October 19, 2016

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By Electronic Delivery

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

Re: Comments Regarding File No. S7-21-16 – List of Rules to be Reviewed Pursuant to the Regulatory Flexibility Act

Dear Mr. Fields:

We appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") regarding Rule 22c-2 under the Investment Company Act of 1940 (the "1940 Act")[1] pursuant to Section 610 of the Regulatory Flexibility Act.[2] Changing technologies and a growing array of investment products over the past decade have significantly transformed how investors and small businesses access the capital markets. Nowhere are these changes more apparent than in the $2.1 trillion United States exchange-traded fund ("ETF") market where American businesses and their employees saving for retirement have come to meet their financial goals.[3] As the Commission reviews its rules that have a significant economic impact upon a substantial number of small entities, we commend the Commission for considering the continued appropriateness and scope of Rule 22c-2 under the 1940 Act ("Rule 22c-2").

We are writing to ask the Commission to consider exempting ETFs from the requirements of Rule 22c-2, most critically the two percent limit that applies to ETF transaction fees. As the Commission has recently noted, "[a]voiding shareholder dilution is a key concern of

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[1] 17 C.F.R. 270.22c-2.
[2] *See* List of Rules to be Reviewed Pursuant to the Regulatory Flexibility Act, Securities Act Release No. 10209, Exchange Act Release No. 78845, Trust Indenture Act Release No. 2511, Investment Advisers Act Release No. 4530, Investment Company Act Release No. 32263 (Sept. 15, 2016), 81 Fed. Reg. 64364 (Sept. 20, 2016).
[3] Investment Company Institute, 2016 Investment Company Fact Book (2016), *available at* https://www.ici.org/pdf/2016_factbook.pdf.

the [1940 Act]."[4] Applying the Rule 22c-2 two percent redemption fee limit to ETFs creates the potential for dilution with no countervailing benefit, as described below. Indeed, limiting the transaction costs that can be recouped by an ETF can, and does, result in immediate tangible harm to the fund and its remaining shareholders and serves no public policy interest.

I. History of Rule 22c-2

Rule 22c-2 was adopted, among other reasons, to allow registered open-end investment companies to charge a fee to redeeming shareholders whose transactions could impose costs on the fund and hence its remaining shareholders.[5] Rule 22c-2 was designed to discourage short-term trading strategies such as market timing,[6] which was understood to cause a myriad of adverse consequences for remaining shareholders.[7] The Commission noted in the Adopting Release that "[t]he redemption fee is intended to allow funds to recoup some of the direct and indirect costs incurred as a result of short-term trading strategies," emphasizing that "[e]xcessive trading in mutual funds occurs at the expense of long-term investors, diluting the value of their shares."[8] However, while the Commission saw value in permitting funds to charge redemption fees, it also took into consideration the interests of "ordinary shareholders" who might need to "make an unexpected redemption as a result of a financial emergency."[9] Balancing these interests, the Commission decided to limit redemption fees to an amount, determined by a fund's board of directors ("Board"), that does not exceed two percent of the value of shares redeemed.

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[4] Investment Company Swing Pricing, Securities Act Release No. 10234, Investment Company Act Release No. 32316 (Oct. 13, 2016) (citing Investment Trusts and Investment Companies Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. (1940), at 37, 137-145) ("Swing Pricing Release").
[5] Mutual Fund Redemption Fees, Investment Company Act Release No. 26782 (Mar. 11, 2005), 70 Fed. Reg. 13328, 13328 (Mar. 18, 2005) ("Adopting Release").
[6] *Id.* ("Market timing includes (a) frequent buying and selling of shares of the same fund or (b) buying or selling fund shares in order to exploit inefficiencies in fund pricing.").
[7] *Id.* ("Market timing, while not illegal per se, can harm other fund shareholders because (a) it can dilute the value of their shares, if the market timer is exploiting pricing inefficiencies, (b) it can disrupt the management of the fund's investment portfolio, and (c) it can cause the targeted fund to incur costs borne by other shareholders to accommodate the market timer's frequent buying and selling of shares.").
[8] *Id.*
[9] Adopting Release at 13331.

The amount of the fee needs to be "appropriate to recoup for the fund the costs it may incur as a result of those redemptions or to otherwise eliminate or reduce so far as practicable any dilution of the value of the outstanding securities."[10] Rule 22c-2 also requires that a redemption fee, if imposed, be limited to redemptions within a designated time period that is not less than seven calendar days after the date of purchase, also as determined by the Board.[11] Rule 22c-2 applies to all open-end funds except money market funds, funds that are listed on an exchange, and funds that permit short-term trading under certain conditions.[12] However, if any of the exempted funds decides to impose a redemption fee, the requirements and limitations of Rule 22c-2 apply.[13] Thus, by operation of Rule 22c-2, if ETFs (as funds listed on an exchange) impose a fee on redemptions of creation units, they may be subject to the two percent limit.[14] Moreover, as described below, ETF exemptive relief expressly allows ETFs to impose transaction fees upon redemptions, but these fees must be "limited in accordance with requirements of the Commission applicable to management investment companies offering redeemable securities," pointing back to Rule 22c-2 (and the two percent limit).[15]

II. Application of Rule 22c-2 to ETFs

Unlike mutual funds, ETFs do not sell shares to or buy shares from retail shareholders, instead engaging in the purchase and sale of large blocks of shares called "creation units" with sophisticated institutional broker-dealers called authorized participants ("APs"). ETFs must obtain a Commission order exempting them from the application of certain sections of the 1940 Act. The exemptive relief, which has many standardized provisions, acknowledges the same potential for dilution in the purchase and sale of creation units as discussed by the Commission

[10] *Id.*
[11] 17 C.F.R. 270.22c-2(a)(1)(i).
[12] 17 C.F.R. 270.22c-2(b).
[13] *See id. See also* Adopting Release at 13330.
[14] *Id.*
[15] *See, e.g.,* Application of Voya ETF Trust et al., File No. 812-14572 (Apr. 7, 2016).

when it adopted Rule 22c-2, and permits ETFs to impose transaction fees on purchases and sales of creation units in certain circumstances and pursuant to prescribed limits:

> Transaction expenses, including operational processing and brokerage costs, will be incurred by a Fund when investors purchase or redeem Creation Units "in-kind" and such costs have the potential to dilute the interests of the Fund's existing shareholders. Hence, each Fund will impose purchase or redemption transaction fees ("Transaction Fees") in connection with effecting such purchases or redemptions of Creation Units. Since the Transaction Fees are intended to *defray the transaction expenses as well as to prevent possible shareholder dilution resulting from the purchase or redemption of Creation Units*, the Transaction Fees will be borne only by such purchasers or redeemers. Where a Fund permits an "in-kind" purchaser to substitute cash in lieu of depositing one or more of the requisite Deposit Instruments, the purchaser may be assessed a higher Transaction Fee on the cash in lieu portion of its investment to cover the cost of purchasing such Deposit Instruments, including operational processing and brokerage costs, and part or all of the spread between the expected bid and offer side of the market relating to such Deposit Instruments. . . . Transaction Fees will be limited to amounts that have been determined by the Adviser to be appropriate and will take into account transaction costs associated with the relevant Deposit Instruments and Redemption Instruments of the Funds. *In all cases, such Transaction Fees will be limited in accordance with requirements of the Commission applicable to management investment companies offering redeemable securities.*[16] (emphasis added)

Although not entirely clear, this last sentence is interpreted by ETFs to mean, by reference to "requirements of the Commission," that the limits of Rule 22c-2, and in particular the two percent limit, apply to the transaction fee that may be charged by ETFs on redemption of creation units. Moreover, the language of Rule 22c-2 itself appears to be broad enough to impose the two percent limit on an ETF whose Board decides to impose fees upon redemptions of creation units, irrespective of the language in the ETF's exemptive relief. Given the unique aspects of how ETFs buy and sell shares, and the nature of the entities that engage in transactions with ETFs, this limit is overly restrictive, counterproductive, and has unintended deleterious consequences.

[16] *Id.* (footnote omitted). Virtually identical language appears in all ETF exemptive applications.

ETFs do not transact with retail investors. Instead, all purchases and sales of shares must be placed by or through APs, at the net asset value ("NAV") next calculated. APs then sell shares on the secondary market at negotiated prices, where shares can be accessed by retail (and other) shareholders. Unlike retail shareholders who may need protection from undue financial penalty upon accessing their funds, APs are not redeeming ETF shares so they can raise cash to pay their bills; APs are redeeming shares in a market making capacity. APs engage in arbitrage activities that are designed to minimize discrepancies between the net asset value per share and the secondary market price of the shares. An AP will create shares when the value of the underlying portfolio is worth less than the market value of a creation unit and will redeem shares when the value of the underlying portfolio is worth more than the market value of a creation unit. The ability to purchase and sell creation units, on a daily basis, is an essential component of this arbitrage process, and is designed to ensure that retail shareholders can buy and sell shares at a price that approximates the value of the ETF's net assets. Therefore, policies designed to discourage frequent trading, which makes sense in the context of mutual funds, should not apply to ETFs, and indeed would be counterproductive.

ETFs charge transaction fees to APs (on purchases as well as sales of creation units) to compensate the ETF for transaction costs, including processing and brokerage costs and other costs incurred by the ETF to purchase the requisite portfolio securities. Transaction fees are based on *actual* costs of a particular transaction; the fee is not fixed in advance, and varies daily based on market conditions. The fees are designed to ensure that the transacting AP bears the costs that the ETF would not otherwise incur but for such transaction.

Imposing the two percent limit on ETF redemptions causes the ETF and its shareholders absorb all transaction costs in excess of two percent of the value of the redemption proceeds. Any such costs that the ETF cannot recoup from the transacting AP will decrease the NAV of the fund, and thus adversely impacts the remaining shareholders (including indirectly those who purchased on the secondary market (many of whom are retail shareholders), whose investment

performance will deteriorate).[17] Accordingly, any excess transaction costs serve to dilute the interests of remaining shareholders, a significant concern acknowledged by the Commission and serving as the impetus for adopting Rule 22c-2 as well as, more recently, amended Rule 22c-1 and Rule 22e-4.[18]

III. ETFs Should Be Exempt From Rule 22c-2

As discussed above, the purpose of Rule 22c-2 is to reimburse funds for the costs of short-term trading and to discourage short-term trading by reducing the profitability of such trading. Conversely, ETFs *require* short-term trading by APs so that the arbitrage function operates effectively. ETF transaction costs are designed to compensate the fund for actual costs that are triggered by AP redemptions. Moreover, the concerns giving rise to the two percent limit, *i.e.*, avoiding penalties on ordinary shareholders, is also inapplicable to ETFs, which transact with APs only. These costs can be calculated on a transaction-by-transaction basis and, as a matter of fairness, should be absorbed by the transacting AP that causes the fund to incur them. (Similarly, the designated time period required by Rule 22c-2 should be inapposite to ETFs, as ETFs need to recoup transaction costs regardless of the AP's holding period.)

ETF transaction fees protect the fund and its remaining shareholders from the costs triggered by purchases and redemptions by APs. The operation of Rule 22c-2 (through the language of Rule 22c-2 or the link through exemptive relief) to limit the fund's ability to recoup these costs harms the fund and remaining shareholders and enables the AP to benefit at the expense of the fund. There are meaningful differences in the operation of ETFs and mutual

[17] Moreover, limiting the transaction fee can enable the AP to gain at the expense of the fund, as in volatile markets the AP can take advantage of the ability to redeem fund shares at a price that the AP knows will be lower the next day.

[18] *See generally* Swing Pricing Release. The importance of this public policy mandate was the focus of the recent adoption of the swing pricing rule for mutual funds (ETFs are not permitted to adopt swing pricing precisely because they can assess transaction fees). That rule, too, limits the adjustment to the NAV or "swing factor" to two percent of the fund's NAV, reflecting the same public policy balancing of interests reflected in Rule 22c-2, and not at all relevant to ETFs. *See also* Investment Company Liquidity Risk Management Programs, Securities Act Release No. 10233, Investment Company Act Release No. 32315 (Oct. 13, 2016) ("Liquidity Risk Management Release").

funds, and the way in which their shares are bought and sold, that warrant reconsideration of the scope of Rule 22c-2. We note that the adopting release for the new rule that requires funds, including ETFs, to adopt liquidity management programs, acknowledged that commentators recommended that the two percent limit on ETF transaction fees be eliminated because doing so would improve the liquidity of ETF shares on the secondary market (by reducing spreads) and would also protect ETFs from the dilution associated with transaction costs in excess of two percent.[19] The Commission determined that addressing the ETF transaction costs issue was "beyond the scope of [that] rulemaking."[20] Thus, the solicitation of comments on Rule 22c-2 provides an appropriate and timely opportunity to consider this issue.

For the reasons stated above, we believe ETFs should be exempt from the application of Rule 22c-2, and particularly the two percent limit on redemption fees.[21]

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[19] Liquidity Risk Management Release ("A few commenters also suggested that increasing ETF basket flexibility and eliminating the two percent limitation on redemption fees for ETFs would help enhance ETF liquidity and the orderly and efficient operation of the arbitrage function."). *See* Letter from Dechert LLP to Brent J. Fields, Secretary, Securities and Exchange Commission (Jan. 13, 2016) ("[T]ransaction fees [] are borne by APs and are tied specifically to the incremental costs incurred by the ETF as a result of the cash redemptions.... In contrast to the redemption fees which are the focus of Rule 22c-2, the redemption transaction fees charged by an ETF are not intended to inhibit frequent trading. In fact, unfettered ability of an AP to redeem is critical to the efficiency and effectiveness of the arbitrage process which tends to ensure that shares trade at market prices of or close to NAV." (footnotes omitted)). *See also* Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission (Jan. 13, 2016) ("Although Rule 22c-2 is intended to inhibit short-term traders from diluting fund shares, an ETF encourages short-term trading of its shares. Indeed, an ETF needs robust trading and arbitrage, through the creation and redemption process, to help keep the market value of its shares aligned with the value of its portfolio. The transaction costs associated with this trading, however, should be borne by the redeeming APs, large institutions that can hedge or pay such costs, rather than the fund.").
[20] Liquidity Risk Management Release.
[21] We also believe the standard representation in exemptive applications described above should be eliminated.

We appreciate the opportunity to comment on Rule 22c-2. We would be pleased to discuss any of these points further and provide any additional information you believe would be helpful. Please feel free to contact me at the above number if you have any questions.

Sincerely,

Amy R. Doberman