The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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INSTITUTE DRAFT COMMENT LETTER ON SEC CONCEPT RELEASE ON ACTIVELY MANAGED EXCHANGE TRADED FUNDS

[14273] December 21, 2001 TO: SEC RULES COMMITTEE No. 98-01 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 24-01 UNIT INVESTMENT TRUST COMMITTEE No. 28-01 RE: INSTITUTE DRAFT COMMENT LETTER ON SEC CONCEPT RELEASE ON ACTIVELY MANAGED EXCHANGE TRADED FUNDS As we previously advised you, last month the Securities and Exchange Commission issued a concept release seeking comment on various issues relating to actively managed exchange traded funds (ETFs).* As noted in the Commission's release, while this product is currently in development, the Commission is interested in receiving public comment on the issues it raises to assist the Commission in its future consideration of an application for exemptive relief filed by an actively managed ETF. Based on the discussion with members during the Institute's December 11th conference call on the SEC's release, the Institute has prepared the attached comment letter, which is briefly summarized below. Comments are due to the SEC on its release no later than January 14, 2002. Accordingly, persons with comments on the Institute's draft letter should provide them to the undersigned no later than Monday, January 7th. Comments may be provided by phone (202-326-5825), fax (202-326-5839), or e-mail (tamara@ici.org). As noted below, the Institute is especially interested in receiving input on whether to include the discussion in part III of the letter in our comments. As a preliminary matter, the Institute's comment letter notes that it is unclear how an actively managed ETF may be structured and operated. Accordingly, when an issuer seeks exemptive relief for such a product, we may identify additional issues that warrant additional comment. In the meantime, the letter identifies three areas in which actively managed ETFs may raise investor protection concerns not present with existing ETFs: portfolio holdings disclosure, the impact of adding an actively managed ETF class to a traditional mutual fund, and potential additional conflicts of interest for the ETF's adviser. * See Memorandum to SEC Rules Committee No. 89-01, Closed-End Investment Company Committee No. 19-01, and Unit Investment Trust Committee No. 24-01, dated November 13, 2001. 2 I. PORTFOLIO HOLDINGS DISCLOSURE The Institute's letter notes that it is likely that all or part of the portfolio of an actively managed ETF will not be publicly disclosed. As a result, the ETF may be unable to maintain a market value that tracks net asset value (NAV). It is possible that, to avoid this problem, the ETF might seek to selectively disclose its portfolio, e.g., to the creation unit holders but not to retail investors. Such selective disclosure would, however, when made to allow a shareholder to trade on the basis of it, would be fundamentally at odds with the core principals of the federal securities laws. Accordingly, the draft letter urges the Commission not to grant exemptive relief to any actively managed ETF that would selectively disclose information about the fund's portfolio holdings. It additionally

recommends that the Commission proceed cautiously in granting relief to an ETF with an opaque portfolio. The draft letter suggests that, at the very least, any such relief should be conditioned on the fund providing to investors clear and prominent disclosure that highlights the risk that the fund's shares may not trade at prices close to NAV and notes the differences between these funds, traditional ETFs, and traditional mutual funds. II. ADDING A CLASS OF ETF SHARES TO AN EXISTING MUTUAL FUND The draft letter notes that the addition of an actively managed ETF class to a fund would likely have a more significant impact on the fund's operations and shareholders than those ETF classes that the Commission has permitted to date. To address concerns arising in connection with the addition of such a class, the letter recommends that the Commission condition any relief granted to such class on the fund's board of directors finding that its addition would not adversely impact the fund's existing shareholders. III. CONFLICTS OF INTERESTS The Institute letter notes that because the adviser to an actively managed ETF would have greater discretion to designate securities to be included in a creation unit holder's portfolio or redemption basket, there may exist a potential for the adviser to indirectly create a market for certain securities in a way that would favor an affiliate. To address this concern, the draft letter recommends that the Commission condition any exemptive relief granted to an actively managed ETF on the adviser being prohibited from including in the deposit/redemption basket any security that the adviser would be prohibited from trading in directly on behalf of the fund, unless the deposit/redemption basket completely or substantially replicates the ETF's total portfolio holdings. The Institute has bracketed this section of the letter and seeks input on whether it should be included in our comments. Tamara K. Reed Associate Counsel Attachment (in .pdf format)