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May 19, 2008

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Exchange-Traded Funds, File No. S7-07-08

Dear Ms. Morris:

The Investment Company Institute[1] is pleased to express its strong support for the Commission's proposal to permit certain exchange-traded funds ("ETFs") to begin operating without first obtaining exemptive orders from the Commission. We also strongly support the proposal to permit investment companies to invest in ETFs to a greater extent than currently permitted by the Investment Company Act of 1940.[2]

As the Proposing Release notes, ETFs have become an increasingly popular investment vehicle. As of March 31, 2008, there were over 640 ETFs on the market with more than $570 billion in assets, and year-to-date net inflows to ETFs were nearly $9 billion.[3] In the last 15 years, the Commission has issued over 60 exemptive orders to ETFs and their sponsors.[4] During this time, the Commission has had ample opportunity to confirm that the permitted ETFs do not raise the concerns underlying the provisions from which they require relief, and to observe the benefits to the marketplace of these investment vehicles. Based on this evidence, we strongly support the Commission's determination that a rule under Section 6(c) of the Investment Company Act to codify existing exemptive relief is

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.31 trillion and serve almost 90 million shareholders.

[2] *See* Exchange-Traded Funds, Proposed Rule, SEC Release Nos. 33-8901 and IC-28193 (Mar. 11, 2008), 73 Fed. Reg. 14618 (Mar. 18, 2007) ("Proposing Release").

[3] *Investment Company Institute,* Exchange-Traded Fund Assets, Statistical Release, dated Apr. 29, 2008, available at http://www.ici.org/stats/latest/etfs_03_08.html#TopOfPage.

[4] Proposing Release at note 19 and accompanying text.

"necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act]."[5]

Our comments on the proposal are provided below, following the order of the Proposing Release.

I. Exemptions Permitting Funds to Form and Operate as ETFs

A. Scope of Proposed Rule 6c-11

1. Index-Based ETFs

We strongly support the Commission's proposal to provide exemptions for index-based ETFs organized as open-end investment companies.[6] We agree with the Commission that the conditions included in the index-based ETF orders issued to date have effectively preserved the purposes of the Investment Company Act. We note, however, that not all index-based ETF orders granted by the Commission require that an index provider disclose on its web site the identities and weightings of the component assets of the index, nor do they all require the funds themselves to publish their portfolio holdings daily.[7] As discussed in more detail in Section I.B.1 below, we believe experience has shown that such disclosures are not a necessary element of an index-based ETF. We recommend that the rule also capture funds that do not track published indexes or disclose their portfolio holdings daily.

2. Fully Transparent Actively Managed ETFs

We support the Commission's proposal to include in the rule fully transparent actively managed ETFs. It is generally understood that portfolio transparency facilitates arbitrage.[8] The daily disclosure of the proposed active ETFs' holdings should enable an arbitrage mechanism with comparable efficiency to those of existing index-based ETFs. We also encourage the Commission to

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[5] 15 U.S.C. §80a-6(c).

[6] Institute members concur with the Commission that the inclusion of ETFs organized as unit investment trusts is unnecessary.

[7] *See, e.g.,* Barclays Global Fund Advisors, *et al.*, Investment Company Act Release Nos. 24394, Apr. 17, 2000 (notice) and 24451, May 12, 2000 (order); Vanguard Index Funds, Inc., Investment Company Act Release Nos. 24680, Oct. 6, 2000 (notice) and 24789 (order); ALPS Advisers, Inc., *et al.,* Investment Company Act Release Nos. IC-28235, Apr. 9, 2008 (notice) and 28263, May 1, 2008 (order).

[8] *See, e.g.,* SEC Concept Release: Actively Managed Exchange-Traded Funds, SEC Release No. IC-25258 (Nov. 8, 2001), 66 FR 57614 (Nov. 15, 2001) ("Concept Release"); Letter from Richard F. Morris, Senior Counsel, Barclays Global Investors, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated Jan. 11, 2002, available at http://www.sec.gov/rules/concept/s72001/morris1.htm; Letter from Heidi Stam, Principal, Securities Regulation, The Vanguard Group, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated Feb. 14, 2002, available at http://www.sec.gov/rules/concept/s72001/s72001-14.pdf.

continue to consider, through the exemptive process, whether less transparent actively managed ETFs could provide the market with sufficient information to facilitate arbitrage effectively.

3. Liquidity

The Proposing Release requests comment on whether liquidity requirements should be imposed as a condition of the proposed rule. We agree with the Commission's proposed approach, which would not limit the rule to ETFs investing only in liquid assets. As the Proposing Release points out, as open-end funds, ETFs comply with Commission guidelines and generally invest no more than 15 percent of their net assets in illiquid securities.[9] While many existing ETFs make representations suggesting that an even higher proportion of their portfolios are comprised of highly liquid securities,[10] not all do.[11] Institute members do not believe that the lack of specific liquidity standards has raised issues for existing ETFs. Imposing such requirements on similar funds going forward is unwarranted.

We acknowledge that the presence of illiquid assets in a fund's portfolio may present challenges. For example, a financial institution seeking to transact with an ETF (an "Authorized Participant") may have difficulty acquiring the securities for purposes of assembling a creation basket. This problem is easily remedied, however, by the ETF accepting cash in lieu of those securities,[12] or by the ETF not including those securities in the creation basket.[13] The inclusion of illiquid securities in an ETF's portfolio could also potentially impact the deviation between the market price of the ETF and its net asset value ("NAV"). For example, the presence of illiquid securities could cause a market maker to

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[9] *See* Proposing Release at note 34, citing "Statement Regarding 'Restricted Securities,'" SEC Release No. IC-5847 (Oct. 21, 1969); Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992); *but see* Registration Form Used by Open-End Management Investment Companies, SEC Release No. IC-23064 (Mar. 13, 1998) (rescinding the guidelines to Form N-1A).

[10] Contrary to the statement in the Proposing Release, ETFs do not typically represent that "their portfolios are comprised of highly liquid securities." Proposing Release at 13. Rather, these representations typically state that the fund will invest a high percentage of its assets in component securities of the underlying index. *See, e.g.,* ProShares Trust, Inc., Investment Company Act Release No. 27323, May 18, 2006 (notice); WisdomTree Investments, Investment Company Act Release No. 27324, May 24, 2006 (notice). As the Proposing Release notes, indexes generally have methodologies that ensure that most of the component securities are liquid. *See* Proposing Release at note 30. Still, indexes may include some illiquid securities. *See, e.g.,* Amex Rule 1000A Commentary .02(A)(a)(1) and (2) (imposing liquidity specifications on 90 percent of the weight of an index for which index fund shares are listed). These illiquid securities may be included in an ETF's basket of component securities.

[11] *See, e.g.,* ProShares Trust notice, *supra* note 10, and Rydex ETF Trust *et al*., Investment Company Act Release No. 27703, Feb. 20, 2007 (notice).

[12] When this happens, ETFs typically charge the Authorized Participants for any additional costs that may result from the ETF converting the cash to securities, so that other shareholders are not negatively impacted.

[13] A creation basket may contain all of the securities held in an ETF's portfolio or an optimized sample of the ETF's portfolio. *See, e.g.,* Vanguard notice, *supra* note 7, at note 4. Thus, an ETF may hold illiquid securities that are not included in the creation basket.

increase the spread at which it will trade ETF securities (the "bid-ask spread"), which would affect the market price of the ETF and may cause it to deviate from NAV.

Institute members believe that, for ETFs permitted by the proposed rule,[14] the risk of deviation between the market price and NAV of an ETF is most appropriately addressed by disclosure to investors. Deviation can happen for many reasons, and the possibility – and potential causes – are routinely disclosed in the "principal risks" section of ETF prospectuses. The potential incremental impact of illiquid securities on deviation is limited, because generally no more than 15 percent of an ETF's portfolio will be invested in such assets. ETF sponsors may also seek to minimize exposure to assets that could impact deviation because, to the extent they make arbitrage opportunities more difficult to evaluate, they may affect the success of the product.[15] Because ETF holdings of illiquid securities present only the possibility of an incremental increase in an already existing (and disclosed) risk, we do not believe additional restrictions on ETF investments are necessary or appropriate.

B. Conditions

1. Transparency

a. Holdings, Index and Basket Disclosure

We strongly support the Commission's approach of codifying exemptive relief for ETFs with an arbitrage mechanism that helps maintain the equilibrium between market price and NAV. We agree that transparency facilitates the maintenance of this equilibrium. Consistent with previous exemptive orders and with the Commission's objectives, we suggest the following changes to the transparency conditions.

First, we believe that the Commission should not permit the disclosure of the component securities of the index (including identities and weightings) to satisfy the transparency requirements for index-based ETFs, except where the ETF holdings fully replicate the holdings of the index. Many ETFs with a stated objective of tracking the performance of an index use an optimization or sampling

[14] The potential impact of illiquid securities could become more pronounced in ETFs that are less transparent than those contemplated by the proposed rule.

[15] *See, e.g.,* Letter from Michael J. Ryan, Executive Vice President and General Counsel, American Stock Exchange, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated Mar. 5, 2002, available at http://www.sec.gov/rules/concept/s72001/ryan1.htm ("Ultimately it is in the interest of the sponsor and investment adviser to provide for effective arbitrage opportunities. It is unlikely that an … ETF sponsor would be able to convince the critical market participants such as specialists, market makers, arbitragers and other Authorized Participants to support a product that contained illiquid securities to a degree that would affect the liquidity of the ETF, making it difficult to price, trade and hedge, ultimately leading to its failure in the marketplace.").

technique, and hold only a representative sample of the component securities.[16] That is, the index may include securities that the fund does not hold. For funds that follow very broad indices, it is impractical to hold more than a small portion of the index components.[17] In other cases, a fund may weight its holdings differently from its underlying index in order to comply with applicable legal requirements. For example, many sector or country funds are not permitted to hold the full weighting of a single security because of diversification requirements.[18] Finally, a fund may hold securities that are not components of its index.[19] Thus, the components of the underlying index may not be a good proxy for the fund's holdings, and therefore may not effectively facilitate the arbitrage function.[20]

By contrast, we recommend that funds with a stated objective of tracking the performance of an index be permitted to disclose their creation basket in lieu of full disclosure of portfolio holdings, provided that the basket is an optimized sample of the full portfolio. As noted above, several existing index-based ETF orders require only that the funds disclose their creation basket. While some funds relying on these orders voluntarily publish their daily holdings, others are forbidden to do so by the terms of their index licensing agreements.[21] These funds provide their baskets to Authorized Participants on a daily basis, and typically post them on their web sites with a 48-hour time lag.

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[16] *See, e.g.,* Barclays notice, *supra* note 7; Vanguard notice, *supra* note 7; First Trust Exchange-Traded Fund, Investment Company Act Release No. 27051, Aug. 26, 2005 (notice); Barclays Global Fund Advisors, *et al*., Investment Company Act Release No. 27608, Dec. 21, 2006 (notice) ("Barclays High Yield Bond notice").

[17] For example, the Lehman U.S. Aggregate Bond Index covers a substantial percentage of outstanding investment grade bonds, amounting to more than 8,000 fixed income securities. None of the three existing ETFs that seek to track this index attempts to hold more than a small portion of the index components, and two of them, sponsored by Barclays Global Investors and State Street Global Advisors, hold fewer than 200 components.

[18] For example, according to the Dow Jones Indexes website (http://www.djindexes.com), AT&T comprises more than 50 percent of the Dow Jones Telecommunications Index (as of Apr. 21, 2008). A fund seeking to track this index could not match this weighting and still meet the diversification requirements to be classified as a diversified company under the Investment Company Act or to qualify for pass-through tax treatment under Subchapter M of the Internal Revenue Code. *See, e.g.,* iShares Dow Jones U.S. Telecommunications Sector Index Fund (http://www.ishares.com/product_info/fund/holdings/IYZ.htm) (in which AT&T comprises approximately 20 percent of the portfolio).

[19] Funds that track indexes typically represent that they will invest a substantial proportion, but not all of their assets, in component securities of the underlying index. *See supra* note 10. *See also* Barclays High Yield Bond notice, *supra* note 16.

[20] As discussed in more detail in Section I.C.1.c. below, the arbitrage mechanism functions in many and varied ways. Typically arbitrageurs will hedge their market exposure – that is, they seek to profit from inefficiencies without taking on market risk. To hedge against market risk, arbitrageurs must understand what securities or other assets they are exposed to by holding ETF shares. For this reason, knowing most or all of what is included in an ETF (such as through disclosure of either the full holdings or an optimized basket) is far superior to knowing only the general trajectory the fund seeks to follow (such as by disclosing the components of the index, of which the fund may only hold a fraction).

[21] Funds that are restricted by the terms of license agreements from publishing full portfolio holdings on a daily basis may instead publish full portfolio holdings less frequently, such as monthly, with a lag. All ETFs disclose their holdings quarterly as required on Form N-Q and in annual and semi-annual reports to shareholders.

We believe experience has demonstrated that it is appropriate to include this alternative in the rule. Many funds that publish only their baskets on a daily basis have been in existence for several years, and have not had substantially greater deviations between NAV and market price than comparable funds that disclose portfolio holdings daily.[22] This result is not surprising because, as noted above, it is in a fund's best interest to minimize the deviation between NAV and market price, in order to facilitate the trading of the product by Authorized Participants. When prohibited by index license agreements from publishing the entire portfolio, ETFs publish their basket, which generally either closely resembles the full portfolio or is an optimized sample designed to track the performance of the full portfolio. The viability of a product would suffer if a fund did not routinely publish a subset of the portfolio that closely tracked the full portfolio, because market makers would not be able to readily hedge their market risk.[23] As a result, these Authorized Participants would either stop making markets in the ETF, or would widen bid-ask spreads to account for the additional risk, neither of which is in the interest of the ETF.

b. Disclosure of Liabilities

The Proposing Release asks whether ETFs should be required to disclose liabilities daily on their web sites to permit investors to evaluate the impact of leverage from borrowings on funds' portfolios. We agree with the Commission that such disclosure is important to help investors evaluate the impact of leverage on the ETF's NAV. In fact, it is our understanding that ETFs with leveraged exposure currently do disclose their liabilities, in part for this reason.

We believe, however, that such information is only relevant in cases where a fund's overall portfolio has leveraged *exposure* – that is, where a fund relies on leverage strategies to achieve a return that correlates with an index in an inverse or incremental way (*e.g.,* leveraged or inverse funds). By contrast, for funds that seek to track the performance of an index, but employ certain leverage strategies

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[22] For example, iShares has two European stock index funds. The MSCI EMU Index Fund (http://www.ishares.com/product_info/fund/overview/EZU.htm) publishes only its basket daily (and its full portfolio holdings at month end), while the S&P Europe 350 Index Fund (http://www.ishares.com/product_info/fund/overview/IEV.htm) publishes holdings daily. The premium/discount charts for these funds show relatively similar deviations over the last year. Similarly, compare the Vanguard Total Stock Market ETF (https://personal.vanguard.com/us/funds/snapshot?FundId=0970&FundIntExt=INT), which publishes only its basket daily, with the iShares Dow Jones Total Market Index Fund (http://www.ishares.com/product_info/fund/overview/IYY.htm), which publishes its holdings daily.

[23] For example, if a specialist or market maker were "long" shares of an ETF as a result of market making activities, it would likely seek to hedge its exposure to the component securities, such as by selling them short. If the performance of the underlying securities, and therefore the hedge, varied substantially from the performance of the ETF shares that the specialist held, the hedge would fail and the specialist would require a greater risk premium (in the form of a wider bid-ask spread) to hold exposure to the ETF's shares.

to accomplish their objective, such disclosure is unnecessary to facilitate arbitrage, and could be confusing to investors.[24]

Ultimately, we expect that market forces will require disclosure of liabilities where such information is necessary to evaluate a fund's leveraged exposure, because failure to provide relevant information to Authorized Participants will reduce interest in trading the ETF and cause the bid-ask spread to widen. Thus, while we would not oppose such a disclosure requirement, we do not think it is necessary. If the Commission does determine to impose such a requirement, we recommend excluding funds that do not have leveraged exposure, even if they engage in leverage strategies.

c. Disclosure of Intra-Day Changes in the Portfolio

We support the Commission's proposal not to require either disclosure of intra-day changes in an ETF portfolio or advance disclosure of portfolio trades. Under the proposed rule – and consistent with current practice under the actively managed ETF exemptive orders – funds would disclose at the beginning of each trading day the portfolio that will form the basis of the NAV calculation at the end of the day. This is the most important element of an efficient arbitrage process, because it provides a benchmark against which arbitrage may take place (*i.e.,* an arbitrageur knows which securities will be tendered in exchange for ETF shares). Disclosure of intra-day changes is unnecessary for this purpose. And, as the Proposing Release indicates, intra-day or advance disclosure of portfolio transactions could be detrimental to an ETF by facilitating predatory trading practices such as front-running and free-riding. For these reasons, we would oppose a requirement to disclose intra-day portfolio changes.[25]

2. Listing on a National Securities Exchange and Dissemination of Intraday Value

We support the Commission's proposal to require that ETF shares be listed on a national securities exchange. Further, we applaud the Commission for considering whether the rule should make allowances for shares that are temporarily delisted or suspended. While in theory such an exception would be welcome, Institute members do not believe it is feasible to craft an exception that would, in practice, appropriately capture the circumstances in which it would likely be necessary. We are confident that, if necessary, the Commission staff will provide relief to such funds as appropriate, based on the individual facts and circumstances.

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[24] For example, a fund may find it expedient to achieve $100 million in exposure to a particular security by investing a fraction of that in futures on the security, and the remainder in cash equivalents. The futures represent a leverage strategy, but the fund itself has no leveraged exposure from this transaction. For purposes of basket creation and disclosure, the fund could disclose the underlying security, which would provide sufficient information for Authorized Participants to both purchase creation units and hedge their market exposure.

[25] We do not believe that a prohibition on advance or intra-day portfolio disclosure is necessary. A process for such disclosure could be developed that offers a benefit to investors and does not impose predatory trading risks. In the meantime, there is no benefit to ETFs from providing disclosure that could result in such practices.

With respect to Intraday Value (also known as "intraday indicative value" or "IIV"), we support the proposal to require dissemination at "regular intervals,"[26] but we suggest that the rule not require such dissemination to occur through a national securities exchange. Instead, we propose that the Commission permit an ETF to rely on the rule if its IIV is widely disseminated by one or more major market data vendors at regular trading intervals during the trading day.[27] We believe that this standard would be adequate to ensure the availability of this information to market participants who desire it.[28] We note that dissemination of the IIV "by one or more major market data vendors" is consistent with exchange listing and trading rules recently approved by the Commission for actively managed ETFs.[29]

3. *Marketing*

Institute members support the proposed conditions requiring ETFs to agree not to market or advertise as open-end or mutual funds and to explain that ETF shares are not individually redeemable. We believe these conditions, as imposed by existing exemptive orders, have been sufficient to prevent investors from confusing ETFs with mutual funds.

We do not believe the rule should require ETFs to identify themselves as either index-based or actively managed ETFs. No such requirement exists with respect to open-end mutual funds, although certainly the same variations exist in that context. More importantly, the distinction between index-based and transparent actively managed ETFs is not necessarily obvious or meaningful. Many existing index-based ETFs track non-traditional indexes; given the opportunity, such funds might have elected to be viewed as transparent actively managed funds.[30] Under the proposed rule, then, two virtually identical funds could have different labels. Moreover, the significance of such a distinction is not clear. Is "actively managed" meant to connote a fund run by a portfolio manager with a subjective (rather than model-based) approach, or a fund that has higher fees than an "index fund," or higher portfolio turnover? We believe these factors are more appropriately set forth in a fund's strategy and risk disclosure than by using labels that do not have a clear meaning.

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[26] We believe this phrasing appropriately takes into account the current variation in required intervals (*i.e.,* 15 seconds for funds tracking domestic indexes and 60 seconds for non-U.S. indexes), as well as other variations that might be developed in the future. As the Proposing Release points out, the Commission must approve the rules of national securities exchanges, so it is unnecessary to include restrictions in this rule.

[27] Many of the national securities exchanges already rely on market data vendors or independent pricing services to calculate the IIV. *See, e.g.,* Letter from Michael J. Ryan, *supra* note 15.

[28] Institute members understand that Authorized Participants do not rely on the published IIV, but instead calculate their own estimates of an ETF's intraday value based on their knowledge of the fund's basket assets and current market values.

[29] *See* SEC Release No. 34-57619 (Apr. 4, 2008), 73 Fed. Reg. 19544 (Apr. 10, 2008), SEC Release No. 34-57514 (Mar. 17, 2008), 73 Fed. Reg. 15230 (Mar. 21, 2008), and SEC Release No. 57800 (May 8, 2008), 73 FR 27874 (May 14, 2008) (granting accelerated approval to rules permitting the listing and trading of managed fund shares on the NYSE Arca, American Stock Exchange, and NASDAQ respectively, subject to certain conditions including that the IIV "will be widely disseminated by one or more major market data vendors at least every 15 seconds…").

[30] Until February 2008, only "index-based" ETFs received exemptive orders.

4. Conflicts of Interest

We agree with commenters on the Commission's Concept Release that actively managed ETFs would not face conflicts of interest that are different from those that currently exist for actively managed mutual funds. We further agree with the Commission that Section 48(a) of the Investment Company Act prohibits an adviser from circumventing other prohibitions under the Act by directing others to engage in proscribed conduct, and we are confident that industry participants are aware of this prohibition. We therefore do not believe it would be necessary or helpful to include a condition in the proposed rule reinforcing the directives of Section 48(a).

5. Affiliated Index Providers

We support the Commission's proposal not to impose specific conditions from previous exemptive applications relating to affiliated index providers. We agree with the Commission that the requirements under existing federal securities laws and exchange rules are sufficient to protect against the misuse of non-public information. For example, Rule 38a-1 under the Investment Company Act requires funds to adopt policies and procedures reasonably designed to prevent violation of the federal securities laws; Rule 17j-1 requires funds to adopt a code of ethics designed to prevent certain fund personnel from engaging in fraudulent or manipulative practices with respect to the fund; and Section 204A of the Investment Advisers Act requires funds to adopt policies and procedures to detect and prevent the misuse of nonpublic information by the adviser and its employees.

We also agree with the Commission that funds and their advisers typically understand the potential circumstances that could give rise to the misuse of non-public information in the context of an affiliated index provider relationship. We expect that, as part of their required procedures, funds, advisers, and index providers would implement appropriate firewalls and other procedures to address these concerns.[31] For example, we expect that advisers would prohibit portfolio managers from participating in the ongoing operation of the index or making decisions about the inclusion or exclusion of specific securities in an index, and would implement procedures to prevent conflicts of interest between the adviser and the affiliated index provider. We therefore agree that the specific conditions included in exemptive applications are unnecessary.

C. Exemptive Relief

1. Issuance of Redeemable Securities

a. Proposed Exemption

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

[31] As the Proposing Release indicates, such firewalls are typically required under the rules of national securities exchanges.

Company Act. 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 current net assets. As existing ETF sponsors have argued in their exemptive applications, ETFs operate with an arbitrage mechanism designed to minimize the potential deviation between the market price and NAV of ETF shares, which typically enables investors to sell ETF shares in the secondary market at approximately their NAV.

b. Size of Creation Unit

As the Commission recognizes, the arbitrage mechanism is also facilitated by the size of creation units. Very small creation units would, in theory, allow retail investors to transact directly with the ETF, while very large creation units could reduce the willingness or ability of Authorized Participants to transact with the ETF, impeding the arbitrage pricing discipline. While both extremes are clearly problematic, the appropriate size of a creation unit may vary depending on a number of factors, such as the type and availability of component securities, the expected uses of the product, and the likely Authorized Participants.[32] We therefore strongly support the Commission's proposed approach of requiring that the creation unit be of a size that is "reasonably designed" to facilitate trading by Authorized Participants. We do not believe that maximum or minimum thresholds, or board findings, are necessary to ensure such a standard, because it is in the ETF's interest to establish a creation unit size that facilitates trading.

c. Definition of Creation Unit

While we agree with the flexible approach to defining the size of a creation unit, we believe the description of the arbitrage mechanism contained in the definition is too narrow. The arbitrage mechanism relied upon by ETFs to ensure that the market price approximates NAV functions in a number of ways. An arbitrageur may, as described in the proposed rule text, purchase the basket securities on the secondary markets and exchange them for ETF shares (or purchase ETF shares on the open market and exchange them for basket securities to be sold) at as close to the same time as is practicable. An arbitrageur may also engage in transactions based on its need for or inventory of existing securities, such as by redeeming ETF shares to obtain securities it sold short, or acquiring ETF shares with basket securities it already holds. Market makers or specialists may also profit from purchasing ETF shares from or releasing shares into the secondary markets in response to supply and demand, typically in connection with appropriate hedges to offset the market risk of holding the ETF

[32] Prior to launching an ETF, sponsors typically discuss the appropriate size for a creation unit with market makers, specialists, and other interested parties to ensure that the established size is conducive to creations and redemptions by Authorized Participants.

shares.[33] Taken together, these and other methods of arbitrage – not only the one described in the proposed rule – work to keep an ETF share's market price close to NAV.[34]

Perhaps more importantly, it seems unnecessary to include a description of arbitrage in the definition of a creation unit. The Proposing Release suggests that the definition is intended to ensure that a creation unit is neither so small as to make its use irrelevant (*i.e.,* to cause individual investors to transact directly with the ETF), nor so large as to reduce the willingness or ability of Authorized Participants to transact in creation units, which could disrupt the arbitrage pricing discipline. A creation unit should, then, be "reasonably designed to facilitate trading with institutional investors authorized, under contract with the ETF or its distributor, to transact directly with the ETF."[35] We believe that this language would adequately achieve the Commission's goals without attempting to reduce a wide and complex range of market forces and activities into a single phrase.[36]

d. Basket Assets

We support the Commission's proposed definition of basket assets. As the Proposing Release recognizes, ETFs and their investors benefit from the flexibility to limit the assets contained in the basket (*i.e.,* to have a basket that does not mirror the full portfolio), and to accept cash instead of securities.[37] We do not believe any conditions are necessary to limit the inclusion of cash in a creation basket. In fact, such limitations could prove problematic if unforeseeable market conditions, such as scarcity of a security or changes in a foreign market's rules about transferring securities, render funds unable to accept in-kind contributions for basket assets. Moreover, shareholders should not be negatively impacted by the inclusion of cash in a creation basket, because ETFs typically charge Authorized Participants for any additional costs that may result from the ETF converting the cash to securities.

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[33] *See, e.g.,* SEC Concept Release, *supra* note 8. This is similar to how markets are made in traditional public company securities, for which there are no ongoing creation and redemption options.

[34] ETF exemptive applications have typically not limited their description of arbitrage to contemporaneous exchanges. *See, e.g.,* In re SPDR Trust, Series 1, Fourth Amended and Restated Application, File No. 812-7545, filed Aug. 11, 1992, at 36 ("[T]he arbitrageur… stands ready to take advantage of any slight premium in the market price of SPDRs over the cost of depositing a Portfolio Deposit and creating a Creation Unit to be broken down into SPDRs. Ordinarily, Applicants would not expect arbitrageurs to hold a SPDR position for any length of time unless they are appropriately hedged.").

[35] Alternatively, we recommend stating that a creation unit should be "reasonably designed to facilitate trading with Authorized Participants." The rule could then define an Authorized Participant as "a participant in an institutional clearing system necessary to settle fund trades that has entered into an agreement with the ETF or its distributor authorizing it to transact directly with the ETF."

[36] We note that the Commission's proposed language also could be read to suggest that ETFs should design creation baskets with a primary goal of facilitating speedy assembly. In practice, ETFs design them to optimally reflect the performance of the portfolio, with convenience as a secondary factor.

[37] As the Proposing Release indicates, some ETFs may accept baskets composed entirely of cash, either on occasion or as a matter of course. *See* Proposing Release at notes 120-121.

We do not believe the rule should address the frequency of composition or mandate the publication of the basket assets on a fund's web site. Except where a fund is relying on the disclosure of its basket assets to satisfy transparency requirements as proposed above, there is no reason to require funds to make their basket assets publicly available – this information is only useful to Authorized Participants for the purpose of transacting with the ETF. It is therefore appropriate for ETFs to have the option of publishing their basket assets on the National Securities Clearing Corporation bulletin board, where they are available to Authorized Participants. Similarly, it seems unnecessary to prescribe the frequency with which ETFs must update their basket assets. It is in a fund's best interest to have a basket that appropriately represents the underlying portfolio, so as to encourage share creation. As discussed above, the viability of a product would suffer if the fund did not routinely maintain a basket that closely tracked the full portfolio.

2. Trading of ETF Shares at Negotiated Prices

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 believe the proposed rule provides the necessary relief and suitable limitations.

3. *In-Kind Transactions Between ETFs and Certain Affiliates*

We support the proposed relief from Sections 17(a)(1) and (2) to permit persons that are affiliated persons of an ETF by reason of ownership of more than five percent (or in some cases, 25 percent) of the fund's outstanding shares to transact with the fund. As the Proposing 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.

For the same reasons, we recommend that this relief be expanded to encompass other affiliates, including broker-dealers that are affiliated with an ETF's adviser. Like affiliates by reason of ownership, these affiliates would purchase and redeem creation units in exactly the same manner, on the same terms, and at the same value as other Authorized Participants.

To the extent the Commission is concerned about an affiliate attempting to influence the ETF's selection of securities for the portfolio or basket (*i.e.,* the sampling of an index or of the portfolio for basket creation), we note that doing so would be a violation of federal securities laws and regulations prohibiting manipulative practices in connection with securities trading, as well as misuse of non-public information.[38] Registered advisers and broker-dealers should have policies and procedures, and related

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[38] Moreover, to the extent a broker-dealer would attempt such conduct, such as by influencing an ETF to include in its basket a security for which the broker-dealer is a market maker, the broker-dealer would stand to benefit regardless of whether it was permitted to transact in creation units with the ETF, because non-affiliated Authorized Participants would

information barriers, in place to prevent such violations. These policies and procedures should be designed to prevent the use or disclosure of material non-public information, which would include sampling methods or models where the fund does not make them available to the general public. A broker-dealer's policies should also prohibit employees from attempting to manipulate the market for securities in which the broker-dealer transacts.

Moreover, ETFs and their shareholders stand to benefit from permitting affiliated broker-dealers to act as Authorized Participants in their shares. As discussed throughout the Proposing Release and this letter, the arbitrage mechanism is a critical element of the functioning and success of ETFs. The arbitrage function would be improved by increasing the number of market participants willing to create or redeem shares. All ETF shareholders would benefit equally from any incremental strengthening of the arbitrage mechanism.

4. Additional Time for Delivering Redemption Proceeds

We support the proposed relief for postponement of payment of redemption proceeds in the event that a foreign holiday prevents timely delivery of a foreign security included in an ETF's redemption basket. Institute members that have obtained such relief through exemptive orders agree that it provides additional assurance that they will not be out of compliance due to circumstances beyond their control, even though we understand that they rarely rely upon it. Members agree that relief is only necessary when a foreign security is included in the basket assets, not just in the full portfolio, and that twelve calendar days is sufficient. Since reliance on this relief would only impact Authorized Participants, we do not think it is necessary to disclose the existence of such relief in the prospectus (rather than the SAI), nor any marketing material. We believe the proposed definition of "foreign security" is appropriate.

D. Disclosure Amendments

1. Delivery of Prospectuses to Investors

Institute members support the Commission's proposed approach to prospectus delivery. The Commission is correct that many broker-dealers deliver a prospectus instead of a product description in connection with sales of ETF shares in secondary market transactions, although some do use product descriptions. While we cannot speak for broker-dealers, Institute members believe that many prefer to use the prospectus because of liability concerns. In any event, members would not object to the elimination of the product description in favor of the recently proposed Summary Prospectus or full statutory prospectus.

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increase demand for the security. That is, permitting affiliates to act as Authorized Participants should not provide any additional incentive to engage in such conduct.

We would not, however, support requiring ETFs to deliver a product description pending the Commission's final determination regarding the Summary Prospectus. To the extent such a document would be prohibited once the Summary Prospectus is permitted, we see no reason to require funds that do not currently use product descriptions to compose an additional disclosure document. For the same reason, we would oppose interim amendments to the full prospectus pending the resolution of the Summary Prospectus proposal. If that proposal were not adopted, we would support requiring ETFs to deliver prospectuses to shareholders, with certain amendments to Form N-1A to include additional information relevant to retail ETF investors as discussed below.

2. *Amendments to Form N-1A*

Institute members generally support the Commission's approach of revising Form N-1A to better serve the information needs of retail investors. We agree that it is appropriate to distinguish between those who purchase on the secondary market and Authorized Participants who transact directly with the fund. We further agree that it is appropriate to eliminate certain disclosures relevant only to Authorized Participants from the prospectus. We agree that such information may be confusing to secondary market participants, and we believe that Authorized Participants are by definition sophisticated investors, and typically do not rely on a fund's prospectus (or SAI) for the information that is proposed to be eliminated.[39]

a. Purchasing and Redeeming Shares

We support the Commission's proposal to eliminate from the prospectus the discussion on how to create and redeem shares of the ETF, and the associated fees. We do not believe retail investors need this information; in fact, it may be confusing to them. We also do not think it is necessary to move such disclosure to the SAI. As noted above, Authorized Participants do not rely on these documents for this information. For the same reason, and because of the potential expense of creating and delivering another disclosure document, we would oppose requiring a supplementary prospectus to be delivered to purchasers of creation units.

Institute members do not believe a minimum creation unit size, below which certain creation and redemption information would still be required, is necessary. Regardless of the size of a creation unit, only Authorized Participants – not retail investors – may transact directly with an ETF. An individual investor seeking to purchase a creation-unit-sized block of shares of an ETF would necessarily do so through a broker-dealer. Even if the investor's purchase order resulted in the broker-dealer creating shares (acting as an Authorized Participant), the broker-dealer, not the investor, would assemble the creation basket and conduct the exchange with the ETF. Because individual investors may not transact directly with an ETF, and Authorized Participants have ready access to creation and redemption information, it seems unnecessary to include such information in the prospectus.

[39] Information on purchases and redemptions is typically conveyed to an Authorized Participant in the agreement it enters into with the ETF or accompanying materials.

If the Commission nevertheless determines to require such information for creation units of a certain size, it may be more appropriate to set a dollar threshold, rather than a number of shares comprising a creation unit, because the price per share of ETFs varies widely.[40] Under this approach, it would be necessary to establish a date certain, so that fluctuations in the market would not cause an ETF to be out of compliance. We propose that funds issuing creation units valued at less than $1 million per unit on the date the prospectus is printed not be exempt from the disclosure requirements.

b. Total Return

We oppose the proposed requirement that ETFs provide return information using their "market price" as well as NAV. We do not agree that returns based on market price may better relate to an ETF investor's experience in the fund. In addition, we are concerned that, despite the limitations with market price, investors may be led to believe that it is in fact more representative of their experience than NAV. Displaying market price returns next to NAV returns may also lead investors to draw false conclusions about the ongoing relationship between an ETF's price and NAV.

Market price, as defined in the proposed rule (*i.e.,* closing price), is a meaningless number to virtually all market participants. It is only a single snapshot in time – not an indication of how the fund has traded throughout the day – and it represents only the experience of the actual parties engaged in the last trade of the day. More importantly, for many ETFs, the last trade could occur several hours before the markets close, so the price may not account for later changes in the markets – that is, the market price may be from a point in time when, were it to be calculated, the NAV would have been different than it was at the end of the day. For example, if the last trade of an ETF is at 2:30 pm, and at 3:30 an earnings announcement is made for a component security, the end-of-day NAV will reflect the market's adjustment for the announcement, while the 2:30 "closing price" will not. And, because the last trade could occur at different times on different days, the return information will not even represent parallel timeframes.

Defining market price as the midpoint between the highest bid and lowest offer at the time the fund's NAV is calculated addresses these timing issues, because the price is calculated at the same time as NAV and should reflect the same market information. But this measure too is extremely problematic. First, the midpoint does not represent *any* market participant's actual experience. In addition, it is subject to outlier bids and offers, and therefore to potential manipulation. Even absent manipulation, studies have shown that bid-ask spreads tend to widen toward the market close, which would render the midpoint even less accurate.[41]

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[40] An Internet search of open-end ETFs showed share prices ranging from $12 or less to over $200. Thus, for a creation unit of 25,000 shares, the initial investment could range from $300,000 to $5,000,000.

[41] *See, e.g.,* Kalok Chan, Y. Peter Chung, and Herb Johnson, *The Intraday Behavior of Bid-Ask Spreads for NYSE Stocks and CBOE Options*, 30 Journal of Financial and Quantitative Analysis 329, Sept. 1995 (confirming several previous studies

The shortcomings of these calculations are compounded when used to show performance over time. For example, if on the first day for which return information is provided the market price indicates that the ETF is trading at a discount, and on the last day it is trading at a premium, the fund's performance will be overstated with respect to investors who did not purchase the shares at a discount. Institute members are also concerned that if the market prices at both the start and end dates indicate a discount (or premium), investors could understand this to indicate the presence of a persistent discount (or premium) that may not exist.

By contrast, while the NAV of an ETF does not represent the experience of any retail investor, it provides a consistent metric, calculated as of the same time each day in accordance with the fund's valuation policies and procedures, and is not subject to the influence of outlier bids or offers. And, as discussed throughout this letter, the arbitrage mechanism enables transparent ETFs to trade consistently at or close to NAV. As a result, NAV is a far more reliable metric of performance than market price. We do not believe the Commission should require ETFs to provide investors with a second, less accurate and potentially misleading picture of its performance. Should the Commission nonetheless require return information based on market price, we recommend that funds have the option to select the metric that is most likely to reflect their true performance.[42]

c. Premium/Discount Information

Based on the concerns described above regarding the use of an ETF's market price, we do not believe that information about the extent and frequency with which fund market prices have tracked NAV is particularly useful, nor do we believe that investors regularly seek it.[43] We therefore oppose its inclusion in the fund's prospectus, and particularly in the proposed Summary Prospectus, which is intended to provide only the key information investors want. We recognize that some investors may wish to look at historical premium/discount information, and we believe that provision of this information on a fund's web site should be sufficient.

d. Periodic Report Information

i. Conforming Amendments

As discussed above, we do not support requiring ETFs to calculate performance information based on both NAV and market price. Should the Commission impose this requirement, we agree that the prospectus and annual report should reflect consistent calculations of performance. As noted

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finding that "the bid-ask spread of New York Stock Exchange (NYSE) stocks follow a U-shaped pattern over the trading day, with spreads widest immediately after the open and prior to the close").

[42] As the Proposing Release indicates, the current practice among ETFs is split between these two metrics for market price. To our knowledge, this approach has not created any concerns for ETFs or their investors.

[43] One large sponsor of ETFs and mutual funds was able to determine that only 0.74% of hits on the sponsor's website were on premium/discount pages.

above, however, we believe a fund's web site is the most appropriate place for historical premium/discount information.

ii. Underlying Index

We oppose the proposal to require an index-based ETF to compare its performance to its underlying index rather than to a benchmark index, as currently required in Form N-1A. The existing requirement was designed with the explicit purpose of "provid[ing] investors with an objective standard against which they can compare the performance of the fund."[44] We believe that, like mutual fund shareholders, ETF investors should get such an objective tool for comparison. There is no policy justification for imposing different requirements on ETFs. Moreover, as discussed above, the distinction between index-based and transparent actively managed ETFs is not necessarily obvious or meaningful. Imposing different benchmark requirements on funds depending on whether they claim to "track an index" or have an "active" strategy is unjustified, and may confuse investors wishing to compare two such ETFs (or an ETF and a similar mutual fund). To the extent the Commission is concerned with index tracking errors, they should be considered separately from market performance disclosure, and should apply equally to all funds that track indexes, not just ETFs.

e. Summary Prospectus

The Institute strongly supports permitting ETFs to use the Summary Prospectus. As we explained in our comment letter on that proposal,[45] providing investors with a streamlined disclosure document containing key information about a fund in a user-friendly format, while making more information available for those who desire it, could benefit funds and shareholders alike. ETFs and their investors deserve these same benefits.

Subject to our comments above regarding the changes to Form N-1A and our prior comments regarding the content and order of the Summary Prospectus,[46] we generally support the proposed amendments to the Summary Prospectus to render it useful to retail ETF shareholders. As we explained in our Summary Prospectus Comment Letter, we do not believe top ten portfolio holdings should be included in the Summary Prospectus for any fund. If the Commission nevertheless

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[44] Disclosure and Analysis of Mutual Fund Performance Information; Portfolio Manager Disclosure, Proposed Rule, SEC Release Nos. 33-6850 and IC-17294 (Jan. 8, 1990), 55 FR 1460 (Jan. 16, 1990). *See also* Disclosure of Mutual Fund Performance and Portfolio Managers, Final Rule, SEC Release Nos. 33-6988 and IC-19382 (Apr. 6, 1993), 58 FR 19050 (Apr. 12, 1993) (explaining that the rule was crafted to "give a fund considerable flexibility in selecting a broad-based index that it believes best reflects the market(s) in which it invests").

[45] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Nancy Morris, Secretary, U.S. Securities and Exchange Commission, dated Feb. 28, 2008 ("Summary Prospectus Comment Letter"), available at http://www.ici.org/statements/cmltr/08_sec_prospectus_com.html#TopOfPage. Our letter also provides detailed comments regarding the content, order and presentation of information in the Summary Prospectus.

[46] *See id.*

determines to require top ten portfolio holdings, we recommend that ETFs be excluded because, given their transparency, providing such information in the Summary Prospectus would seem counterproductive.

E. Amendment of Previously Issued Exemptive Orders

Subject to our comments above regarding amendments to Form N-1A and ETFs' use of the Summary Prospectus, we do not object to the rescission of relief from Section 24(d) that has been granted in previous exemptive orders. Those funds that do currently use product descriptions also maintain statutory prospectuses, so requiring the prospectus to be sent to retail investors in place of the product description is not particularly problematic.

We would, however, strongly oppose the rescission of existing exemptive orders more broadly. As discussed above, certain aspects of the proposed rule – in particular, with respect to transparency – are more restrictive than existing exemptive orders. The proposed rule also would not cover ETFs that are share classes of traditional funds.[47] Because the rule does not codify all aspects of previously granted exemptive relief, we cannot agree with the assumption that most ETFs that have orders would rely on the rule.

II. Exemption for Investment Companies Investing in ETFs

A. Background

We strongly support the Commission's proposed Rule 12d1-4, which would provide relief from the limits set by Sections 12(d)(1)(A) and (B) of the Investment Company Act for investment companies investing in ETFs. As the Commission has recognized, over the years a number of "fund of funds" arrangements have been developed that serve legitimate and worthwhile purposes, offering investors a wider range of investment options. These include asset allocation funds, target date or lifecycle funds, and, more recently, managed payout or income preservation funds. The Commission has also recognized that investment companies are often suitable investments for funds that are not "funds of funds" in the traditional sense, such as those that use money market funds for "cash sweep" arrangements.[48]

ETFs can be suitable investments for both funds of funds and traditional mutual funds. Among other things, they can provide an efficient and cost-effective means to achieve asset allocation, offer exposure to a broad range of markets, sectors, regions and industries in a single transaction, and

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[47] *See, e.g.,* Vanguard notice and order, *supra* note 7.

[48] Many of these arrangements are now permissible under the "fund of funds" rules adopted by the Commission in 2006. *See* Fund of Funds Investments, SEC Release Nos. 33-8713 and IC-27399 (June 20, 2006), 71 Fed. Reg. 36640 (June 27, 2006).

provide a convenient way for an investing fund to hedge its portfolio or equitize idle cash.[49] Many funds currently invest in ETFs in excess of Section 12(d)(1) limitations under exemptive orders, and experience has shown that the legislative concerns expressed by Congress, in particular "pyramiding," layering of fees, and overly complex structures, to the extent implicated by these arrangements, can be satisfactorily addressed. The exemptive orders, however, imposed onerous and costly conditions on both the ETFs and the investing funds, including the need to execute a "participation agreement" between the ETF and each investing fund, among others.[50] For all of these reasons, we applaud the Commission's willingness to codify the previously granted exemptive orders and to revisit the conditions those orders imposed.

B. Proposed Rule 12d1-4 Conditions

1. Control

We support the Commission's general approach of using the concept of "control" as defined under the Investment Company Act to guard against potential coercive behavior by an acquiring fund. The proposed rule would create a rebuttable presumption that an acquiring fund's beneficial ownership of up to 25 percent of the voting securities of an ETF does not constitute control over the ETF. We also appreciate that the proposal takes into account the possibility that, as a result of redemptions, a fund could inadvertently become an owner of more than 25 percent of the voting securities, and we agree that mirror voting is appropriate in that case.[51] Institute members that currently sponsor ETFs agree that this approach will sufficiently protect their funds from coercive behavior. Institute members are concerned, however, that in practice, the range of entities that must be surveyed for purposes of assessing beneficial ownership is far too broad, and would make reliance on the rule impractical – and in some cases could violate federal regulations or fiduciary duties – for many investing funds. We believe ETFs could be sufficiently protected from coercive behavior even if the ownership requirement were narrowed to address these issues.

Of primary concern is the proposed requirement that the calculation for determining beneficial ownership includes not just companies controlling, controlled by or under common control with the

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[49] As the Commission has recognized, mutual funds can provide many of the same benefits in fund of funds products. The Commission has granted exemptive relief to permit funds of funds to invest in unaffiliated mutual funds, as well as ETFs. *See* Proposing Release at note 202 and accompanying text. As a follow-up to this rule proposal, we recommend that the Commission consider codifying those arrangements in which mutual funds are the underlying investment vehicles.

[50] Participation agreements are necessary largely to enforce the terms of the exemptive order, which by definition only apply to the ETF recipient, with respect to the investing fund. Once a rule is adopted that applies to both parties, these agreements will be unnecessary.

[51] As currently drafted, however, an acquiring fund that holds more than 25 percent of outstanding voting securities of an ETF as a result of redemptions would seem to be presumptively in violation of the provision in paragraph (a)(1)(i) of the proposed rule (prohibiting an acquiring fund from controlling the ETF), even if it voted its shares as required by paragraph (a)(1)(ii). We recommend that paragraph (a)(1)(ii) state that a fund that votes as directed by the paragraph would not be presumed to control the ETF on the basis of its ownership, notwithstanding the rebuttable presumption to the contrary.

acquiring fund itself, but also those in a control relationship with the fund's investment advisers. This control group is far broader than the one established by Section 12(d)(1) of the Investment Company Act, which requires only the aggregation of holdings of the acquiring fund and any entities it controls. The proposed requirement would be extremely problematic for the considerable number of Institute members that are affiliated with large, often international financial concerns, including investment banks, commercial banks, insurance companies, and other investment services providers. These funds' investment advisers may be controlled by or under common control with a wide range of entities that may invest in an ETF, including offshore or foreign investment advisers or banking entities, insurance companies, and trustees or fiduciaries of defined benefit plans, among others.

In some cases, there are firewalls between these entities to prevent the exchange of information that would be necessary to assess a fund's ownership, or policies and procedures that would prohibit it.[52] There are also serious practical implications to monitoring affiliates' holdings on a daily basis. Language barriers, lack of communications, and different recordkeeping systems are just a few of the barriers that might prevent a fund's adviser from ascertaining the daily holdings of, for example, a foreign subsidiary of a common bank holding company.[53] More importantly, a fund's adviser cannot and should not be able to stop such affiliates from investing in certain securities. Further, it is highly unlikely that such distant "affiliates" would have either the ability or the incentive to join an adviser to collectively control an ETF.

Even if fund advisers could effectively monitor and influence the holdings of all their affiliates, in the event they collectively exceed 25 percent of voting securities, the mirror-voting requirement could be problematic for certain affiliates. For example, an affiliate that is a trustee or other fiduciary of an employee benefit plan could be in violation of its fiduciary duties under Sections 404(a)(1)(A) and (B) of the Employee Retirement Income Security Act of 1974.[54] These fiduciary duties require that, in voting proxies, the trustee "consider those factors that may affect the value of the plan's investment and

[52] The Commission offered guidance on a related subject when it amended its beneficial ownership reporting requirements. *See* Amendments to Beneficial Ownership Reporting Requirements, SEC Release No. 34-39538 (Jan. 12, 1998), 63 Fed. Reg. 2854 (Jan. 16, 2008). The adopting release acknowledged that "certain organizational groups are comprised of many different business units that operate independently of each other," and stated that "in those instances where the organizational structure of the parent and related entities are such that the voting and investment powers over the subject securities are exercised independently, attribution may not be required for the purposes of determining whether a filing threshold has been exceeded and the aggregate amount owned by the controlling persons." The release went on to say that whether the voting and investment powers are exercised independently is based on facts and circumstances, which may include "informational barriers" and "policies and procedures established to prevent the flow of information among the related entities." *Id.* at 17-20.

[53] Several Institute members informed us that they had considered entering into participation agreements with ETFs, but opted not to after determining that they would be unable to comply with this condition.

[54] 29 U.S.C. §1104(a)(1)(A) – (B).

not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives."[55]

The Commission has recognized that, due to the growth of funds and changes in their organization, a growing number of persons are prohibited from entering into certain transactions, and has adopted exemptive rules in circumstances in which it is unlikely that these relationships will cause harm to a fund.[56] Rule 17a-10 permits certain subadvisory affiliates to enter into transactions with a fund, as long as their advisory contracts prohibit them from consulting with other subadvisers of the fund concerning transactions for the fund. This limitation may provide an analogy by which the Commission could narrow the scope of affiliates that must be included in the 25 percent calculation.

We recommend that the 25 percent calculation exclude entities that control, or are under common control with, the fund's advisers or depositors, unless those entities consult with the adviser on securities transactions. Under this construction, the ETF holdings of all funds – registered and unregistered – and other accounts advised by the acquiring fund's adviser would be included. In addition, holdings of affiliates of the adviser who could intentionally join together with the adviser to collectively take a position in an ETF would be captured. On the other hand, an adviser would not need to monitor or influence holdings information from affiliates with which it does not ordinarily communicate for purposes of assessing limits on the fund's holdings.[57]

Regardless of whether the Commission is prepared to offer this relief, it should, at minimum, narrow the requirements for mirror voting. As proposed, the rule would require each of the holders that collectively own 25 percent of the ETF to vote in the manner prescribed by Section 12(d)(1)(E) of the Investment Company Act. We request that the Commission require only the registered investment companies to vote in that manner. This would be consistent with Section 12(d)(1)(E), which only calls for mirror voting by the acquiring investment company[58] itself, even though any companies it controls are included for purposes of ownership limitations.

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[55] Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 C.F.R. §2509.94-2.

[56] *See, e.g.,* Transactions of Investment Companies with Portfolio and Subadviser Affiliates, SEC Release No. IC-25888 (Jan. 14, 2003), 68 Fed. Reg. 3142 (Jan. 22, 2003).

[57] Alternatively, the Commission could look to Section 13(d) of the Securities Exchange Act, governing reporting of beneficial ownership of securities, to determine when affiliates should aggregate their holdings for this purpose. Under Section (13)(d)(3), aggregation is required "when two or more persons act as a partnership, limited partnership, syndicate or other group for the purpose of acquiring, holding, or disposing of securities of an issuer." *See* 15 U.S.C. §78m(d) and rules thereunder.

[58] Entities that would be investment companies but for the exceptions under Sections 3(c)(1) and (7) of the Investment Company Act are not deemed investment companies for these purposes. *See* 15 U.S.C. §§80a-3(c)(1) and (7). *See also infra* note 68.

2. Redemptions

We support the Commission's proposal to prohibit an acquiring fund from redeeming shares it acquired in reliance on the proposed rule. Institute members agree that fund investments in ETFs are typically made through the secondary market, and that these restrictions would not impede the ability of acquiring funds to dispose of ETF shares. We do not believe that any additional conditions, such as those included in existing exemptive orders, are necessary to protect ETFs from the threat of redemption or other coercive behavior.

Institute members that sponsor ETFs are concerned, however, that compliance with the proposed prohibition on an ETF accepting redemptions from acquiring funds that rely on the rule to exceed the three percent threshold would be problematic. As the Proposing Release acknowledges, it may be difficult for an ETF, its principal underwriter, a broker or a dealer to know whether a redemption order is submitted by such an acquiring fund. In fact, in many cases it would be impossible. Because the ETF may only transact with an Authorized Participant, it would by necessity rely on the Authorized Participant to evaluate the redeeming fund's status under the rule. And, where a redeeming fund is only seeking to redeem a fraction of its holdings in the ETF, the Authorized Participant also may not know whether the fund's total holdings exceed the three percent threshold.

We recognize that the proposed rule contains a safe harbor to protect an Authorized Participant in the event it does not know the status of the fund seeking to redeem ETF shares. However, given that in many cases only the acquiring fund knows its status, and the ETF, underwriter, broker and/or dealer would by necessity rely on a representation from the acquiring fund, this prohibition and associated safe harbor seem redundant and unnecessary. An acquiring fund relying on the rule to hold more than three percent of an ETF's shares would already be prohibited from redeeming those shares. There is no reason to force the other parties to actively seek a representation from the acquiring fund as to whether the transaction is permitted, and to maintain compliance records indicating that they did so and that they have no reason to believe the transaction is improper. We believe the proposed restriction on redemptions by acquiring funds is sufficient to protect ETFs from the threat of redemption or other coercive behavior.

3. Complex Structures

We believe that there are circumstances in which investors may benefit from the existence of an acquiring fund investing in an ETF that itself invests in other funds or ETFs.[59] We strongly encourage the Commission to consider these types of arrangements. Should the Commission wish to maintain

[59] For example, assume ETF A is an India fund. ETF B, from the same complex, is an Asia fund that finds it more efficient and cost-effective to hold shares of ETF A for its India allocation (along with traditional securities or other affiliated ETFs covering other regions in Asia). Fund C, an affiliated or unaffiliated fund (or ETF) with a global strategy, may wish to use ETF B to obtain its Asia allocation. Under the proposed rule, Fund C would not be permitted to do so (assuming ETF B held more than 10 percent of its assets in underlying funds), even though ETF B's use of ETF A was more efficient than acquiring all of the underlying securities in ETF A.

the restriction on these arrangements in the proposed rule, however, we suggest the following clarifications and changes.

Acquired ETFs must retain the flexibility to invest a limited amount in other funds and ETFs. We agree that the proposed 10 percent threshold is reasonable.[60] By including in the 10 percent total only unregistered funds and those funds acquired in reliance on the statutory exceptions under Sections 12(d)(1)(F) and (G),[61] we read the proposed rule to permit an acquired ETF to invest an unlimited proportion of its assets in money market funds in reliance on Rule 12d1-1, and not to require the ETF to include such investments in the 10 percent maximum or disclose its policy regarding money market fund investments. The flexibility to invest in money market funds is extremely important to all funds, and we request that any adopting release make clear that this is permissible.[62]

We also agree that requiring an ETF to disclose its policy about investing in other funds will help potential acquiring funds more easily determine if they may invest in the ETF. We believe, however, that it is unnecessary and potentially problematic to require the ETF's policy to "prohibit" it from investing more than 10 percent of its assets in other funds. Many mutual funds, particularly actively managed ones, state in the "investment strategy" section of their prospectuses that they may, on occasion or under extraordinary circumstances, invest in securities that do not meet the funds' normal investment criteria.[63] ETFs may wish to have the same flexibility, but such language could confuse the question of whether the ETF's policy "prohibits" it from investing more than 10 percent of its assets in other funds. We believe the Commission's objective of limiting multi-tiered structures could be accomplished, while still permitting flexibility in extraordinary circumstances, by requiring an acquired ETF to have a disclosed policy that it "ordinarily does not invest" more than 10 percent of its assets in other funds (excluding money market funds).

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[60] The 10 percent threshold also has a statutory basis, as set forth in Section 12(d)(1)(A)(iii) of the Investment Company Act.

[61] Section 12(d)(1)(F) permits a fund to take small positions in an unlimited number of other unaffiliated funds, and Section 12(d)(1)(G) permits a fund to acquire an unlimited amount of shares of other registered open-end funds and UITs that are "part of the same group of investment companies."

[62] While the proposed rule text supports our reading, note 225 of the Proposing Release seems to suggest otherwise. It states that an acquiring fund "may have difficulty determining whether an acquired ETF would itself be considered a fund of funds because the acquiring fund might not be able to ascertain easily if the ETF is relying on an order, section 12(d)(1)(E) of the Act, or rule 12d1-1 to invest in other funds beyond the limits of section 12(d)(1)(A) of the Act... Limiting exemptive relief to investments in ETFs with disclosed policies would allow an acquiring fund to determine easily if it could invest in a particular ETF."

[63] *See, e.g.,* Vanguard Windsor Fund Prospectus, dated Feb. 27, 2008, at 10, available at https://personal.vanguard.com/us/funds/prospectus?FundId=0022&FundIntExt=INT ("The Fund may temporarily depart from its normal investment policies and strategies when doing so is believed to be in the Fund's best interest, so long as the alternative is consistent with the Fund's investment objectives. For instance, the Fund may invest beyond the normal limits in derivatives or ETFs that are consistent with the Fund's objective when those instruments are more favorably priced or provide needed liquidity, as might be the case when the Fund is transitioning assets from one advisor to another... ").

4. Layering of Fees

We support the Commission's proposal to place limits on sales charges and service fees imposed by an acquiring fund. We agree that it is unnecessary to impose the conditions from existing exemptive orders that require the acquiring fund adviser to waive the part of its fee equal to any compensation received from the ETF in connection with its investment in the ETF, and require the board of the acquiring fund to make a specific finding that its advisory fees are for services that are in addition to, rather than duplicative of, the services provided by the adviser to the acquired ETF. Fund boards are already obligated to evaluate the terms of advisory agreements, which should encompass these findings. In addition, because acquiring funds calculate their performance results net of acquired fund fees, as well as other operating expenses, we believe investors receive sufficient information to assess whether the fund's overall performance, taking such fees and expenses into account, is consistent with their investment objectives.[64]

We question, however, whether the proposed fee limits that would apply when a separate account invests in an acquiring fund are necessary or appropriate.[65] Proposed Rule 12d1-4(a)(3)(i) already would limit the sales charges and service fees that could be charged by an acquiring fund, taking into consideration any fees charged by the acquired fund, so including limits on the same charges and fees in Rule 12d1-4(a)(3)(ii)(A) and (B) seems duplicative. And, for reasons that are not explained in the Proposing Release, the specific limits that would apply to an acquiring fund and underlying ETF when a separate account invests in the acquiring fund are different from those that would apply if there were no separate account. For example, the rule would permit both an acquiring fund and an underlying ETF to impose sales charges (subject to aggregate limits), but a separate account would not be permitted to invest in an acquiring fund where this is the case. Rather, a separate account may only invest in an acquiring fund when either the acquiring fund *or* the underlying ETF (or neither) charges any sales charge. The practical effect is that a separate account could invest in an acquiring fund if the acquiring fund or underlying ETF has a .75% asset-based sales charge, but it could not invest in an acquiring fund if both the acquiring fund and the underlying ETF have a .25% asset-based sales charge or service fee, even though the aggregate charges (.50%) would be lower. This result does not seem to serve the best interests of investors.

[64] Institute members continue to strongly oppose the inclusion of "acquired fund fees and expenses" in the calculation of operating expenses, particularly for funds that are not funds of funds but may invest a small portion of their assets in other investment companies. Funds may invest in other mutual funds or ETFs simply as a more efficient – and cost-effective – means to buy the underlying securities, yet as a result of this requirement their fees appear higher. Members are also concerned that the difference between the operating expenses percentage listed in the fee table and the one in the financial highlights section of the statutory prospectus could confuse investors.

[65] Proposed Rule 12d1-4(a)(3)(ii) includes certain conditions specific to separate accounts that invest in acquiring funds. The Proposing Release offers no insight on the purposes or need for these restrictions, other than to note that NASD Conduct Rule 2830, which includes fee limits for funds of funds, does not apply to variable annuity contracts.

The need for subparagraphs (A) and (B) is further subject to question in light of the proposed requirement set forth in subparagraph (C). Subparagraph (C) appears to be an expanded version of Section 26(f) of the Investment Company Act,[66] designed to encompass the fees of acquiring funds and any underlying ETFs in which such funds invest within the "reasonableness" determination made by an insurance company offering a variable insurance contract. Given that the insurance company is required to make a determination as to the reasonableness of aggregate fees and charges at the variable contract level, it seems unnecessary for the Commission to impose the specific restrictions in subparagraphs (A) and (B). We therefore recommend that these restrictions be eliminated. We also request that the Commission clarify that the determination required in subparagraph (C) is to be made by the insurance company, and that the boards of the acquiring fund and underlying ETF are not required to undertake additional responsibilities or liability related to this requirement.[67]

C. Scope of Proposed Rule 12d1-4

1. Acquiring Funds and ETFs Eligible for Relief

We support the proposed scope of the rule, and believe that it could be broadened further. We do not believe any special concerns arise with respect to permitting business development companies to invest in ETFs. The proposed conditions protect the acquired ETFs from threats of control, minimize the ability to create complex structures, and limit duplicative and excessive fees for investors in acquiring funds. For these reasons, we also believe it is unnecessary to exclude unregistered funds, such as those companies that rely on Sections 3(c)(1) or (7) of the Investment Company Act, from investing in ETFs in excess of the limits imposed by Section 12(d)(1)(A)(i).[68] Such funds may already rely on the relief granted by Rule 12d1-1, which permits them to invest in money market funds excess of these limitations. We propose that, like Rule 12d1-1, proposed Rule 12d1-4 define investment company in such a way as to include these unregistered funds.[69]

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[66] Section 26(f) provides that the trustee, custodian and depositor requirements for unit investment trusts set forth in Section 26(a) of the Investment Company Act do not apply to a registered separate account funding variable insurance contracts, or to the sponsoring insurance company and principal underwriter of the account if, among other things, the fees and charges deducted under the contract, in the aggregate, are reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company.

[67] For example, the text of subparagraph (C) could read: "The insurance company offering the variable insurance contract determines that the fees associated with the variable insurance contract … are reasonable in relation to the services rendered…".

[68] Contrary to the statement in note 194 of the Proposing Release, unregistered funds relying on Sections 3(c)(1) and (7) are not subject to all of the limits imposed by Sections 12(d)(1)(A) and (B). They are only subject to the limits of Sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i), which prohibit them from acquiring more than three percent of the outstanding voting shares of an acquired fund, and prohibit an acquired fund from selling them more than three percent of its outstanding shares.

[69] *See* Rule 12d1-1(d)(1), 17 C.F.R. §270.12d1-1(d)(1).

2. Investments in Affiliated ETFs Outside the Fund Complex

We support the proposed relief from restrictions on affiliated transactions for funds that acquire five percent or more of an ETF's outstanding voting securities. As discussed above, we agree with the Commission that this exemption is appropriate, because such affiliates are not treated differently from non-affiliates when transacting with the ETF in creation units. In addition, in light of the proposed protections the rule would provide for acquired ETFs with respect to attempts to control (*e.g.*, the prohibition on control, mirror voting, and restrictions on redemption), such relief seems to provide little opportunity for the acquiring fund to manage the ETF for its own benefit.

3. Use of Affiliated Broker to Effect Sales

We support the proposed relief to permit funds that are affiliated with an ETF solely by virtue of acquiring five percent or more of its assets to transact with a broker that is affiliated with the ETF without meeting the conditions set forth in Rule 17e-1. We agree that it is unlikely that the affiliated broker-dealer would be in a position to take advantage of the acquiring fund based on the fund's affiliation with the ETF.

III. Exemption for Affiliated Fund of Funds Investments

A. Affiliated Fund of Funds Investments in ETFs

We support the inclusion of ETF shares in the list of permissible investments for affiliated funds of funds relying on Rule 12d1-2. We agree with the Commission that no special issues appear to arise from this relief. With respect to the acquired ETF, there are no grounds for distinguishing between an acquiring fund that is primarily an affiliated fund of funds and another type of acquiring fund. And, since Rule 12d1-2 already permits investments in other funds subject to statutory limits, as well as securities not issued by investment companies, we see no reason to prevent affiliated funds of funds from investing in ETFs up to the limits established by proposed Rule 12d1-4.[70]

B. Affiliated Fund of Funds Investments in Other Assets

We strongly support the Commission's proposal to allow funds relying on Rule 12d1-2 to invest in assets other than securities. Many exemptive orders that predated Rule 12d1-2 permitted affiliated funds of funds to invest in "other financial instruments" or similar,[71] and many funds that

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[70] As the Proposing Release notes, many funds treat ETF investments like investments in traditional equity securities. This proposal is consistent with that view. *See* Proposing Release at note 212.

[71] *See, e.g.,* Smith Breeden Trust, *et al.*, Investment Company Act Release Nos. 23918, July 21, 1999 (notice) and 23947, Aug. 17, 1999 (order) (permitting investments in "securities and other instruments"); Morgan Grenfell Investment Trust, Investment Company Act Release Nos. 25063, July 13, 2001 (notice) and 25105, Aug. 9, 2001 (order) (permitting investments in "certain securities and financial instruments").

otherwise rely on Rule 12d1-2 continue to seek such relief.[72] These funds typically desire the flexibility to invest, consistent with their investment objectives, in assets that may not be securities under the Investment Company Act. Such assets might include financial futures, forwards, options, swaps, reverse repurchase agreements, and other derivative instruments. Through the exemptive process, the Commission has had ample opportunity to confirm that investments by affiliated funds of funds in such assets do not present any novel concerns, and should be permitted by rule.

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The Institute appreciates the opportunity to provide comments on this proposal. If you have any questions about our comments or would like any additional information, please contact me at 202/326-5815 or Mara Shreck at 202/326-5923.

Sincerely,

/s/

Karrie McMillan
General Counsel

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins
The Honorable Kathleen L. Casey

Andrew J. Donohue, Director
Robert E. Plaze, Associate Director
Division of Investment Management

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[72] *See, e.g.,* Vanguard Star Funds, *et al.,* Investment Company Act Release Nos. 28009 (Sept. 28, 2007) (notice) and 28024 (Oct. 24, 2007) (order); JP Morgan Trust I, *et al.,* Investment Company Act Release Nos. 28183 (Mar. 4, 2008) (notice) and 28230 (Apr. 1, 2008) (order).