

**MEMO# 31382**

September 12, 2018

# ICI Draft Comment Letter on SEC ETF Rule Proposal; Comments Due September 19

[31382]

September 12, 2018 TO: ETF (Exchange-Traded Funds) Committee  
ETF Advisory Committee RE: ICI Draft Comment Letter on SEC ETF Rule Proposal;  
Comments Due September 19

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.<sup>[1]</sup> 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.

A draft of ICI's comment letter is attached and briefly summarized below. Please note that we intend to file our comment letter on Friday, September 21. As such, please send your written comments to [jheinrichs@ici.org](mailto:jheinrichs@ici.org) by Wednesday, September 19.

## Summary of Comments and Recommendations

ICI's comment letter expresses strong support for the proposal. In summary, our comments and recommendations are as follows:

### 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 first- or second-tier affiliates of an ETF by reason of holding with the power to vote 5 percent or more of (i) the ETF's shares; or (ii) any investment company that is an affiliated person of the ETF. 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; however, we 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. Further, we support the Commission's determination that the rule should not include an exception to this requirement for an ETF whose shares are suspended or delisted.
- We strongly support the Commission's decision not to require the dissemination of an intraday estimate of an ETF's 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 would require each ETF relying on the rule to adopt and implement written policies and procedures governing the construction of baskets and the process that would be used for the acceptance of baskets. We also think it is appropriate that an ETF's basket policies and procedures (including its custom basket policies and procedures discussed below) should be covered by the ETF's compliance program and other requirements under Rule 38a-1 under the Investment Company Act.

### **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 strongly 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 that are in the best interests of the ETF and its

shareholders. We are concerned, however, that requiring an employee, especially an employee outside of portfolio management, to review each custom basket each day would be overly burdensome and impracticable. Rather, we recommend that the policies and procedures only specify the titles or roles of employees that are responsible for establishing the custom basket parameters. Individual compliance reviews, especially by employees outside of portfolio management, should be limited to those custom baskets that deviate from those parameters.

- 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 a portfolio disclosure format 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*: 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.
- 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. We note that this requirement would seem to contradict the Commission's proposed amendments to Form N-1A and N-8B-2 that would eliminate certain disclosures from

the prospectus that are relevant only to authorized participants and potentially confusing to secondary market participants.

- *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 because these disclosures are generally consistent with the SEC's exemptive orders. We oppose, however, 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.

## **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 ETFs to 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 on 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 the Item 3 expense table 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 ("Q&As") 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 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 replace proposed Q&As 3-5 with a hypothetical example using standard inputs, like the current fee example.
- Although we appreciate the Commission's desire to provide investors with a tool

relating to the total costs of trading ETFs on the secondary market, we do not believe ETFs should be required to add an interactive calculator on their websites. Creating and maintaining this kind of website functionality will likely require the ongoing assistance of outside vendors and third-party data feeds, costs borne by shareholders. Rather, we recommend that if the Commission wishes to move forward with an interactive investor calculator, it should add it to the SEC's website and utilize the advanced market metrics available through its Market Information Data Analytics System (MIDAS).

### **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.

### **Securities Exchange Act Relief**

- We recommend the Commission consider ways to streamline the regulation of ETFs under the Securities Exchange Act of 1934, including the exchange listing process. 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.

Jane G. Heinrichs  
Associate General Counsel

[Attachment No. 1](#)

[Attachment No. 2](#)

#### **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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