

**MEMO# 31400**

September 24, 2018

# ICI Files Comment Letter on SEC's ETF Rule Proposal

[31400]

September 24, 2018 TO: ICI Members

Investment Company Directors

ETF (Exchange-Traded Funds) Committee

ETF Advisory Committee

ICI Global Exchange Traded Funds Committee SUBJECTS: Exchange-Traded Funds (ETFs)

RE: ICI Files Comment Letter on SEC's ETF Rule Proposal

As you know, the SEC proposed a new rule (Rule 6c-11) under the Investment Company Act of 1940 that would permit ETFs that satisfy certain conditions to operate without first obtaining an exemptive order from the Commission.[\[1\]](#) In connection with the proposed rule, the Commission proposes to rescind certain exemptive orders that have been granted to ETFs and their sponsors. The Commission also is proposing certain disclosure amendments to Form N-1A and Form 8B-2 to provide investors who purchase and sell ETF shares on the secondary market with additional information regarding ETF trading costs. Finally, the Commission is proposing related amendments to Form N-CEN.

ICI's comment letter is attached and summarized below.

## Summary of Comments and Recommendations

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

### Scope of Proposed Rule 6c-11

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

### Exemptive Relief Under Proposed Rule 6c-11

- We strongly support the Commission's proposal to deem an equity security issued by an ETF covered by the rule to be a "redeemable security" for purposes of Section 2(a)(32) of the Investment Company Act. We also recommend the SEC extend this same treatment to the shares of ETFs registered under the Investment Company Act that are not permitted to rely on the proposed rule.
- We agree with the Commission that exemptive relief from Section 22(d) of the

Investment Company Act and Rule 22c-1 thereunder is appropriate for ETFs permitted under the proposed rule.

- We support the proposed relief from Sections 17(a)(1) and (2) to permit in-kind creation and redemption transactions involving persons who are affiliates of an ETF by reason of holding with the power to vote 5 percent or more of (i) the ETF's shares; or (ii) any investment company that is an affiliated person of the ETF. We also recommend that this relief be expanded to encompass other affiliates, including broker-dealers that are affiliated with an ETF's adviser.
- We support the proposed relief for postponement of payment of redemption proceeds when a foreign holiday prevents timely delivery of a foreign security included in an ETF's redemption basket, but we request a change or clarification to the definition of "foreign investment," as to the requirement that the security have "no established United States public trading market." We also do not believe a 10-year sunset provision for this exemption is necessary.

### **Conditions for Reliance on Proposed Rule 6c-11**

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

### **Basket Policies and Procedures**

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

### **Custom Baskets**

- We strongly support the Commission's proposal to give all ETFs the flexibility to use "custom baskets." We have long argued that basket flexibility benefits investors by helping the ETF meet its investment objective more efficiently, improving its tradability and thereby allowing its investors to enjoy lower costs and better tax treatment. We therefore commend the Commission for recognizing these benefits and incorporating custom basket flexibility into the proposed rule.
- We generally support the proposed requirement that an ETF using custom baskets adopt policies and procedures setting forth detailed parameters for the construction and acceptance of custom baskets.
- We question why the definition of custom baskets should include cash substitutions. A

cash substitution does not raise the same potential conflicts of interest as a security substitution and therefore should only be governed by an ETF's regular basket policies and procedures rather than be subject to the proposed heightened processing requirements of custom baskets.

## **Portfolio Holdings and Basket Website Disclosure**

- *T-1 Orders*: As proposed, an ETF's basket and portfolio holdings must be published on its website before it accepts creation and redemption orders. This requirement would seem to preclude an ETF from accepting creation and redemption orders shortly after the US market closes (4:00 pm ET) but before the basket holdings are published ("T-1 orders")—a practice that is quite common and beneficial for certain ETFs and their investors. We strongly urge the Commission to reconsider this requirement and change the proposed rule so that T-1 orders can be accepted.
- *Regulation S-X*: Although we appreciate the Commission's desire to standardize the manner in which portfolio holdings and baskets are presented on the ETF's website, presenting this information consistent with Article 12 of Regulation S-X as proposed is problematic. We are concerned that certain requirements in Article 12 may prove overly burdensome for purposes of daily disclosure. Instead, we recommend that the Commission specify formats for the portfolio disclosure and basket disclosure similar to that required by the exchange listing standards. If the Commission still determines to standardize the format of website portfolio holdings and baskets consistent with Regulation S-X, we recommend that certain required data elements within the Article 12 schedules be omitted because such information is not necessary to achieve the Commission's stated rationale for requiring the disclosure (*i.e.*, to facilitate the arbitrage process).
- *Basket Disclosure*: We urge the Commission to reconsider the proposed requirement that ETFs disclose baskets on their websites. Unlike portfolio holdings, the contents of an ETF's basket are simply not relevant for most secondary market investors, and, in fact, may be confusing for investors who mistake the basket (which, for some ETFs, may only be a representative sample of the entire portfolio) for the ETF's portfolio holdings.
- Under the proposal, an ETF would publish a basket that it would accept if presented by any authorized participant in exchange for creation units (or presented to an authorized participant redeeming creation units). We request that the Commission clarify that even if an ETF does not publish a custom basket at the beginning of the trading day, it can still use custom baskets in addition to the published (*e.g., pro rata*) basket.
- We would not support a requirement that an ETF post every basket it accepts from or presents to an authorized participant after the close of trading on each business day. We agree with the Commission's preliminary belief that such a requirement would be unnecessarily burdensome and costly to implement.
- *NAV, Market Price, and Premium or Discount Website Disclosure*: We do not object to the proposed requirement that would require ETFs to disclose: (i) the ETF's NAV per share, market price, and premium or discount, each as of the end of the prior business day; and (ii) historical information regarding premiums and discounts.
- We oppose disclosure that would require any ETF whose premium or discount was greater than 2 percent for more than seven consecutive trading days to post that information on its website, along with a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount. For certain ETFs, especially those investing in international markets, the proposed disclosure

requirement may be triggered more frequently, leading to disclosure that is unnecessary (given the asset class) or repetitive. It also may be difficult for an ETF to accurately identify the material factors that caused the deviation before the ETF must post the information and provide the narrative discussion of factors. An investor interested in information about the extent and frequency with which an ETF's market prices have tracked its NAV would still have access to the daily and historical premium/discount information proposed above.

## **Recordkeeping**

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

## **Effect of Proposed Rule 6c-11 on Prior Orders**

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

## **Amendments to Form N-1A**

- We generally support the Commission's approach of revising Form N-1A to better serve the information needs of retail investors and we agree that it is appropriate to distinguish between those who purchase in the secondary market and authorized participants who transact directly with the fund.
- *Changes that Affect Mutual Funds and ETFs:* We support the Commission's proposal to add disclosure that would clarify that, in addition to the current disclosures relating to investors who buy or hold shares, the fees and expenses reflected in Item 3 may be higher for investors if they sell shares of the fund. We also support the Commission's proposal to require a statement that investors may be subject to other fees not reflected in the table, such as brokerage commissions and fees to financial intermediaries.
- *Changes that Affect ETFs:* We have serious concerns with the proposed new section in Item 3 that would add a series of question and answers that would require disclosure of certain ETF trading information and trading costs. Although we support narrative disclosure that would highlight the transaction fees and costs for ETFs that are not reflected in the fee table, we do not believe ETFs should be required to calculate and disclose their bid-ask spread costs. Unlike an ETF's other quantitative disclosure responsibilities, an ETF does not control bid-ask spread costs and must either purchase market data to calculate it or rely on third party vendors for this information. To demonstrate how costs attributable to bid-ask spreads can affect an investor's total costs of investing in an ETF, we recommend the Commission add a hypothetical example using standard inputs, like the current prospectus fee example.
- Although we appreciate the Commission's desire to provide investors with a tool relating to the total costs of trading ETFs in the secondary market, we do not believe ETFs should be required to add an interactive calculator on their websites. Not only is historical bid-ask spread data not necessarily predictive of an investor's future spread costs, the proposed bid-ask spread disclosure and the interactive calculator add

additional vendor and licensing fees to a growing list of SEC-mandated disclosures for registered funds. If the Commission still wishes to move forward with an interactive calculator for investors despite our concerns, we recommend that it utilize the advanced market metrics available on the SEC's website. This way there would be a single data source and methodology for the calculator allowing investors to assess these costs in one place and in a comparable manner.

### **Amendments to Form N-8B-2**

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

### **Amendments to Form N-CEN**

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

### **Regulation of ETFs Under the Securities Exchange Act of 1934**

- We recommend the Commission consider ways to streamline the regulation of ETFs under both the Investment Company Act and the Securities Exchange Act of 1934. We also urge the SEC to consider ways the Divisions of Investment Management and Trading and Markets can work together to establish a single process for all ETF approvals.

### **Exemptions for Investment Companies Investing in ETFs**

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

Jane G. Heinrichs  
Associate General Counsel

### **[Attachment](#)**

#### **endnotes**

[1] See Investment Company Act Release No. 33140 (June 28, 2018), *available at* <https://www.sec.gov/rules/proposed/2018/33-10515.pdf>. The SEC proposed, but never adopted, an ETF rule in 2008. See Investment Company Act Release No. 28193 (March 11, 2008), 73 FR 14618 (March 18, 2008).

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