DRAFT Comment Letter of the FIMSAC Subcommittee on ETFs and Bond Funds

October 29, 2018

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Exchange-Traded Funds, File No. S7-15-18

Dear Mr. Fields:

This letter responds to the request of the Securities and Exchange Commission (the "Commission") for comment on the proposed new Rule 6c-11 under the Investment Company Act of 1940 ("Act") that would exempt exchange-traded funds ("ETFs") from certain provisions of the Act and the Commission's regulations under that Act.

FIMSAC commends the Commission for seeking to streamline the applicability of the Act to ETFs, which have become an increasingly popular investment option for investors offering transparency, low cost, and diversification.[1] We highlight, however, the need for a consistent naming convention or "Truth in labeling" so that various types of exchange-traded products (ETPs) could be appropriately classified and labeled. While all ETPs share certain characteristics, including intraday exchange-tradability, the term "ETF" is used in describing many products that have a wide range of different structures, investment objectives and risk profiles.

Based on numerous presentations and internal discussions, FIMSAC has concerns regarding the use of the term "ETF" by products that have materially different risks embedded in their structures than traditional ETFs.[2] Examples of these products include certain exchange traded notes (ETNs) and leveraged and inverse exchange traded products.[3]

The sharp spike in volatility during the first week of February 2018 provides a clear example of the different risk profiles associated with different types of ETPs. Specifically, February 5, 2018 saw the largest ever one-day percentage increase ever recorded in the VIX volatility index. Post-close on February 5, 2018, a subset of inverse VIX ETPs suffered declines in excess of 90%. These price declines reflected the embedded leverage of these inverse ETPs, as a fall in the VIX increases the value of the inverse ETP while a rise in the VIX decreases the value of the ETP. While these products

[1] There are over $6 trillion in ETF assets globally as of June 2018. Source: FactSet (June 30, 2018). Madhavan ("ETFs and the New Dynamics of Investing," Oxford University Press, 2016) provides an overview of the growth of ETF assets and the benefits offered to investors from this structure.

[2] On September 10, 2018, the SEC suspended trading in Bitcoin and Ethereum-related products citing confusion over materials characterizing the products as exchange-traded funds. See: https://www.cnbc.com/2018/09/10/sec-suspends-trading-in-cryptocurrency-products-over-etf-confusion.html

[3] See BlackRock Viewpoint, ETFs: A Call for Greater Transparency and Consistent Regulation (Oct. 2011), available at https://www.blackrock.com/corporate/insights/public-policy/viewpoints-letters-consultations

performed as designed, the dramatic jump in VIX prompted the closure of an inverse VIX ETN by its sponsor under the terms detailed in the ETN's prospectus (a so-called "event acceleration"). In our view, this episode highlights the need for clearer labeling of ETPs in order to make sure investors understand that certain ETPs come with greater embedded risks and more complexity than others.

Our guiding principle is truth in labeling, to provide enhanced clarity for self-directed investors as well as those with financial advisors. FIMSAC believes that the proposed Rule 6c-11 offers a timely opportunity for the Commission to consider more consistent terminology for ETPs as the Commission works to foster more consistent regulatory standards for traditional ETFs. In particular, Rule 6c-11 imposes certain disclosure requirements on ETFs that further the truth-in-labeling principle including daily transparency of portfolio holdings, written policies and procedures on custom basket creation, and disclosing historical information regarding premiums and discounts and bid-ask spreads on ETF's website.

We believe that potential problems could arise if investors mistakenly assume that all products referred to as ETFs are structured and regulated like traditional ETFs that meet the Rule 6c-11 standard, particularly if such products have materially different structural risks than ETFs that will be able to rely on proposed Rule 6c-11.

Based on this potential concern, we recommend that the Commission consider an amendment to Rule 35d-1 of the Act that would preclude registered investment companies that are not within the scope of Rule 6c-11 from using the terms "ETF" or "Exchange Traded Fund" in their fund name unless they are currently classified as an ETF whose sole reason for their not being in the scope of Rule 6c-11 is due to the fund being structured as a unit investment trust. Specifically, Rule 35d-1 could be amended to require that a registered investment company with the term "Exchange Traded Fund" or "ETF" in its name comply with Rule 6c-11.

Of course, this solution would only address the use of the term "ETF" by registered investment companies that do not meet the requirements of Rule 6c-11 and that this solution would not apply to other types of ETPs that are not registered investment companies. As such, while we believe that a naming convention in the context of the Act would be a helpful step forward, it is not sufficient to address the lack of a common classification scheme for ETPs.

In this context, while the proposed Rule does not address the use of the term "ETF" by leveraged and inverse ETFs, we appreciate several of the Commissioners' remarks acknowledging that these products have different risks than traditional ETFs and warrant additional consideration by the Commission and its staff. The Fund Subcommittee views that leveraged and inverse exchange-traded products are not ETFs in the traditional sense and should not be permitted to refer to themselves as ETFs. A more clear-cut and consistent naming convention for ETPs would better serve retail investors by ensuring there is clarity around the structure and risks of different types of ETPs.

As such, FIMSAC suggests that the Commission consider a more comprehensive approach to ETP classification to improve investors' abilities to understand and analyze the risks of individual ETPs.[4] There are several choices in classification systems. When tested in practice, some of these distinctions

[4] It is frequently difficult for investors to compare even structurally similar ETPs. For example, various market data services, electronic trading systems, broker-dealers and sponsors of fixed-income ETFs have historically each reported basic metrics such as yield, spread and duration using their own proprietary calculations. This has made it difficult to compare fixed income ETFs to other fixed-income investments, as well as to each other. A number of leading market participants have recently come together to promote a common reporting standard. See Alastair Marsh, "BlackRock, State Street Seeking ETF Standards for Trading Boost," Bloomberg (Jul. 27, 2015), available at http://www.bloomberg.com/news/articles/2015-07-27/FIMSAC-state-street-seeking-etf-standards-for-trading-boost.

draw sharper lines amongst ETFs while others may provide greater "truth in labeling."

Some of the classification choices discussed by the Fund Subcommittee include making distinctions between:

1. Passive vs. active investing strategy;
2. Rules-based vs. discretionary investments;
3. Long, short, and leveraged exposures using derivatives; and
4. Creation and redemption arbitrage mechanisms.

All these distinctions, while useful or informative, present practical challenges and possibly increase investor confusion. For example, industry participants note that distinctions between active and passive products (items 1 and 2) are increasingly blurred with the advent of "smart beta" or factor products, or of index products with active elements, such as a model-based approach to hedging currencies for an international equity fund. Similarly, in item 3, certain derivatives (e.g., an equity option) and swaps may have different risk profiles as opposed to a listed derivative or cash underlying. On the last point (item 4), an ETF could be defined as any investment vehicle that uses an arbitrage mechanism.[5]

FIMSAC recognizes these distinctions can be important to some investors, but from a practical perspective, we suggest the Commission focus on establishing greater clarity around the term ETF as commonly understood, as noted above. Below, we provide an example of a potential classification scheme (discussed in the subcommittee's meetings) that would better categorize the risks associated with different types of ETPs. This would include a category of exchange-traded instruments (ETIs) that is intended to capture leveraged and inverse funds. We welcome an open dialogue with the Commission and with other market participants as to the best approach to ETP classification.

Potential Classifications for ETPs

- **Exchange Traded Product (ETP)**
  - Generic term for any portfolio exposure product that trades on an exchange.
  - ETFs, ETNs, ETIs, and ETCs are distinct subsets of the ETP classification.

- **Exchange Traded Fund (ETF)**
  - ETFs are registered investment companies that trade on an exchange.
  - US listed ETFs comply with the provisions of Rule 6c-11[8].
  - ETFs can be passive or active funds that meet diversification and liquidity thresholds set by regulators and exchanges.
  - ETFs' underlying securities can include stocks, bonds, futures, or other investment instruments (e.g., bank loans, exchange traded options).
  - This category should exclude funds with embedded leverage or inverse features.

- **Exchange Traded Note (ETN)**
  - Debt instruments that provide an index-based return. ETNs are not subject to Rule 6c-11 as

[5] For example, Professors Henry Hu and John Morley in their publication "A Regulatory Framework for ETFs," argue that an ETF could be defined as a pooled investment vehicle that publicly trades on an exchange and that permits an investor to create and redeem shares in exchange for assets or a combination of assets and cash at values equal to the entity's net asset value.

[8] We recommend that an existing ETF that does not fall within the scope of Rule 6c-11 solely due to its structure as a Unit Investment Trust (UIT) or as a share class of a fund that issues multiple classes of shares representing interest in the same portfolio ("share class ETFs") be grandfathered into this classification.

they are not registered investment companies.
  - ETNs may or may not be collateralized, but depend on the issuer's solvency and willingness to buy and sell securities to deliver fully to expectations.

- **Exchange Traded Commodities (ETC)**
  - Not Registered Investment Companies under the 1940 Act and hence are not subject to Rule 6c-11.
  - Listed under different Exchange Rules than 1940 Act Funds.
  - Include commodity futures and physical commodities.

- **Exchange Traded Instrument**
  - An ETI is a registered investment company.
  - Has embedded structural features designed to deliver performance that will not track the full unlevered positive return of the underlying index or exposure over a specific period of time such as a day exposure (that is, products that seek to provide a leveraged or inverse return, a return with caps on upside or downside performance or "knock-out" features).
  - Products designed to outperform a specific index (e.g., active funds) but not by a particular multiple of a period's return are not considered ETIs.

Additional Comments on 6c-11

1. FIMSAC also supports the Commission's efforts to create a level playing field among market participants by permitting both index-based and actively-managed ETFs to operate under the proposed rule, subject to the same conditions. We agree with the Commission that eliminating the regulatory distinction between index-based and actively-managed ETFs will provide a more consistent and transparent regulatory framework and promote consistency with the Commission's regulation of other types of open-end funds.

2. We appreciate the Commission's distinction between non-leveraged and leveraged ETPs, and agree that they deserve unique consideration. We view education and knowledge surrounding leveraged ETPs as an area that may benefit from additional investor communication, to further understanding of these products and ensure investors understand the differentiating characteristics.

   a. As noted in the Commission's Request for Comment, these products may produce performance that differs significantly from investors' expectations. We support the Commission's proposal to prevent leveraged ETPs from relying on proposed Rule 6c-11 for naming purposes.
   b. The unique characteristics associated with these products call for additional disclosure and investor education generally, and we recommend the Commission consider future rulemaking regarding leveraged ETP investor disclosure requirements. For example, requiring marketing materials for leveraged ETPs to contain cautionary statements about the risks and volatility of these products, would assist in investor understanding. In addition, required, standardized statements and/or graphs containing data on the impact of compounding would also be beneficial.

3. Intraday Indicative Value or IIV (Question page 75): *Do retail investors use or rely on the IIV, and if so, how? Do they use the IIV for international and fixed income ETFs, and if so, how? Is there a risk that this information could be misleading in certain circumstances? Would omitting the IIV have a disparate impact on retail investors as opposed to more sophisticated market participants?*

a. While we agree with prior commenters (2015 ETP Request for Comment) that the published intraday indicative value (IIV) may differ from an ETF's NAV, we believe the IIV contains valuable information which may be used by market participants, particularly retail investors. Because of the potential for stale pricing, particularly for international and fixed income ETFs which may contain securities which are not currently trading (e.g. local market is closed) or are not continuously traded, the IIV may not reflect a "transactable" data point.
b. However providing no information on the most updated available pricing of the underlying assets of an ETF would disadvantage investors, particularly less sophisticated retail investors, as they may not have access to the technology that would aid in calculating an accurate IIV. We recognize that sophisticated market participants may not be using the published IIV, and may be calculating their own real-time IIV. However, rather than omitting IIV publication, further explanation of potential limitations of the calculation would benefit market participants, particularly retail investors.
c. In addition, we believe there may be value in standardization of an IIV calculation methodology, to introduce consistency. In our separate recommendations regarding investor education and data, we recommend a consortium of market participants collaborates to develop industry standards for a number of data points, including IIV.

4. Disclosure of premiums/discounts (Question page 121): *Should we require that information regarding NAV per share, market price, and premiums and discounts be posted on an ETF's website each business day as proposed? Should we specify the time by which such information must be posted? For example, should we require that an ETF post the information on its website before the opening of trading each business day?*

    a. We support the idea of requiring information on NAV, market price, and range of premium/discount be readily available to investors. While posting on each ETF's website is helpful, a centralized database (potentially EDGAR) accessible free of charge would be ideal to access this valuable data.
    b. The Commission has discussed requiring disclosure of premiums/discounts using market close information be posted. We would suggest that if this information is posted it should be augmented by disclosures that warn when it may be potentially misleading, as we note in 3b above.

5. Questions page 132: *To further prevent investors from confusing ETFs with mutual funds, should the Rule require an ETF to include the identifier "ETF" in its name? To further prevent investors from confusing ETFs with mutual funds, should the Rule require an ETF to explicitly disclose in its sales literature that shareholders may pay more than NAV when buying shares and may receive less than NAV when selling ETF shares? Should the Commission consider proposing naming conventions based on these or other distinctions in a future rulemaking?*

    a. We have proposed a broad naming scheme which would further differentiate ETPs, including ETFs, which we believe would benefit market participants by easily distinguishing products. If an ETP provider was required to meet specific criteria to use the term ETF, we believe requiring "ETF" in its name would clearly identify it as such, and be the basis for establishing broad investor expectations. Other ETPs, with specific characteristics (e.g. leveraged ETPs) would similarly be identified by a specific name (e.g. ETP-L) to assist with investor differentiation. We do not support satisfying this naming convention using a generic "ETF" as a base (e.g. ETF-L, rather than ETP-L) as we believe ETF should be specifically reserved for products relying on the proposed Rule 6c-11, so as to establish investor expectations for "ETFs". These distinguishing "titles" added to an ETP's name, would serve to clearly differentiate ETPs not registered from those that are registered investment companies, and would facilitate intermediaries' communication thereof.

   b. Further, we believe adding language to sales literature explicitly disclosing the potential for investors to pay a premium/discount when purchasing/selling ETPs would be beneficial, and would not create undue burden to ETP companies.

6. Page 155: The Commission has proposed amendments to Item 3 of Form N-1A, which we believe are beneficial disclosures. We believe all of the elements shown in the example "Exchange-Traded Fund Trading Information and Related Costs" are valuable, and particularly believe the Q&A format is user-friendly and explicit. While the proposed content of the Q&A is relevant and helpful, we believe that in addition to the median annual bid-ask spread, we would like the Commission to consider adding the range of the spread (intraday max and min during the year) as additional data for investor consideration. This addition would help further inform investors of past trading behavior of a particular ETF.

We thank the Commission for providing the members of FIMSAC with the opportunity to comment on the Release, and we are eager to assist the Commission in any way we can to ensure that the Rule proposal will benefit ETF investors. Please contact the undersigned if you have any questions or comments regarding our views.

Sincerely,

Securities and Exchange Commission Fixed Income Market Structure Advisory Committee

cc:

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission

The Honorable Robert J. Jackson, Jr.
Commissioner
Securities and Exchange Commission

The Honorable Hester M. Peirce
Commissioner
Securities and Exchange Commission

The Honorable Elad L. Roisman
Commissioner
Securities and Exchange Commission

The Honorable Kara M. Stein
Commissioner
Securities and Exchange Commission

Dalia Blass
Director
Division of Investment Management, Securities and Exchange Commission