

September 27, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

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

Dear Mr. Fields:

The Independent Directors Council¹ appreciates the opportunity to comment on the Commission's proposed new rule that would permit exchange-traded funds ("ETFs") that satisfy certain conditions to operate without the expense and delay of obtaining an exemptive order.² We commend the SEC for proposing a rule that would bring greater consistency and efficiency to the ETF regulatory framework, level the playing field for ETFs that have been operating under inconsistent exemptive orders, and facilitate greater competition and innovation among ETFs. Proposed rule 6c-11 would codify much of the relief granted under the exemptive orders that have been issued over the past 26 years. The rule would provide ETFs with exemptions from certain provisions of the Investment Company Act of 1940 ("1940 Act") that are necessary to allow ETFs to operate, if they satisfy specified conditions.

We support the new rule and focus our comments on the fund governance aspects of the proposal and proposed disclosure requirements.

¹ IDC serves the US-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. 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. There are approximately 1,800 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

² *Exchange-Traded Funds*, SEC Release No. IC-33140 (June 28, 2018) ("Release"), available at <https://www.sec.gov/rules/proposed/2018/33-10515.pdf>.

Board Oversight

Importantly, proposed rule 6c-11 aptly does not impose any new responsibilities on fund boards as part of the conditions to rely on the rule, and we strongly agree with this approach. The directors of an ETF oversee its management and operations under the same regulatory framework as other registered funds. That regulatory framework includes the significant responsibilities imposed on directors under the 1940 Act and its rules, as well as the duties of loyalty and care to which directors are typically bound under state law. Pursuant to those regulatory and fiduciary obligations, ETF directors serve to protect the interests of shareholders.

Moreover, the Release provides an appropriate description of the oversight role of fund boards. The Release references fund boards in connection with the discussion of custom baskets.³ Under the proposed rule, an ETF would have the flexibility to use custom baskets, subject to additional conditions designed to address concerns regarding the potential risk of overreaching. The Release states that the use of custom baskets presents an increased risk that an ETF may be subject to improper pressure by an authorized participant to create specific baskets that favor that authorized participant, such as through cherry picking or dumping certain securities.⁴ Thus, the proposed rule would require the policies and procedures adopted by an ETF that uses custom baskets to include additional detail and constraints.⁵

The Release notes that an ETF's basket policies and procedures—including those for custom baskets—should be covered by the ETF's compliance program under rule 38a-1 under the 1940 Act. The Release also notes that the board's oversight of an ETF's compliance policies and procedures, as well as its general oversight of the ETF, would provide an additional layer of protection for use of custom baskets.⁶ We agree with these observations. Rule 38a-1 provides a robust oversight framework, and, as noted above, boards, pursuant to their regulatory and fiduciary obligations, provide diligent oversight on behalf of ETF shareholders.

³ Proposed rule 6c-11 defines two types of custom baskets: (i) baskets that are composed of a non-representative selection of the ETF's portfolio holdings; and (ii) different baskets used in transactions on the same business day.

⁴ See Release, *supra* n. 2, at 96.

⁵ Proposed rule 6c-11(c)(3) would require an ETF using custom baskets to 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.

⁶ See Release, *supra* n. 2, at 99.

The Release asks whether any parameters should be placed on board oversight of the policies and procedures and whether the rule should include board reporting requirements.⁷ In our view, the answer to both questions is a resounding “no.” An ETF board currently has—and should continue to have—the discretion to determine for itself how to go about its oversight process, including the content of the policies and procedures it oversees and the frequency and level of reporting it receives from the adviser. The rule 38a-1 framework works well: the rule establishes the minimum requirements for compliance oversight by the board, and any additional actions taken by the board beyond those minimum requirements are at the board’s discretion.

Proposed Disclosure Amendments

The Commission also is proposing disclosure amendments intended to provide investors with additional information regarding the costs associated with investing in ETFs (as well as mutual funds).⁸ Under the proposal, both mutual funds and ETFs would be required to add narrative disclosure clarifying that, in addition to current disclosures relating to investors who buy and hold shares, the fees and expenses reflected in the fee table may be higher for investors if they sell shares of the fund. Mutual funds and ETFs also would be required to include a statement that investors may be subject to other fees not reflected in the table, such as brokerage commissions and fees to financial intermediaries. We support these proposed additions for both mutual funds and ETFs as this information would help investors better understand that there are costs, in addition to those reflected in the fee table, that the investor may incur in buying or selling shares.

The Commission also proposes disclosure requirements applicable only to ETFs. Through a proposed question and answer format, ETFs would be required to disclose certain trading information and trading costs, including bid-ask spread information. Although we support disclosure that would help investors understand that their investments in ETFs are subject to trading costs, we question the usefulness to investors of bid-ask spread information in the prospectus and are concerned that it could be misleading. Because there is not a uniform method for assessing bid-ask spreads, the bid-ask spread information would not facilitate comparisons between different investment options, as the Commission intends for this disclosure. Moreover, because bid-ask spreads change, the information included in a prospectus would be stale and potentially misleading to investors buying or selling ETFs throughout the year.

We also question putting the burden on ETFs to disclose this information, when they do not control trading costs or generally maintain the data associated with them. The shareholder’s financial intermediary, rather than the ETF itself, would have the most useful and accurate information on the shareholder’s trading costs, and investors should be directed to their financial intermediaries for this

⁷ See Release, *supra* n. 2, at 100 and 103.

⁸ Proposed amendments to Item 3 of Form N-1A (described in Release, *supra* n. 2, at 152-64).

Mr. Brent J. Fields
September 27, 2018
Page 4 of 5

information, rather than the ETF. Indeed, requiring ETFs to include bid ask spread information in their prospectuses may give shareholders the misleading impression that ETFs control these costs. To comply with the proposed disclosure, an ETF would have to purchase market data to calculate it or bid ask spread information from a third party source. The costs associated with obtaining and disclosing the bid ask data would ultimately be borne by the ETF's shareholders.

For similar reasons, we question the benefit to investors of an ETF being required to maintain on its website an interactive calculator based on bid ask spreads. Again, this requirement would put an unnecessary burden on ETFs to maintain and disclose data and information that it does not control.

In light of the questionable value to investors of the bid ask spread information and the costs to ETFs and their shareholders of its required disclosure, we recommend that the Commission consider other ways to facilitate investor understanding of ETF trading costs. For instance, the Commission could require ETFs to include narrative disclosure explaining that there are other costs associated with buying and selling ETFs and stating that the investor should consult a financial professional for that information. In addition, the disclosure could include a hypothetical example that illustrates how a hypothetical bid ask spread would affect an ETF investment.⁹ We believe that this type of disclosure would provide a more useful explanation to investors and avoid the burdens and confusion associated with disclosing historical bid ask data.

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If you have any questions about our comments, please contact Annette Capretta, Deputy Managing Director, at [REDACTED] or me at [REDACTED].

Sincerely,



Amy B.R. Lancellotta
Managing Director

⁹ For a hypothetical example, see Letter from Susan Olson, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, regarding Exchange-Traded Funds, File No. S7-15-18 (September 21, 2018) at 30, available at https://www.ici.org/pdf/18_ici_sec_etf_ltr.pdf.

Mr. Brent J. Fields
September 27, 2018
Page 5 of 5

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