a recently launched ETF may determine that holding more index components than the ETF currently holds through sampling of the index or holding investments that are highly correlated with index components would more efficiently and effectively help the ETF meet its investment objective. In so doing, it may want to invest in an index component, or, with

---

[13] Rule 38a-1 under the Investment Company Act requires, among other things, that registered funds: adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws; obtain the approval of the fund's board of directors, including a majority of directors who are not interested persons of the fund, of the fund's policies and procedures and those of each investment adviser, principal underwriter, administrator, and transfer agent of the fund (principal service providers); review, no less frequently than annually, the adequacy of the policies and procedures and the effectiveness of their implementation; and designate a single chief compliance officer responsible for administering the fund's policies and procedures.

[14] The proposed rule defines two particular types of baskets as "custom baskets." First, baskets that are composed of a non-representative selection of the ETF's portfolio holdings, which would include, but not be limited to, baskets that do not reflect: (i) a pro rata representation of the ETF's portfolio holdings; (ii) a representative sampling of the ETF's portfolio holdings; or (iii) changes due to a rebalancing or reconstitution of the ETF's securities market index, if applicable. Second, different baskets used in transactions on the same business day. For example, if an ETF exchanges a basket with an authorized participant that reflects a representative sampling of the ETF's portfolio holdings and a different basket with either the same or another authorized participant that represents a different representative sampling, both baskets would be custom baskets. Similarly, if an ETF substitutes cash in lieu of a portion of basket assets for a single authorized participant, that basket would be a custom basket.

[15] *See e.g*., Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission (January 13, 2016) at 50-53, available at https://www.sec.gov/comments/s7-16-15/s71615-54.pdf.

respect to an actively managed ETF, another highly correlated security, that the ETF currently does not hold. Restricting creation baskets only to securities the ETF holds does not permit the ETF to most efficiently obtain the exposure it wants through the in-kind transaction process. Rather, the ETF would receive the creation basket and would then need to sell certain unwanted securities of the creation basket, using the money it receives to purchase the desired index components. Eliminating this unnecessary step would reduce transaction costs and allow the ETF to accept substitute securities (that are desired by the investment adviser and consistent with the fund's investment objectives) to the benefit of ETF shareholders.

Similarly, with the ability to use custom baskets, an ETF's investment adviser may determine to redeem in-kind baskets of securities that have embedded capital gains, thereby increasing the tax efficiency of the ETF. This directly benefits ETF shareholders. Further, ETF basket flexibility could allow funds to retain portfolio securities that the ETF's investment adviser believes the ETF should continue to hold. For example, fixed-income ETFs may determine that retaining certain bonds that are difficult to acquire may assist the ETF to better meet its investment objective. Rather than tendering those bonds to meet redemption requests (or being forced to redeem with cash), the ETF can retain those assets and simply choose another basket composition to redeem, better protecting the fund's long-term interest and more cost-effectively achieving its investment objective.

Basket flexibility also facilitates a more efficient creation and redemption process by improving the tradability and pricing of ETF shares. An ETF also may have thousands of securities in its portfolio. Requiring an authorized participant to provide each of those securities in a *pro rata* amount to the ETF's holdings may dissuade an authorized participant from trading in ETF shares that would require transactions in smaller, more costly lot sizes. Baskets with fewer securities, but that still produce performance consistent with its investment objective, could enable authorized participants to trade portfolio securities in more cost-effective lot sizes, especially for smaller orders. Reduced transaction costs for authorized participants and other market participants can make arbitrage more efficient, which leads to a reduction in premiums and discounts and narrower bid-ask spreads on ETF shares. Reduced transaction costs also may attract more authorized participants, which could increase market competition and lower costs to investors.

Preliminary econometric analysis suggests that basket flexibility benefits investors by significantly reducing bid-ask spreads, tracking differentials, and premiums/discounts.[16] Using information from a confidential ICI survey on basket flexibility for fixed income ETFs, we tested whether ETFs with basket flexibility provide benefits to investors when compared to ETFs without basket flexibility.[17] Our full sample regression analysis contains daily data from

[16] See Appendix A for a detailed description of the data, estimation methodology, and regression results.

[17] For purposes of our survey, an ETF is classified as "flexible" if the fund is allowed to construct/tailor the basket for individual authorized participants when in the best interests of the ETF and its shareholders. An ETF is

January 1, 2007 to April 1, 2018 covering 324 fixed income ETFs and is shown by the green bars in Figure 1.

In summary, our analysis indicates that fixed income ETFs with basket flexibility had bid-ask spreads that were 36 basis points lower, on average, than fixed income ETFs without basket flexibility. Fixed income ETFs with basket flexibility had absolute tracking differentials that were, on average, 11 basis points lower and absolute discounts that were, on average, 28 basis points lower than fixed income ETFs without basket flexibility. Fixed income ETFs with basket flexibility did not have expense ratios that were, on average, statistically significantly lower than ETFs without basket flexibility.

We also found that basket flexibility could be more important during periods of market stress. For example, we conducted the same econometric analysis on 315 fixed income ETFs during the period December 8, 2015 through December 18, 2015 when the high-yield bond market in the United States was under stress. Our results are summarized by the blue bars in Figure 1. Fixed income ETFs with basket flexibility had bid-ask spreads during this period that were, on average, 69 basis points lower than fixed income ETFs without basket flexibility. Absolute discounts on fixed income ETFs with basket flexibility were, on average, 51 basis points lower than on fixed income ETFs without basket flexibility. There was no statistically significant difference in absolute tracking differential between fixed income ETFs with or without basket flexibility.

---

classified as "not flexible" if baskets must be a pro rata slice of its portfolio, with exceptions for fractional shares, round lots, and minimum size requirements for component securities. ETFs classified as "not flexible" may permit or require cash in lieu of certain securities under certain circumstances.

Figure 1: Estimated Benefits to Fixed Income ETF Investors from Flexible Baskets

Estimated coefficient on basket flexibility indicator variable, basis points

*p < 0.10, **p < 0.05, ***p < 0.01

[1]Data from January 1, 2007 to April 1, 2018 covering 324 fixed income ETFs.

[2]Data from December 8, 2015 to December 18, 2015 covering 315 fixed income ETFs.

[3]Tracking differential is measured as the absolute vaue of the difference between the ETF's daily return and the daily return of its benchmark.

[4]Discount is measured as the absolute value of the difference between the ETF's closing price and its NAV relative to its NAV.

Source: Two stage instrumental variables regression estimated by ICI staff.

In short, using custom baskets can benefit investors by helping the ETF meet its investment objective more efficiently, improving its tradability and thereby allowing its investors to enjoy lower costs and better tax treatment. As such, all ETF sponsors should have the ability to deliver these important investor benefits by determining the composition of ETF portfolio creation and redemption baskets. We therefore strongly commend the Commission for recognizing these benefits and incorporating custom basket flexibility into the proposed rule.

1. Custom Basket Policies and Procedures

Nevertheless, the SEC also believes that the use of custom baskets presents an increased risk that the ETF may be subject to improper pressure by an authorized participant to create specific baskets that favor the authorized participant.[18] As a result, an ETF using custom

---

[18] Such transactions, however, are contrary to an ETF's business interests. Indeed, there is little incentive for an ETF sponsor to construct a redemption basket with its most liquid assets, leaving the most illiquid assets in the ETF. Indeed, these actions would be visible in the marketplace through daily required disclosure of the ETF's portfolio holdings. Likewise, it is not in the interests of ETF sponsors to operate an ETF in a manner that

baskets must adopt policies and procedures that: (i) set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for any revisions to, or deviation from, those parameters; and (ii) specify the titles or roles of the employees of the ETF's investment adviser who are required to review each custom basket for compliance with those parameters ("custom basket policies and procedures"). As part of this review, the Release notes that an ETF may want to consider whether employees outside of portfolio management should review the components of custom baskets before approving a creation or redemption.

We generally support this principles-based approach and believe it is an appropriate and effective way to limit any potential abuses relating to an ETF's use of custom baskets. Although we do not oppose the Commission's suggestion in the Release that an ETF may want to "consider whether employees outside of portfolio management" should review the components of custom baskets before approving a creation or redemption, we would oppose adding this as a requirement to the rule. Members are concerned that this additional layer of oversight could be overly burdensome, impracticable, and cause delays that would impact the authorized participants' ability to assess their risk of meeting client demands for shares. Such a requirement also is unnecessary to address conflicts of interest or to protect investors. As policies and procedures covered by the ETF's compliance program, requirements under Rule 38a-1 already provide an additional layer of oversight. Specifically, Rule 38a-1 would require the ETF to annually review the adequacy of its custom basket policies and procedures and the effectiveness of their implementation. The fund's chief compliance officer must annually present the results of this review to the ETF's board, including information on (1) any material changes made to the custom basket policies and procedures and (2) details about any material compliance matters involving the custom basket policies and procedures. We therefore believe the Rule 38a-1 requirements will provide regular and ongoing oversight of the custom basket policies and procedures, obviating the need for yet another layer of review.

2. Definition of Custom Basket

As noted above, proposed Rule 6c-11 defines two types of custom baskets. According to the Release, the Commission includes within that definition situations when an ETF substitutes cash in lieu of a portion of basket assets for a single authorized participant. We question why cash substitutions should in all cases be subject to the proposed heightened processing requirements. The Release notes that a custom basket could give authorized

---

increases the bid-ask spread or the premium or discount of the market price relative to the ETF's NAV. As discussed below, the bid-ask spread adds to the implicit costs that an investor incurs when buying and selling ETF shares. In the highly competitive and growing ETF market, diluting shareholder interests and reducing share value are not conducive to the growth or long-term success of an ETF. Furthermore, as noted above, there is no opportunity for an authorized participant to engage in transactions that could be detrimental to the fund or other shareholders. All purchases and redemptions of creation units are at an ETF's next-calculated NAV pursuant to Rule 22c-1 and the assets submitted for creation or delivered upon redemption are valued in the same manner, and under the same terms, as those assets are valued for purposes of calculating the ETF's NAV per share.

participants more opportunities for cherry picking, dumping, or other abuses, including the potential for manipulative trading in the underlying portfolio securities. We fail to see how a cash substitution raises the same potential conflicts of interest as a security substitution, especially since the ETF typically charges the authorized participant a cash adjustment and/or a transaction fee to offset transaction expenses *e.g.*, operational processing and brokerage costs incurred by the fund. We therefore believe cash substitutions should only be governed by an ETF's regular basket policies and procedures.

E. Portfolio Holdings and Basket Website Disclosure

Proposed Rule 6c-11 would require an ETF to disclose on its website, each business day, the portfolio holdings[19] that will form the basis for the next calculation of NAV per share, information regarding a published basket that will apply to orders for the purchase or redemption of creation units each business day, and the estimated cash balancing amount, if any. This information must be published on the website before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting orders for the purchase or redemption of creation units. The rule also would require that the portfolio holdings and basket information be presented and contain information regarding description, amount, value and/or unrealized gain/loss (as applicable) consistent with Article 12 of Regulation S-X, which sets forth the form and content of fund financial statements.

1. T-1 Orders

As proposed, an ETF's basket and portfolio holdings must be published on its website before it accepts creation and redemption orders. This requirement would seem to preclude an ETF from accepting creation and redemption orders shortly after the US market closes (4:00 pm ET) but before the basket holdings are published ("T-1 orders")—a practice that is quite common and beneficial (as explained below) for certain ETFs and their investors.

a) How Authorized Participants Use ETF Transparency

An effective arbitrage mechanism relies on a combination of several different factors, including: the ability to determine the current intrinsic value of the ETF's portfolio holdings intraday; the ability for market participants to hedge a position in an ETF's shares to provide liquidity; and the confidence that both the ETF and associated hedge trades will stand.[20]

---

[19] Portfolio holdings is defined to mean an ETF's securities, assets, or other positions. As a result, an ETF would be required to disclose its cash holdings, as well as holdings that are not securities or assets, including derivative positions, short positions, or written options. Changes in an ETF's holdings of portfolio securities also must be reflected on a T+1 basis. More specifically, portfolio trades executed on the preceding business day must be reflected in the portfolio disclosure posted to the ETF's website prior to the opening of regular trading on the primary listing exchange on the current business day.

[20] *See* Comment Letter of BlackRock on 2015 ETP Request for Comment (August 11, 2015), available at https://www.blackrock.com/corporate/literature/publication/sec-request-for-comment-exchange-traded-products-081115.pdf.

Ideally, this means an authorized participant will have (i) a high degree of certainty about the basket securities along with (ii) the ability to trade or hedge the underlying exposures at the same time the ETF strikes its NAV. Authorized participants operate most efficiently when both of these conditions are met. If an authorized participant has full transparency to an ETF's basket, but cannot trade/hedge the exposure, the bid-ask spreads will reflect that resulting uncertainty and risk. If an authorized participant can trade/hedge, but has little transparency on *what* to hedge, spreads will again reflect that uncertainty.

For the above process to work most effectively, basket securities must be known before the market for those securities closes. For the US market, an authorized participant can purchase or sell securities throughout the day, or at the US market close, to meet in-kind delivery for a create/redeem order. Similarly, for certain foreign markets (*e.g.*, Japan) an authorized participant will trade Japanese equities at the local market close (2:00 am ET), and as such, the authorized participant will place orders for those trades on T-1. If the authorized participant intends to deliver the basket securities in-kind, the authorized participant can enter the creation/redemption order on T.

Other foreign markets *e.g.*, South Korea, India), however, do not permit the ETF to transfer in-kind securities to the authorized participant. There also may be other circumstances when specific securities cannot be delivered in-kind, or there are efficiencies that make cash in lieu preferable for ETFs and authorized participants. In these cases, the ETF's portfolio manager must determine, prepare, and place orders shortly after the US market closes with a local trading desk to ensure that the orders are executed at prices on which the NAV will be based. For this to happen, the trade window for create/redeem orders is typically between 4:00 pm and 5:00 pm ET on T-1 to take into consideration the operational steps needed to meet the local trading deadlines. The timing of this process is both practical and necessary to meet the second condition outlined above. Regardless of whether authorized participants deliver shares in-kind or through cash in lieu, authorized participants prefer to place their create/redeem orders on T-1 for Asian ETFs because of the need to source the underlying securities.

b) How T-1 Orders Work

Certain ETFs that invest in foreign markets that close overnight US Eastern time utilize the T-1 order window to ensure investors receive the most efficient pricing possible. To illustrate, an ETF that is invested in South Korean equities, and is required by that market to accept creation and redemption orders in cash, would utilize this order flow. Throughout the day, an authorized participant will buy and sell the ETF. At the end of the day, the authorized participant may have net sold $10 million of the ETF to investors and seek to create new shares to satisfy that demand. The authorized participant cannot buy Korean securities and deliver them in-kind to the ETF. Instead, the ETF's portfolio manager must purchase the Korean securities with cash in lieu that the authorized participant will deliver on the creation order.

For the most efficient pricing (and therefore tighter bid-ask spreads), the authorized participant needs the Korean securities to execute at the same prices at which the ETF strikes its NAV. To achieve that result, orders for the Korean securities must be determined, prepared, and placed with a local trading desk shortly after the US market closes (between 4:00 pm and 5:00 pm ET) and executed overnight at the local market close *i.e.*, 2:30 am ET) to correspond to the following day's NAV. Before an ETF can place those trades, it will need a confirmed creation or redemption order on T-1.

An order flow that utilizes T-1 helps to ensure maximum efficiency of pricing to investors. To do this, creation/redemption orders must be received before the market close of the underlying securities, which for markets that close overnight Eastern time, means the prior day (T-1). Any lack of transparency is already reflected in the ETFs' price during the day. The short period between receiving a T-1 order and the publication of the basket is purely a logistical time delay as custodian batch processes run and is understood and managed by market participants. A timeline illustrating this example is included in Appendix B.

To address the concern that there is a lack of transparency in this process, we note the following points:

- An ETF's basket is generally published between 6-8pm ET, so full transparency is available before any underlying basket trades are executed.

- The yet to be published basket can be predicted with a high degree of certainty based on the prior day's basket or portfolio holdings (published that morning) and transparent rebalance schedule.

- For active funds, the level of transparency will be slightly lower for T-1 orders; however, this is both expected for this type of product and already included in the pricing throughout the day, not only at the time of a creation order.

- An authorized participant can achieve significantly more pricing efficiency with a high degree of transparency AND the ability to participate in the market close of the underlying securities, compared to complete transparency and no ability to participate in the market close of the underlying securities.

c) Why T Doesn't Work

If the T-1 window was not available, bid-ask spreads would likely widen in the relevant ETFs. Using the same example as above, in a T order only scenario, an authorized participant would enter a trade on T for the NAV that will be calculated that evening (typically between 6:00 and 7:00 pm ET) based on the Korean market close earlier that morning (2:30 am ET—a differential of about 16 hours). The authorized participant will deliver cash to the ETF but is now exposed to where Korean securities open the following morning. This introduces uncertainty on execution and almost certainly slippage (the difference between the expected price of a trade and the price at which the trade is actually executed) to the prices used to strike the NAV, which in turn may lead to wider bid-ask spreads and larger premium/discounts for these ETFs. In addition, for ETFs that track an index, tracking differentials to that index may increase. We therefore strongly urge the Commission to reconsider this requirement and change the proposed rule so that T-1 orders can be accepted.

2. Regulation S-X

We also appreciate the Commission's desire to standardize the manner in which portfolio holdings and baskets are presented on the ETF's website. To do this, the rule would require information for portfolio holdings and for baskets be presented consistent with Article 12 of Regulation S-X. Specifically, the proposal would require for each security the name of issuer and title of issue, the balance held (*i.e.*, number shares or principal amount of bonds), and the value. For derivatives, the proposed disclosure would include the reference asset or index, the number of contracts, the counterparty, the notional amount, the exercise price, the expiration or settlement date, and the value or unrealized appreciation/depreciation.[21]

Although ETFs already comply with Regulation S-X for periodic reports, members are concerned that certain requirements in Article 12 may prove overly burdensome for purposes of daily disclosure. Furthermore, we believe certain information required by Regulation S-X is unnecessary to achieve the Commission's stated rationale for requiring the disclosure (*i.e*., to enable market participants to value the basket or portfolio for purposes of determining whether arbitrage opportunities exist .[22] This is particularly true for the basket disclosure that simply describes the securities the ETF would accept from authorized participants in exchange for a creation unit.

Accordingly, instead of requiring disclosure consistent with Article 12, we recommend that the Commission include within the final rule specified formats for the portfolio disclosure and the basket disclosure similar to that required by the exchange listing standards.[23] The Commission could specify the ordering and format of these data elements to better standardize portfolio disclosure presentation and basket disclosure presentation across ETFs. The specified formats would apply to all ETFs relying on the rule. The format for portfolio disclosure should include all the items listed below. The format for basket disclosure describing the securities the fund would accept from authorized participants (or provide to authorized participants) should include only items A, B, C, and F, which is the information that currently is included in the

---

[21] The Release at note 220 indicates that ETFs should include in the portfolio and basket disclosures the data elements required by the notes to the "description column" in each of the Article 12 schedules. We interpret this to mean, for example, that funds would include the data elements required by notes one through four of Rule 12-12 of Regulation S-X (Investments in securities of unaffiliated issuers), and not those data elements required by notes five through ten. Similarly, the data elements required by notes one through three of Rule 12-13 of Regulation S-X (Open option contracts written) would be required, and not those data elements required by notes four through eight.

[22] Release at 76-77.

[23] *See* NYSE Arca Rule 8.600-E c) 2); Nasdaq Rule 5735(c)(2); Cboe BZX Rule 14.11(i)(3)(B).

portfolio composition file sent to the National Securities Clearing Corporation (NSCC) and more relevant for authorized participant creation/redemption activity.

A. Ticker symbol;
B. Security identifier;
C. Description of the holding;
D. With respect to holdings in derivatives, the identity of the security, commodity, index or other asset upon which the derivative is based;
E. The strike price for any options;
F. The quantity of each security or other asset held as measured by:
    1. Par value,
    2. Notional value,
    3. Number of shares,
    4. Number of contracts, and
    5. And number of units;
G. Maturity date;
H. Coupon rate;
I. Effective date;
J. Market value; and
K. Percentage weighting of the holding in the portfolio.

Furthermore, it is unclear how Regulation S-X-based disclosure would relate to the schedule currently required by exchange listing standards. For example, does the proposal contemplate that ETFs would provide two separate schedules (one as required by exchange listing standards and one consistent with Article 12)? Our recommendation to standardize the presentation formats based on exchange listing requirements would obviate the need for two separate schedules, a costly and largely redundant exercise with no additional benefit.

If the Commission is unwilling to standardize the format of website portfolio holdings and baskets by specifying a format similar to that required by the exchanges within the final rule, and instead determines to require presentation consistent with Regulation S-X, then we recommend that certain required data elements within the Article 12 schedules be omitted from the rule, as described below. We believe these elements are not necessary to facilitate the arbitrage process.

For example, note two of Rule 12-12 requires the categorization of investments by security type, industry, and geography and note three requires disclosure of the reference rate and spread for variable rate securities. Since the information in these notes is not needed to identify or value the security or evaluate arbitrage opportunities, we recommend that these disclosures be omitted from the rule.

Note three of Rule 12-13 (Open option contracts written) and note three of Rule 12-13C (Open swap contracts) each require that where the notional amount of the contract exceeds 1 percent of NAV and the reference instrument is an index or basket, the components of which are not publicly available, that the fund disclose specified information for the 50 largest components and any other components where the notional for the component exceeds 1 percent of the notional value of the index or basket. Furthermore, the specified information includes, for each component separately listed, the information required by the relevant schedule (*e.g.*, if an equity investment is an unaffiliated issuer, then the disclosures required by Rule 12-12). To simplify the disclosures for contracts on indexes the components of which are not publicly available, we recommend that the final rule permit the fund to provide a description of the non-public index in lieu of the 50 largest components and any other components where notional exceeds 1 percent of the notional of the index.

As noted above, the Release indicates that ETFs should include in the portfolio and basket disclosures the data elements required by the notes to the "description column" in each of the Article 12 schedules. We observe that the notes relating to the description column (column A) in Article 12, however, are not consistent across the different schedules. For example, the notes to the description column in Rule 12-13A (Open futures contracts) would require disclosure by appropriate symbol of each security that cannot be sold because of restrictions and each security whose value was determined using unobservable inputs. Although Rule 12-12 requires these same disclosures, they are not required by the description column (column A) and thus we believe would not be required by the proposal for investments in unaffiliated issuers. If the rule as adopted requires disclosures consistent with Article 12, then we recommend that the rule clearly identify those note disclosures that should be provided for each of the Article 12 schedules.

3. Basket Disclosure

Under the proposal, an ETF would publish a basket that it would accept if presented by any authorized participant in exchange for creation units (or presented to an authorized participant redeeming creation units). Thus, if an ETF planned to use only custom baskets on a particular business day (*e.g.*, a basket reflecting a non-representative selection of the ETF's portfolio holdings), it would be required to post a custom basket as its "published" basket; however, the rule would only require an ETF to publish one basket per day, even where an ETF may use multiple custom baskets.

Under current practice, ETFs typically publish their basket by sending a portfolio composition file containing their basket contents each business day to the NSCC. Authorized participants, market-makers, and other liquidity providers are typically NSCC members and therefore have access to the daily portfolio composition files. Unlike portfolio holdings, however, the contents of an ETF's basket are simply not relevant for most secondary market investors, and, in fact, may be confusing for investors who mistake the basket (which, for some ETFs, may only be a representative sample of the entire portfolio) for the ETF's portfolio holdings. Indeed, this requirement would seem to contradict the Commission's proposed amendments to Form N-1A and N-8B-2 (discussed below) that would eliminate certain disclosures from the prospectus that are relevant only to authorized participants and potentially confusing to secondary market participants. We therefore urge the Commission to reconsider the proposed requirement that ETFs disclose baskets on their websites.

Currently, members will often publish a *pro rata* basket, and then customize the basket as appropriate throughout the trading day. For example, creations typically aim to add underweights and new securities entering the index. Conversely, redemptions aim to remove over-weights and index deletions, and maintain hard to obtain securities in the fund. Also depending on the size of the creation/redemption order or the volume of activity, the baskets may be broader or look different (*e.g.*, an ETF that runs out of a security for a large redemption order may need to adjust accordingly) throughout the trading day. Further, certain ETFs may use both a *pro rata* and custom basket on the same business day. We therefore request that the Commission clarify that even if an ETF does not publish a custom basket at the beginning of the trading day, it can still use custom baskets in addition to the published (*e.g., pro rata* basket.

In any case, we would not support a requirement that an ETF post on its website every basket it accepts from or presents to an authorized participant after the close of trading on each business day. We agree with the Commission's preliminary belief that such a requirement would be unnecessarily burdensome and costly to implement, and similar to the discussion above, is not relevant to most secondary market investors and may in fact be confusing to investors.

F. NAV, Market Price, and Premium or Discount Website Disclosure

In addition to portfolio holdings and basket disclosure discussed above, proposed Rule 6c-11 would require ETFs to disclose: (i) the ETF's NAV per share, market price, and premium or discount, each as of the end of the prior business day;[24] and (ii) historical information regarding premiums and discounts (both a table and line graph showing the ETF's premium and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year).[25] We do not object to these disclosures and find that they are generally consistent with the SEC's exemptive orders and current Form N-1A disclosure.

The proposed rule also would require any ETF whose premium or discount was greater than 2 percent for more than seven consecutive trading days to post that information on its website, along with a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount. Although we agree with the Commission that the deviation between the market price for most ETFs and NAV per share, each calculated as of the close of trading each day, is relatively small; for other types of ETFs, especially those investing in international markets where the ETF and its underlying securities trade on exchanges that are in different time zones, the deviation may be a bit greater or persist for longer periods of time.

---

[24] This requirement is consistent with the SEC's exemptive orders and generally consistent with the 2008 ETF proposal.

[25] Historical information regarding premiums and discounts is a condition in many of the SEC's exemptive orders and required by Form N-1A.

We are concerned, therefore, that for some ETFs, the proposed disclosure requirement may be triggered more frequently, leading to disclosure that is unnecessary (given the asset class) or repetitive. It also may be difficult for an ETF to accurately identify the material factors that caused the deviation. Although some market events are easily identifiable, others are less so. Similarly, thanks to the creation/redemption mechanism, deviations between an ETF's market price and its NAV tend to be short-lived and quickly self-correct. Other deviations may persist for a variety of reasons, none of which are easily understood or recognizable at the time the ETF is required to post the information and provide the narrative discussion of factors. Based on these concerns, we oppose this disclosure. An investor interested in information about the extent and frequency with which an ETF's market prices have tracked its NAV would still have access to the daily and historical premium/discount information proposed above.

IV. Recordkeeping

We support the Commission's proposal to require that ETFs preserve and maintain copies of authorized participant agreements. The Release notes that this requirement is designed to provide the SEC's examination staff with a basis to determine whether the relationship between the ETF and the authorized participant is in compliance with the requirements of proposed Rule 6c-11 and other provisions of the Investment Company Act and rules thereunder.

We also support the Commission's proposal to require ETFs to maintain information regarding the baskets exchanged with authorized participants. In particular, the proposed rule would require an ETF to maintain records setting forth the following information for each basket exchanged with an authorized participant: (i) the names and quantities of the positions composing the basket; (ii) identification of the basket as a "custom basket" and a record stating that the custom basket complies with the ETF's custom basket policies and procedures (if applicable); (iii) cash balancing amounts (if any ; and (iv) the identity of the authorized participant conducting the transaction. These records would provide the SEC's examination staff with a basis to understand how baskets are being used by ETFs, as well as to evaluate compliance with the rule and other provisions of the Investment Company Act and rules thereunder.

V. Effect of Proposed Rule 6c-11 on Prior Orders

We do not object to the SEC's proposal to amend and rescind (one year following the effective date of any final rule) the exemptive relief it has issued to ETFs that would be permitted to rely on the proposed rule. The rescission of orders would specifically be limited to the portions of an ETF's exemptive order that grant relief related to the formation and operation of an ETF. We also do not object to the SEC's proposal to rescind the master-feeder relief granted to ETFs that do not rely on the relief as of the date of this proposal (June 28, 2018), preventing the formation of new master-feeder arrangements. The proposal would not rescind the relief from Section 12(d)(1) and Sections 17(a)(1) and (a)(2) of the Investment Company Act relating to fund of funds arrangements involving ETFs.

We also strongly agree with the SEC's proposal to retain the exemptive relief of ETFs that would not be permitted to rely on the proposed rule. Specifically, the SEC does not propose to rescind the exemptive relief for ETFs organized as UITs, ETFs that are organized as a share class of a fund, or leveraged ETFs. Instead, the Release notes that it is appropriate for ETFs seeking to utilize these structures to continue to request SEC relief through its exemptive application process, and for the SEC to continue to make facts-and-circumstances-based determinations regarding whether such relief is appropriate for any particular applicant.

VI. Amendments to Form N-1A

The SEC is proposing several amendments to Form N-1A, which are designed to provide investors who purchase ETF shares in secondary market transactions with additional information regarding ETFs, including information regarding costs associated with an investment in ETFs. The proposal also would eliminate certain disclosures that would be duplicative of the proposed amendments to Item 3 of Form N-1A regarding the exchange-traded nature of ETFs.

We generally support the Commission's approach of revising Form N-1A to better serve the information needs of retail investors. Consistent with our 2008 comment letter, we agree that it is appropriate to distinguish between those who purchase in the secondary market and authorized participants who transact directly with the fund.[26] As such, we agree that it is appropriate to eliminate certain disclosures from the prospectus that are relevant only to authorized participants and may be confusing to secondary market participants. Our comments are focused on the proposed new language in Item 3.

A. Item 3

Item 3 of Form N-1A requires funds to include a table describing the fees and expenses investors may pay if they buy and hold shares of the fund. Item 3 does not currently distinguish between ETFs and mutual funds, and only requires disclosure of sales loads, exchange fees, maximum account fees, and redemption fees that funds charge directly to shareholders. The Commission therefore is proposing several amendments to this Item to clarify that there are certain fees that are not reflected in the fee table for both mutual funds and ETFs and to require new disclosure requirements that capture ETF-specific trading information and costs. Like all information disclosed in Items 2, 3, or 4 of Form N-1A, the information disclosed in amended Item 3 would have to be tagged and submitted in a structured data format.

1. Changes That Affect Mutual Funds and ETFs

We support the Commission's proposal to add disclosure that would clarify that, in addition to the current disclosures relating to investors who buy or hold shares, the fees and

---

[26] 2008 ICI comment letter.

expenses reflected in the Item 3 expense table may be higher for investors if they sell shares of the fund. This amendment would be applicable to both mutual funds and ETFs given that an investor may incur expenses other than redemption fees when selling shares of either a mutual fund or ETF. For example, although substantially less common than they were in the past, an investor may incur a back-end sales load when selling a mutual fund share. Likewise, an investor may bear costs associated with bid-ask spreads when selling ETF shares. We also support the Commission's proposal to require a statement that investors may be subject to other fees not reflected in the table, such as brokerage commissions and fees to financial intermediaries.

2. Changes That Affect ETFs

Because ETF shares are exchange-traded, secondary market investors in ETF shares are subject to trading costs external to the ETF that are not currently disclosed under Item 3. As a result, the Commission is proposing a new section, formatted as a series of question and answers ("Q&As"), in Item 3 that would require disclosure of certain ETF trading information and trading costs.[27] The six proposed Q&A disclosures would require information relating to the trading of ETFs in the secondary market and the costs associated with such trading.

We support narrative disclosure (similar to the proposed language in Q&As 1-3) that would highlight the transaction fees and costs for ETFs that are not reflected in the fee table, such as brokerage commissions,[28] bid-ask spread,[29] and costs attributable to premiums and discounts.[30] We agree that investors may overlook these costs and that additional disclosure would help them better understand the total costs of investing in an ETF.

---

[27] An ETF that had its initial listing on a national securities exchange after the beginning of its most recently completed fiscal year would not report the bid-ask spread information, as described below.

[28] ETF investors may pay a broker sales commissions with each purchase or sale of ETF shares. To the extent a brokerage commission is applied, it may be structured as a flat fee charged every time an investor trades. With a flat fee, the smaller the amount traded, the larger the percentage cost per trade is to the investor.

[29] ETFs and other securities that trade on a securities market have two market prices—the bid price (the highest price a buyer will pay to buy a specified number of ETF shares) and the ask price (the lowest price at which a seller will sell the ETF shares). The bid price will be lower than the ask price and the difference between the two prices is called the spread. Similar to brokerage commissions, spreads can reduce potential returns.

[30] For a variety of reasons, an ETF's market price may reflect a premium or a discount to the ETF's underlying value or NAV. An ETF share is trading at a premium when its market price is higher than the NAV or the value of its underlying holdings. An ETF share is trading at a discount when its market price is lower than the NAV or value of its underlying holdings. Premiums and discounts are not direct costs to an investor, but changes in premiums and discounts may affect the realized return on the investor's ETF shares—for example, if an investor buys shares at a premium and sells at a discount.

a) Costs Attributable to Bid-Ask Spread—Prospectus Disclosure

In addition to the narrative disclosure noted above, however Q&As 3-5 require trading costs attributable *solely* to bid-ask spread. Specifically, Q&A 3 requires an ETF to calculate and disclose its median bid-ask spread over the most recently completed fiscal year. Q&A 4 requires the ETF to include a question on how the bid-ask spread impacts the return on a hypothetical $10,000 "round trip" investment based on data from the ETF's prior fiscal year. Instead of the hypothetical trading costs attributable to a single round trip, Q&A 5 would require the ETF to disclose the trading costs of 25 round trips (each trade being $10,000).

Although we agree that investors should pay attention to the costs attributable to bid-ask spread when trading *any* financial instrument,[31] calculating an ETF's bid-ask spread is significantly different from an ETF's other quantitative disclosure responsibilities, such as calculating a fund's performance and the shareholder fees and annual fund operating expenses listed in the prospectus. Funds produce those figures using highly prescribed methodologies with objective inputs. By contrast, an ETF does not control bid-ask spread costs and cannot independently calculate its bid-ask spread. Rather, this information is available only by purchasing market data to calculate it, or through third party vendors that may use a variety of non-standard, and sometimes, inconsistent inputs. Indeed, according to our members, currently there is no single, verifiable metric for assessing bid-ask spread that will allow for accurate comparisons across funds.

Including this information in a fund's prospectus is even more concerning. The information will be stale (up to 16 months old) and potentially misleading because it is unlikely to represent a market participant's actual costs in the near-term and also suggests the ETF controls this cost. There are several factors that contribute to the difference between the bid and ask prices, including a security's liquidity or volume, volatility, time of execution, quality of execution, order size, and price. An investor's financial intermediary is in the best position to provide more useful and accurate information on trading costs to an investor. In today's fast-moving markets, ETF prices fluctuate continuously throughout the day like stocks. Accurately reflecting these fluctuations and the various factors that contribute to the bid-ask spread in a prospectus will not be possible, leaving investors with information that is at best of limited value and quite possibly misleading.

We also are concerned the bid-ask spread calculations will raise prospectus liability concerns. Under Section 11 of the Securities Act of 1933, purchasers of an issuer's securities have private rights of action for untrue statements of material facts or omissions of material facts required to be included in the registration statement or necessary to make the statements in the registration statement not misleading. As noted above, adding bid-ask spread costs to the prospectus raises a host of potential issues, including the possibility that the information will be

[31] Investors pay bid-ask spreads on other financial instruments, such as when they purchase stocks of operating companies in the secondary market. The SEC does not require bid-ask spread disclosures in these instances.

considered misleading if an investor's actual bid-ask spread costs differ from the prospectus calculations. We note that, as proposed, an ETF could not customize the proposed Q&As to add disclaimer language to help alleviate these liability concerns.

To demonstrate how costs attributable to bid-ask spreads can affect an investor's total costs of investing in an ETF, we recommend the Commission replace proposed Q&As 3-5 with a hypothetical example using standard inputs, like the current fee example, similar to the following:

> Bid-ask spreads are one component of costs associated with trading shares, including ETF shares, on an exchange. The bid-ask spread is the difference between the price that an investor is willing to buy shares (the "bid" price) and the price at which an investor is willing to sell shares (the "ask" price). This spread can have an impact on the return an investor earns.
>
> For example, assume that you want to buy 200 shares of an ETF that is valued at $50.00 and has an ask price of $50.05 and a bid price of $49.95. Although individual trade execution will vary based on a variety of circumstances, the total amount of your purchase would be $10,010 (200 shares at $50.05 each), assuming the execution is at the ask price. This is $10 more than if you had been able to purchase the 200 shares at $50.00 each for a total of $10,000. If you were to immediately sell these 200 shares, and assuming the execution is at the bid price, you would receive the bid price of $49.95 for each share and your total proceeds would be $9,990. This is $10 less than if you had been able to sell the 200 shares at $50.00 each for a total of $10,000. In this hypothetical example, the bid-ask spread accounted for $20 in costs in this one roundtrip (buy and sell) transaction and reduced the return on your investment by 0.2 percent ($20/$10,000 . The potential impact of bid-ask spreads may be greater the more roundtrip transactions you make in a given period.
>
> Bid-ask spreads may be higher or lower than noted in this example for any given ETF and are subject to change. Investors should consult with a financial professional to further understand how trading frequency, bid-ask spreads, and other transaction costs may affect the returns on their investments.

We believe this approach would provide investors with a more accurate and effective way of understanding costs associated with investing in ETFs without misleading investors or the additional prospectus liability concerns. We also believe this approach encourages investors to seek information regarding their actual trading costs from their financial intermediaries who have that information.

b) Interactive Calculator

Proposed Q&A 6 would require a cross reference to the ETF's website disclosures, including an interactive calculator that an investor can use to determine how the bid-ask spread would impact the investor's specific investment using bid-ask data from 10-second intervals during each trading day of the ETF's prior fiscal year. According to the Release, the purpose of the calculator is to provide investors with the ability to customize the hypothetical calculations in Item 3 to their specific investing situation. Although we appreciate the Commission's desire to provide investors with a tool relating to the total costs of trading ETFs in the secondary market, we are concerned that historical spread data which, as noted above, is not information an ETF controls or can calculate independently) is not necessarily predictive of an investor's future spread costs.

Furthermore, creating and maintaining this kind of website functionality will likely require the ongoing assistance of outside vendors. The Release estimates that for the proposed amendments to Forms N-1A and N-8B-2, including the interactive calculator, each ETF would incur a one-time cost of $6,710 and an ongoing cost of $3,355 per year for a total industry cost equal to $19,123,500 for the first year). The Release also assumes that ETFs already have the required data for these new disclosures, including the data for the interactive calculator as part of their regular operations. Our members report, however, that they do not currently collect or process data as contemplated by Q&As 3-6, including the historical spread data that would be necessary for the interactive calculator.

Smaller members are especially concerned about the potential costs of these new disclosures and the interactive calculator because they would add additional vendor and licensing fees to a growing list of SEC-mandated disclosures for registered funds. For example, funds must pay a third-party vendor for the use of CUSIP standard security identifiers to meet SEC disclosure and reporting requirements. Likewise, the SEC requires funds to use a broad-based securities market index in their prospectuses and annual reports. Although the intent of this requirement is to provide some context for investors to understand a fund's returns, members have indicated that licensing fees to the limited number of widely recognized index providers have greatly increased in recent years.

If the Commission nevertheless wishes to move forward with an interactive calculator despite our concerns, we believe it should be located in one central location, similar to the SEC's Mutual Fund Cost Calculator.[32] Specifically, we recommend the Commission consider creating a calculator utilizing the advanced market metrics available through its Market Information Data Analytics System (MIDAS). According to the Commission's website, MIDAS collects more than one billion records per day from each of the 13 national equity exchanges, each time-stamped to the microsecond, using the consolidated public feeds and the exchange proprietary feeds.[33] Using interactive data visualization tools, the Commission's

---

[32] The SEC's Mutual Fund Cost Calculator is available on the SEC's website at https://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm.

[33] Information about MIDAS is available on the SEC's market structure website at https://www.sec.gov/marketstructure/midas.html#.W5FJpehKiUk. According to the website, the MIDAS data is extremely voluminous, challenging to process correctly, and requires specialized data expertise.

website already allows users to examine metrics and trends based on the data the Commission has collected through MIDAS. Adding a functionality to this website would allow investors to access bid-ask spread costs (for all financial instruments) using a single data source and methodology. It also would further the Commission's goal when it created its market structure website—to promote better understanding of our equity markets and equity market structure through the use of data and analytics.

VII. Amendments to Form N-8B-2

Subject to our comments regarding the amendments to Form N-1A, we generally support the Commission's proposal to amend Form N-8B-2 to require UIT ETFs to provide disclosures that mirror certain of the proposed disclosure changes in Form N-1A.

VIII. Amendments to Form N-CEN

Item C.7. of Form N-CEN requires management companies to report whether they relied on certain rules under the Investment Company Act during the reporting period. We support the Commission's proposal to add to Form N-CEN a requirement that ETFs report if they are relying on Rule 6c-11.

IX. Regulation of ETFs Under the Securities Exchange Act

The Release requests comment on whether the Commission should exempt ETFs relying on proposed Rule 6c-11 from any rules under the Securities Exchange Act. We believe that automatic relief from certain Securities Exchange Act rules could be warranted, and recommend that the SEC consider ways to streamline the regulation of ETFs under both the Investment Company Act and the Securities Exchange Act. Currently, ETFs often must satisfy multiple and sometimes conflicting requirements from different divisions within the SEC.

An ETF must comply with the initial and continued listing requirements of the exchange upon which it will list its shares. If a new ETF cannot meet an exchange's preapproved "generic" listing or continued listing standards, even in an immaterial manner, then the exchange must submit an individual proposed rule change to the Division of Trading and Markets to obtain approval to list and trade that product.[34] Under Securities Exchange Act Rule 19b-4, exchanges have no discretion to offer issuers any waiver from the initial or continuing listing standards. Unfortunately, the current process for submitting and obtaining approval of a proposed rule change can slow the launch of new ETFs by more than a year thereby depriving investors of new investing opportunities , creates different rules for similar products depending on the approval vintage, and is an inefficient use of the SEC's resources.

[34] Section 19(b) of the Securities Exchange Act of 1934 requires an exchange to obtain SEC approval for the listing or trading of any new ETF. Rule 19b-4(e) creates an exception from this requirement for ETF shares that meet "generic listing requirements" that have already been approved by the SEC.

In addition to meeting listing requirements, ETFs must obtain exemptive or no-action relief from the SEC from various Securities Exchange Act provisions and rules governing, among other things, certain activities of broker-dealers related to the distribution of ETF shares. The relief must be granted before trading on the exchange may commence. Specifically, the relief relates to: credit on ETF shares, customer confirmation disclosures, advance notices of corporate actions,[35] certain tender offer provisions, broker relationship disclosures, and anti-manipulation provisions of Regulation M.[36] Absent this relief, ETFs would be inhibited unnecessarily from operating as designed or subject to requirements that were intended to deter manipulation of individual securities rather than funds.

Since 2001, the SEC has made available class relief for most types of ETFs that meet certain conditions, which obviates the need for each new fund falling within the class from obtaining individual exemptive or no-action relief.[37] These conditions include minimum creation unit sizes, dissemination of the IIV, restrictions on the payment of certain cash compensation or economic incentives, minimum levels of diversification in the ETF's basket, and whether the ETF tracks an index. If class relief is unavailable, then an ETF sponsor must seek relief before its fund can be listed and traded on an exchange, which can take a significant amount of time to obtain and slow the launch of new ETFs considerably.

We urge the SEC to consider ways that the Divisions of Investment Management and Trading and Markets can work together to establish a single process for all ETF approvals.

X. Exemption for Investment Companies Investing in ETFs

Many existing ETFs have exemptive orders that permit other registered investment companies to make investments in them in excess of the Section 12(d)(1)(A) and (B) limits. Unlike the 2008 ETF proposal, the proposed rule does not address this aspect of the exemptive relief, and ETFs that have an exemptive order containing fund of funds relief may continue to rely on that aspect of the relief, including the related relief from Sections 17(a)(1 and 17(a)(2). ETF sponsors that do not have fund of funds relief, however, must file a separate exemptive application to obtain similar relief. We strongly support a proposal to permit investment companies to invest in ETFs to a greater extent than currently permitted by the Investment

[35] We note that relief from this requirement is not necessary if, as proposed, ETF shares are deemed to be redeemable securities for purposes of Section 2(a)(32) of the Investment Company Act.

[36] Similiarly, relief from this requirement is not necessary if ETF shares are deemed to be redeemable securities.

[37] *See Understanding the Regulation of Exchange-Traded Funds Under the Securities Exchange Act of 1934*, Investment Company Institute, August 2017, available at https://www.ici.org/pdf/ppr_17_etf_listing_standards.pdf.

Company Act and commend the Commission for including a proposed fund of funds rule on its rulemaking agenda for next year.[38]

* * * *

ICI and its members appreciate the opportunity to comment on the SEC's proposed new rule and form amendments intended to modernize the regulatory framework for ETFs. We remain firmly committed to assist the SEC in any way that we can. If you have any questions, please contact me ([redacted] or [redacted]) or Jane Heinrichs, Associate General Counsel [redacted] or [redacted]).

Sincerely,

/s/ Susan Olson

Susan Olson
General Counsel

cc: The Honorable Jay Clayton
The Honorable Kara M. Stein
The Honorable Robert J. Jackson Jr.
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman

Dalia Blass
Director, Division of Investment Management

---

[38] Securities and Exchange Commission, Agency Rule List—Spring 2018, available at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCd=3235&Image58.x=58&Image58.y=.

Appendix A

We conducted an econometric analysis exploring whether basket flexibility benefits ETF investors. Preliminary results indicate that basket flexibility benefits investors by significantly reducing bid-ask spreads, tracking differentials, and premiums/discounts.

1 Data

We collected daily data for bid-ask spreads, tracking differentials, and premiums/discounts, and annual data on expense ratios for 324 fixed income ETFs from January 1, 2007 to April 1, 2018. The sample starts in 2007 because prior to that date few fixed income ETFs were traded. All daily data are from Bloomberg. A fund's observed discount is the absolute value of the difference in the closing price and the reported net asset value relative to the net asset value. A fund's relative bid-ask spread is the difference between the closing ask and closing bid prices relative the closing mid point. A fund's tracking differential is the absolute difference between the daily return of the ETF and the daily return of the fund's Morningstar benchmark. We collected the annual expense ratios from Lipper and Morningstar and obtained a fund's number of authorized participants from a confidential 2014 ICI survey. To remove outliers, we winsorized the bid-ask spreads, the tracking differentials, and the discounts at the fifth percentile.

We obtained information on basket flexibility from a confidential 2018 ICI survey of ETFs and classified a fund's basket flexibility as either flexible or not flexible. We augmented the survey results by further classifying funds for which we did not receive any response based on the date of exemptive relief granted and the inception date.

2 Estimation Methodology

We analyzed whether basket flexibility benefits investor by measuring the impact of flexibility on bid-ask spreads, tracking differentials, premiums/discounts, and expense ratios. More specifically, let y_{it} be either the relative bid-ask spread, tracking differential, discount, or expense ratio, and let D_{score} be the flexibility score set equal to one if the fund has flexibility. We estimated for each y_{it} the following pooled instrumental variable regression

$$y_{it} = \beta_0 \, D_{score_i} + \beta_1 F_{it} + \beta_2 D_{it} + \varepsilon_{it} \tag{1}$$

where F contains fund specific information that may vary over time, and D contains individual and interacted investment objective and annual fixed effects. All data for the expense ratio regressions are annual or annual averages of daily data, and the regression only contains investment objective fixed effects. We clustered the errors ε at the fund level and report robust standard errors. As the first stage regression, we ran the following linear probability model

$$D_{score_i} = \alpha X_{it} + \zeta_{it} \tag{2}$$

where X contains, besides all explanatory variables F and D from equation (1), the independent instruments fund age and the natural log of fund size (AUM). We would expect that if basket flexibility is beneficial that the coefficient β_0 in equation (1) would be negative.

3 Regression Results

3.1 Full sample

We present in table 1 results for the full sample. The results suggest that fixed income ETFs with basket flexibility had bid-ask spreads that were 36 basis points lower, on average, than fixed income ETFs without basket flexibility. Furthermore, fixed income ETFs with basket flexibility had tracking differentials that were, on average, 11 basis points lower and discounts that were, on average, 28 basis points lower than fixed income ETFs without basket flexibility. These results are statistically significant at least at the ten percent level. However, fixed income ETFs with basket flexibility did not have, on average, statistically different expense ratios than ETFs without basket flexibility.

Table 1: Basket Flexibility and Benefits to Investors for Full Sample

	Bid-Ask Spread	Tracking Differential	Discount	Expense Ratio
D_{score}	-0.35670*	-0.11112*	-0.27760***	-0.09781
	(0.0695)	(0.0903)	(0.0039)	(0.4694)
ln(Number of Active APs)	-0.25310***	-0.01875	-0.02830	0.00057
	(0.0000)	(0.2662)	(0.3288)	(0.9880)
Redemption+Creation (Dollars)	-0.00559	-0.01418	0.01762	-0.00789
	(0.8326)	(0.1941)	(0.1435)	(0.6930)
|Fund return|	0.14565***	0.34513***	0.06054***	0.10293*
	(0.0058)	(0.0000)	(0.0005)	(0.0654)
Volume	-0.02459**	0.00136	0.00741	-0.01750
	(0.0447)	(0.8904)	(0.1542)	(0.3427)
Turnover	0.00524	-0.00156	-0.00183	0.48976***
	(0.2050)	(0.5191)	(0.2613)	(0.0062)
Adjusted R-Square	0.154	0.521	0.213	0.395
Observations	202,204	202,219	220,733	721

$^{*}p < 0.10$, $^{**}p < 0.05$, $^{***}p < 0.01$

3.2 Stress Period

Excluding year fixed effects, we re-estimated model (1) using the sample of 315 funds covering only the days from December 8, 2015 through December 18, 2015 when the high-yield bond market in the United States was under stress. The results presented in table 2 indicate that basket flexibility could be more important during periods of market stress. For example, fixed income ETFs with basket flexibility had bid-ask spreads during this stress period that were, on average, 69 basis points lower than fixed income ETFs without basket flexibility, and discounts on fixed income ETFs with basket flexibility were, on average, 51 basis points lower than on fixed income ETFs without basket flexibility. Both of these results are statistically significant at the five percent level. However, we did not find a statistically significant difference in tracking differentials between fixed income ETFs with and without basket flexibility during this period.

Table 2: Basket Flexibility and Benefits to Investors during Stress Periods

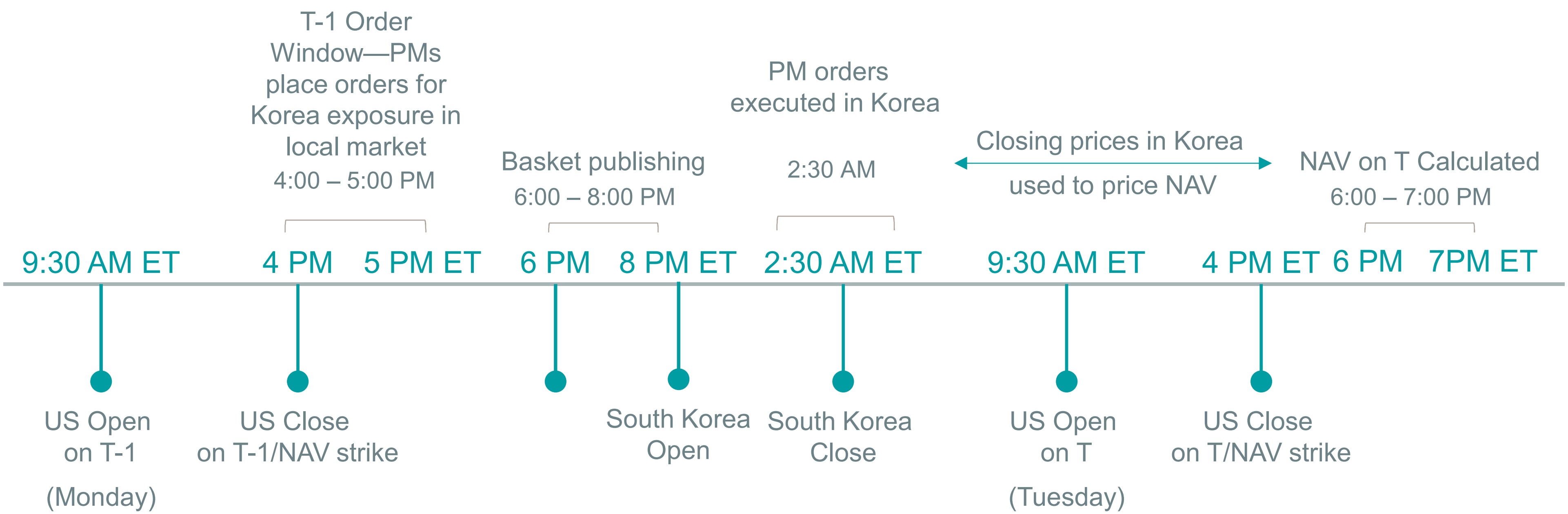
	Bid-Ask Spread	Tracking Differential	Discount
D_{score}	-0.68684**	-0.08498	-0.51017**
	(0.0141)	(0.4556)	(0.0160)
ln(Number of Active APs)	-0.09519	-0.02791	0.01480
	(0.1348)	(0.1997)	(0.7734)
Redemption+Creation (Dollars)	0.07088*	-0.02953	0.04627
	(0.0986)	(0.1476)	(0.1070)
|Fund returns|	0.11299*	0.35193***	0.06411*
	(0.0976)	(0.0000)	(0.0653)
Volume	-0.00167	0.00604	0.00887
	(0.8201)	(0.1638)	(0.2053)
Turnover	0.12793	0.05425	-0.21543
	(0.6642)	(0.9195)	(0.3140)
Adjusted R-Square	-0.228	0.492	-0.522
Observations	2,408	2,308	2,408

$^{*}p < 0.10$, $^{**}p < 0.05$, $^{***}p < 0.01$

Note: Adjusted R-Squares are affected by the limited number of observations and large number of fixed effects.

Appendix B

Orders After US Market Closes But Before Basket Publication (T-1 Orders)*



*The timeline is a sample only, and is intended to reflect ICI's general understanding of the operations of member firms, though not necessarily at any specific firm.