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June 13, 2023

Ms. Vanessa Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549-1091

*Re: Supplemental Information and Reopening of Comment Period for Amendments  
Regarding the Definition of “Exchange;” File No. S7-02-22*

Dear Ms. Countryman:

The Investment Company Institute<sup>1</sup> is writing to provide comments on the Securities and Exchange Commission’s (the “Commission” or SEC) supplemental information and reopening of the comment period for its proposal that would, among other things, amend Rule 3b-16 under the Securities Exchange Act of 1934 (“Exchange Act”), which defines certain terms used in the statutory definition of “exchange.”<sup>2</sup> The Reopening Release primarily focuses on how proposed amended Rule 3b-16 (“Proposed Rule 3b-16”) would apply to crypto asset securities and blockchain trading systems and provides associated supplementary economic analysis. The Reopening Release additionally provides supplemental commentary on Proposed Rule 3b-16’s application to order management systems, order execution systems, and order execution management systems (collectively referred to as OEMSs) and ETF portals. Because ICI

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<sup>1</sup> The [Investment Company Institute](https://www.ici.org) (ICI) is the leading association representing regulated investment funds. ICI’s mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of \$30.2 trillion in the United States, serving more than 100 million investors, and an additional \$8.6 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through [ICI Global](https://www.ici.org/global).

<sup>2</sup> *Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of “Exchange,”* Exchange Act Release No. 97309 (April 14, 2023), 88 Fed. Reg. 29448 (May 5, 2023), available at <https://www.govinfo.gov/content/pkg/FR-2023-05-05/pdf/2023-08544.pdf> (“Reopening Release”). See also *Amendments to Exchange Act Rule 3b-16 Regarding the Definition of “Exchange” and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities,* Exchange Act Release No. 94062 (Jan. 26, 2022), 87 Fed. Reg. 15496 (Mar. 18, 2022), available at <https://www.govinfo.gov/content/pkg/FR-2022-03-18/pdf/2022-01975.pdf> (“Original Proposal”).

members<sup>3</sup> utilize both OEMSs and ETF portals, this letter addresses the Commission's questions in the Reopening Release relating to OEMSs and ETF portals.

ICI agrees with the Commission's statements in the Reopening Release suggesting that OEMSs and ETF portals do not generally have the characteristics of an exchange and do not otherwise fall within the regulatory intent of Proposed Rule 3b-16. As stated in our comment letter filed in response to the Original Proposal, we do not believe the SEC intended OEMSs and ETF portals generally to meet the definition of "exchange," although Proposed Rule 3b-16's broad and ambiguous language created uncertainty regarding whether such systems could be deemed "exchanges."<sup>4</sup> While we support the Commission further revising Proposed Rule 3b-16 to incorporate the language it requests comment on in the Reopening Release, we additionally continue to believe that the market would benefit from the regulatory certainty provided by the Commission explicitly clarifying that OEMSs that perform specified functions, as described below, and ETF portals are not "exchanges."

Section 1 of our letter recommends that the SEC provide explicit clarification, by adopting clearer language in Proposed Rule 3b-16 and by including clarifying statements and guidance in any adopting release, that OEMSs with certain characteristics are not "exchanges" under any final Rule 3b-16. In Section 1, we first provide background information about how advisers currently use OEMSs. Second, we recommend that the SEC adopt many of the changes to Proposed Rule 3b-16 on which the SEC requests comment in the Reopening Release. Third, we recommend that the Commission provide certainty to market participants by providing a list of non-exclusive examples of functions that would not cause an OEMS to meet the definition of an

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<sup>3</sup> ICI members, which include US-registered investment companies ("registered funds"), such as mutual funds, ETFs, and money market funds in addition to other investment companies regulated under the Investment Company Act of 1940, as amended ("1940 Act"), as well as non-US regulated funds (together with registered funds, "regulated funds"), along with their advisers, are significant participants in the US and global securities markets across equities, fixed income, and other asset classes. "Non-US regulated funds" refer to funds that are organized or formed outside the United States and are substantively regulated to make them eligible for sale to retail investors, such as funds domiciled in the European Union and qualified under the UCITS Directive (EU Directive 2009/65/EC, as amended), Canadian investment funds subject to National Instrument 81-102, and investment funds subject to the Hong Kong Code on Unit Trusts and Mutual Funds. Because well-calibrated regulation is critical to promoting the integrity and quality of these markets for advisers, funds, and the millions of investors who use advisers and funds to achieve their most important personal financial goals, ICI is submitting this comment letter to provide clarity on how members utilize OEMSs and ETF portals and underscore why such systems should not be regulated as "exchanges."

<sup>4</sup> Letter from Sarah A. Bessin, Associate General Counsel, and Nhan Nguyen, Assistant General Counsel, ICI, to Vanessa A. Countryman, Secretary, SEC, on the Original Proposal at 2-3 (April 18, 2022), *available at* <https://www.sec.gov/comments/s7-02-22/s70222-20124231-280809.pdf> ("Prior Letter").

“exchange” under any final Rule 3b-16, similar to the list the SEC included in the 1998 Regulation ATS Adopting Release.<sup>5</sup>

Section 2 of our letter similarly recommends that the SEC explicitly clarify that ETF portals are not “exchanges” under any final Rule 3b-16. In Section 2, we first provide background on how ETF portals operate and the functions they help facilitate. Second, we explain why ETF portals are not, and should not be deemed, “exchanges” under any final Rule 3b-16. Finally, for the avoidance of doubt, we request that the Commission explicitly clarify that an ETF portal is not an “exchange.”

### **Section 1. SEC Should Explicitly Clarify that OEMSs with Certain Characteristics are Not “Exchanges”**

As we explained in our prior letter, ICI does not believe that the Commission intended for the “exchange” definition to apply to OEMSs used by investment advisers to manage portfolio investments of regulated funds and other clients.<sup>6</sup> Nevertheless, the broad scope of Proposed Rule 3b-16, particularly inclusion of the term “communication protocol,” could result in adverse outcomes for funds and advisers with respect to their use of OEMSs.<sup>7</sup> We are therefore supportive of many of the suggested changes to Proposed Rule 3b-16 that the Commission solicits for comment in the Reopening Release, which would address many of the ambiguities caused by the Original Proposal with respect to the use of OEMSs by funds and advisers.

#### **Section 1.1. Description of OEMS Functions Utilized by Advisers**

In the Reopening Release, the Commission requests comment on “what activities are performed today using OEMS technology and how the use of OEMS technology might change in the future.”<sup>8</sup> Investment advisers utilize OEMSs to carry out investment activities on behalf of funds and other clients. An OEMS, which can either be developed internally for proprietary use or provided by a third-party vendor, typically offers a range of customizable tools, functions, and

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<sup>5</sup> See *Regulation of Exchanges and Alternative Trading Systems*, Exchange Act Release No. 40760 (Dec. 8, 1998), 63 Fed. Reg. 70844, 70854-56 (Dec. 22, 1998), available at <https://www.govinfo.gov/content/pkg/FR-1998-12-22/pdf/98-33299.pdf> (“Regulation ATS Adopting Release”).

<sup>6</sup> See Prior Letter at 2-3. We believe that our view is supported by the Commission’s subsequent statement in the Reopening Release that “[t]he proposed amendments to Rule 3b-16 were not designed to capture within the definition of exchange the activities of brokers, dealers, and investment advisers who use an OEMS to carry out their functions (e.g., organizing and routing trading interest)[.]” Reopening Release, 88 Fed. Reg. at 29461 (Question 17).

<sup>7</sup> See Prior Letter at 10-13 (explaining how including OEMSs as “exchanges” under Proposed Rule 3b-16 would impose significant costs with no benefit, inhibit further innovation, would not promote competition among trading venues, and result in inconsistent and duplicative regulation).

<sup>8</sup> Reopening Release, 88 Fed. Reg. at 29461 (Question 17).

services that a single end-user (*e.g.*, an investment adviser) can customize to manage holdings across multiple asset classes and products based on its own needs.<sup>9</sup> An OEMS allows a user to perform a broad range of complex functions across the entire investment process, including investment data research and analysis, identification of liquidity in different marketplaces, monitoring of real-time market conditions, order instruction routing to different liquidity sources, and post-trade processing and execution analysis. OEMSs allow advisers to manage investments more efficiently, facilitate fund pricing, and reduce overall transaction costs and trading frictions, thereby facilitating the ability to attain best execution on behalf of funds and their investors. While a user could pursue each of these functions individually, an OEMS greatly increases investment and trading efficiency by allowing the user to perform these interrelated activities in an integrated and less costly manner.

While it is impossible to predict how OEMSs may evolve in the future, we focus in this letter on four key functions currently performed by OEMSs that should not cause them to meet the definition of “exchange” under Proposed Rule 3b-16 (collectively, the “Four Functions”):

1. Facilitate communication of trading interest by connecting a single-end user (*e.g.*, an investment adviser) to a liquidity source, such as an exchange, ATS, OTC or an exchange market-maker, futures or options market, broker, dealer, bank, or other trading venue (*i.e.*, providing a communications link and conveying trading instructions to a liquidity source via an OEMS).
2. Import and display data fields or information from connected liquidity sources, *e.g.*, facilitating submitting requests-for-quotes (RFQs) or receipt of indications of interest (IOIs), including from multiple single broker-dealers, based on the methods, rules, or protocols set forth by those liquidity sources.
3. Apply protocols that are established by the connected market participants (*e.g.*, the counterparties to which trading interest is visible, minimum sizes for transactions, time periods for responses, and counterparty credit limits).
4. Organize, present, or otherwise display trading interest (whether firm or non-firm) that is available at connected liquidity sources.

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<sup>9</sup> To the extent that the OEMS is provided by a third-party vendor to a single end-user (*e.g.*, an investment adviser), the third-party vendor does not impose non-discretionary protocols on how the end-user transacts. Routing protocols may be established by the end-user and execution protocols are generally developed by the liquidity sources to which the OEMS connects. When communicating trading interests to a customer via the OEMS, for example, the liquidity source has discretion regarding which customers can see and respond to such trading interest. The OEMS software does not aggregate and redistribute such trading interests to every entity utilizing the third-party OEMS.

## **Section 1.2. ICI Supports Many of the Commission’s Suggested Changes to Proposed Rule 3b-16**

We believe the Commission’s suggested changes in the Reopening Release would resolve many of the ambiguities raised by the Original Proposal with respect to OEMSs. In the Original Proposal, Proposed Rule 3b-16(a) would define as an “exchange” any organization, association, or group of persons that:

- (i) brings together buyers and sellers of securities using trading interest; and
- (ii) makes available established, non-discretionary methods (whether by providing a trading facility or communication protocols, or by setting rules) under which buyers and sellers can interact and agree to the terms of a trade.<sup>10</sup>

The Original Proposal’s use of new terms, such as “trading interest,” “communication protocols,” and “makes available,” and the deletion of well-known terms, such as “orders” and “multiple” buyers and sellers, resulted in significant market confusion as to what activities would cause a system to be deemed an “exchange” under Proposed Rule 3b-16. We believe that the SEC’s suggested revisions in the Reopening Release, primarily replacing the term “makes available” with “establishes” and replacing “communication protocols” with “negotiation protocols” and providing an accompanying definition, would resolve many of the ambiguities.

### **Section 1.2.1. The Commission Should Replace “Makes Available” with “Establishes”**

The SEC asks in the Reopening Release whether it should replace “makes available” in Proposed Rule 3b-16 with “establishes.”<sup>11</sup> We believe that it should.

Replacing “makes available” with “establishes” provides more clarity that OEMSs would not meet the definition of “exchange” under Proposed Rule 3b-16. While an OEMS provides connectivity to liquidity sources, it does not itself establish the protocols for trading on or through such venues—any such protocols typically are established by the particular liquidity source to which the OEMS connects. The OEMS does allow the user to submit RFQs or responses to IOIs, including, for example, IOIs from single-dealer systems, to the destination venue. However, such communications or interactions involve protocols supported by the connected venue according to its rules or methods. They are not “established” by the OEMS.

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<sup>10</sup> Original Proposal, 87 Fed. Reg. at 15646.

<sup>11</sup> Reopening Release, 88 Fed. Reg. at 29459 (Question 11).

### **Section 1.2.2. The Commission Should Replace “Communication Protocols” with “Negotiation Protocols” and Define the Term**

The SEC asks:

To reflect systems that provide non-discretionary methods under which buyers and sellers negotiate terms of a trade, should the Commission adopt amendments to Exchange Act Rule 3b-16(a)(2) that replace the proposed term “communication protocols” with the term “negotiation protocols” and adopt the following definition under a new Rule 3b-16(f): For purposes of this section, the term “negotiation protocols” means a nondiscretionary method that sets requirements or limitations designed for multiple buyers and sellers of securities using trading interest to interact and negotiate terms of a trade.<sup>12</sup>

We believe that the Commission should adopt these suggested amendments.

An OEMS neither creates a marketplace nor performs the functions of an exchange. The core functions of an OEMS, which include acting as a conduit to liquidity sources, providing users with the ability to view liquidity on those sources, and facilitating communication to those sources in accordance with each liquidity source’s methods, rules, or protocols, neither meet the criteria of an “exchange” nor represent the functions the SEC intends to regulate through Proposed Rule 3b-16. Importantly, the actual matching of the orders or agreement to trade occurs on or through those regulated venues, not on or through the OEMS.

As reflected in many of the comment letters on the Original Proposal, “communication protocols,” without an accompanying definition, is an overly broad and vague term. We agree with the SEC that revising Proposed Rule 3b-16 to instead include the term “negotiation protocols” and defining that term in Proposed Rule 3b-16 will “better focus the non-discretionary methods that the Commission intend[s] to capture[.]”<sup>13</sup> Defining a negotiation protocol as a “nondiscretionary method that *sets requirements or limitations* ... to negotiate terms” clarifies that an open-ended communication system would not meet the definition of an “exchange.” Only the system setting the requirements or limitations of any negotiated transactions would meet the definition, rather than the venue through which the communications occur, such as an OEMS. Further, referencing “multiple buyers and sellers” in the definition would provide greater market clarity that new systems included under Proposed Rule 3b-16 as “negotiation protocols” must allow for multiple buyers and multiple sellers to interact for any given trade. An OEMS that allows a single adviser to see IOIs of multiple single dealer systems, for example, would not be

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<sup>12</sup> *Id.* at 29460 (Question 13).

<sup>13</sup> *Id.* (Question 14).

an “exchange” under this definition because multiple buyers and multiple sellers are not able to interact with each other on any given trade.<sup>14</sup>

### **Section 1.3. The SEC Should Include Examples of Functions That Would Not Cause a System to be an “Exchange” Under Proposed Rule 3b-16**

The SEC asks whether:

As an alternative to adopting a definition of “negotiation protocols” in the rule text, should the Commission provide an explanation and examples of what negotiation protocols are and are not in any adopting release, similar to what the Commission did in the Regulation ATS Adopting Release when analyzing the application of Rule 3b-16 to hypothetical Systems A through T?<sup>15</sup>

As previously stated, we believe that the SEC should revise Proposed Rule 3b-16 to incorporate the changes on which it has requested comment. We also recommend, **as an addition and not as an alternative**, that the SEC include, in any adopting release, a list of non-exclusive examples of functions that would not cause a system to be deemed an “exchange,” similar to the approach the Commission took in the Regulation ATS Adopting Release. This list should not be limited to providing examples of systems that are not “negotiation protocols” but, more broadly, provide examples of systems that are not “exchanges” under Proposed Rule 3b-16. To provide certainty to advisers that use OEMSs to carry out investment activities on behalf of funds and other clients, such list should include as examples the Four Functions described in Section 1.1.<sup>16</sup>

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<sup>14</sup> Communication within such a system is always bilateral, thus there are not multiple buyers and multiple sellers seeking to engage in trades with each other. *See* Regulation ATS Adopting Release, 63 Fed. Reg. at 70849 (explaining that “a single counterparty that buys and sells securities through a system, where other parties entering orders only execute against the single designated counterparty, would not meet the requirements” of Rule 3b-16).

<sup>15</sup> Reopening Release, 88 Fed. Reg. at 29460-61 (Question 16).

<sup>16</sup> In our Prior Letter, we also noted that OEMSs may facilitate internal agency cross-trades of advisory clients or affiliates, consistent with the adviser’s fiduciary duty and applicable statutes (*e.g.*, the Investment Advisers Act of 1940 (“Advisers Act”) and the 1940 Act, rules (*e.g.*, Rule 17a-7 under the 1940 Act), and Commission and staff guidance and relief). Given statements by the SEC in the Regulation ATS Adopting Release that a system that internally “crossed or matched customer orders” would be excluded from Rule 3b-16’s definition of “exchange” because such systems merely “automate the management of customer orders that require [using] discretion” and “do not use non-discretionary methods,” we continue to believe that systems facilitating internal agency cross-trades of advisory clients or affiliates do not utilize non-discretionary methods and thus would not constitute an “exchange” under Rule 3b-16, currently or as proposed to be amended. Our view is consistent with existing SEC guidance and interpretations that neither the Original Proposal nor the Reopening Release directly impacted. *See* Regulation ATS Adopting Release, 63 Fed. Reg. at 70851.

## **Section 2. The Commission Should Explicitly Clarify That ETF Portals Are Not “Exchanges” Under Proposed Rule 3b-16**

In the Reopening Release, the SEC requests comment on how ETF portals operate, whether they fall within the definition of “exchange” under Rule 3b-16, currently or as proposed to be amended, and whether the SEC should adopt an exclusion for ETF portals from the definition of “exchange” in Proposed Rule 3b-16. Similar to our analysis of an OEMS, we believe that the Commission did not intend for an ETF portal to meet the definition of “exchange” under Proposed Rule 3b-16. ETF portals do not create a marketplace for secondary market trading activity and are used by ETF issuers and APs to facilitate specific, bilateral transactions—to create and redeem an ETF issuer’s securities. However, to provide certainty to market participants, we urge the Commission to explicitly confirm that an ETF portal would not be deemed to be an “exchange” within the meaning of Proposed Rule 3b-16. Below, we provide background information on how ETF portals operate and the functions they facilitate, analyze why ETF portals do not meet the definition of “exchange,” and, for the avoidance of doubt, support the Commission adopting an explicit exemption, as outlined below.

### **Section 2.1. Operation of ETF Portals**

In the Reopening Release, the Commission asks:

How do ETF Portals operate for the creation and redemption of securities? Who are the participants in ETF Portals and how do they interact? Are there any trading activities conducted as part of the creation and redemption process through an ETF Portal that are exchange activities or necessitate further clarification by the Commission as to whether such activities are exchange activities? Do an ETF Portal’s activities facilitate secondary market activity in the ETF? ... Does trading in ETF Portals involve multiple buyers and sellers of securities? ... What non-discretionary methods are generally used by ETF Portals?<sup>17</sup>

In response, we provide the following explanation as to how ETF portals operate and the functions they help facilitate.

ETF portals are the platforms through which “creation baskets” and “redemption baskets” (each defined below) are submitted by an authorized participant<sup>18</sup> (AP) in exchange for an ETF issuer’s

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<sup>17</sup> *Id.* at 29463 (Question 28).

<sup>18</sup> Rule 6c-11(a)(1) under the 1940 Act defines an “authorized participant” as “a member or participant of a clearing agency registered with the Commission, which has a written agreement with the exchange-traded fund or one of its service providers that allows the authorized participant to place orders for the purchase and redemption of creation units.”



shares. Prior to the creation of ETF portals, sending lists of constituent securities comprising baskets was accomplished via fax machines and emailing spreadsheets. As the ETF market has grown, ETF portals have emerged to facilitate, through electronic means, this necessary administrative function and make it more efficient. ETF portals may be proprietary and only include ETFs of one sponsor, or they may be developed and administered by a third-party and used by multiple different ETF sponsors. Whether an ETF portal is proprietary or provided by a third-party does not affect the fundamentals of how it functions; the primary difference is who is providing the technology and customer support.

“Creation baskets” are comprised of constituent securities and a cash balancing amount, if any, that an ETF issuer will accept from an AP in exchange for issuing to the AP a specified number of ETF shares. “Redemption baskets” are comprised of constituent securities and a cash balancing amount, if any, that the ETF issuer will provide to an AP in exchange for a specified number of ETF shares from the AP. The ETF publishes the constituent securities comprising the creation basket and redemption basket in the portal.<sup>19</sup> Except for custom baskets, creation baskets and redemption baskets are offered on a “take-it-or-leave-it” basis. For custom baskets, while negotiation regarding the constituent securities of a basket may occur, either through a chat function in or outside of the portal<sup>20</sup> or via telephone, no negotiation as to the terms of the trade, such as price, buy or sell side, or size, takes place.<sup>21</sup> Further, the ETF issuer is not required to accept any custom basket of securities offered by the AP. Such negotiations are often highly

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<sup>19</sup> The list of constituent securities is also published through other venues, primarily by ETF issuers sending a portfolio composition file containing basket contents each business day to the NSCC. *See* Letter from Susan Olson, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, on the Exchange-Traded Funds Proposing Release at 24 (Sept. 21, 2018), available at <https://www.sec.gov/comments/s7-15-18/s71518-4403410-175592.pdf>. Additionally, the ETF portal may provide an administrative function and automate the creation or redemption basket’s constituent securities and cash balancing amount, if any, in accordance with policies and directions given to it by the ETF issuer. This is more common for ETF issuers wanting a basket comprising a pro rata slice of the ETF’s holdings as opposed to custom baskets, which the ETF sponsor must negotiate.

<sup>20</sup> If custom basket constituent security negotiations do occur through the portal, the function offered by the portal allowing such conversations is very similar to an instant message chat function. Through the chat function, an AP can submit a proposed list of securities comprising the basket, which would be derived from a large list of securities provided by the ETF issuer as possible basket constituents prior to the ETF’s NAV being struck. The ETF issuer can accept or reject the AP’s proposed basket. If it is rejected, further negotiation occurs as to what securities will be included in the basket and then the AP will resubmit the revised basket for acceptance or rejection.

<sup>21</sup> Thus, even if constituent securities of a custom basket are being negotiated through the portal, such a system would not meet the SEC’s proposed definition of “negotiation protocols” as any chat function offered through the portal is not setting “requirements or limitations designed for multiple buyers and sellers of securities using trading interest to interact and negotiate terms of a trade.” As stated in Section 1.2.2, we support the SEC’s suggested revisions to Proposed Rule 3b-16, including replacing “communication protocols” with “negotiation protocols” and defining the term.

bespoke, and the ETF issuer always has the authority to accept or reject a proposed custom basket. Custom baskets are generally more common for fixed income ETFs.<sup>22</sup>

Additionally, the size of the “creation unit,” *i.e.*, the number of ETF shares issued to an AP in exchange for a creation basket or received from an AP for a redemption basket, is set by the ETF issuer as required by Rule 6c-11 under the 1940 Act<sup>23</sup> and is disclosed on Form N-CEN.<sup>24</sup> The established creation unit size with respect to a specific ETF is uniform for all transactions, among all APs, and is not negotiable. Further, the only securities the creation basket or redemption basket is offered in exchange for are the ETF’s shares (*i.e.*, the creation unit), and such ETF’s shares are always priced at NAV for the exchange, as required by Rule 22c-1 under the 1940 Act.<sup>25</sup> Thus, price is not negotiable either with respect to the creation basket, redemption basket, or the ETF’s shares constituting the creation unit. For this reason, ETF portals and the creation and redemptions occurring through them do not contribute to price discovery, as there is no open competition or negotiation occurring relating to price or size. Additionally, ETFs are required, subject to specified SEC guidance, to accept creation or redemption orders submitted by an AP in proper form and do not have discretion to prioritize

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<sup>22</sup> Fixed income index ETFs often track indexes composed of thousands of bonds. Because trading a pro rata slice of thousands of bonds is not practicable, fixed income index ETF issuers generally use a representative sample of the index to compose the ETF’s portfolio. For that reason, creation and redemption baskets need to be negotiated so that the bonds entering or leaving the ETF’s portfolio as part of the in-kind exchange are representative of the ETF’s strategy. The ETF issuer will generally provide a list of bonds that the ETF would be willing to accept on that trade day in exchange for shares of the ETF. An AP will provide a proposed subset of such securities for the in-kind exchange that may be accepted or denied, and if denied, the ETF issuer will require resubmission with different securities if the AP wishes to continue the create or redeem transaction. Once the basket is agreed to, that potential basket is sent to the portfolio manager for sign-off. The portfolio manager decides whether the basket is consistent with the ETF’s investment strategy and whether the ETF issuer should accept the basket.

<sup>23</sup> See Rule 6c-11(a)(1) under the 1940 Act (defining “creation unit” as “a specified number of exchange-traded fund shares that the exchange-traded fund will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount if any”). Accordingly, an ETF issuer must establish the creation unit size and such number of shares is usually set forth in both the ETF’s policies and procedures as well as the AP agreement entered into between the ETF issuer and the AP. While an ETF issuer may change its creation unit size, to do so, it must change its policies and procedures and potentially enter into a new AP agreement with each of its APs. An ETF’s creation unit size cannot be changed on a transaction-by-transaction basis, on an AP-by-AP basis, or otherwise negotiated. The established creation unit size with respect to a specific ETF is uniform for all transactions and APs.

<sup>24</sup> See Item E.3.a of Form N-CEN, available at <https://www.sec.gov/files/formn-cen.pdf>.

<sup>25</sup> See Rule 22c-1 under the 1940 Act (“No registered investment company issuing any redeemable security [such as an ETF] ... shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security[.]”).

orders.<sup>26</sup> The ETF also establishes when orders for creation or redemption requests must be submitted<sup>27</sup> and when the NAV of the ETF is calculated.<sup>28</sup> To the extent any of these order characteristics can be viewed as “non-discretionary” methods, they are established by the ETF, and not the ETF portal, in accordance with SEC rules and the ETF’s policies and procedures.<sup>29</sup>

No secondary market trading takes place in the portal. ETFs trade efficiently due to their arbitrage mechanism, which provides a profit incentive for APs to engage in creation or redemption transactions with the ETF if the market trading price of the ETF moves sufficiently higher or lower than the NAV of the ETF’s portfolio. ETF shares are listed on a public exchange and are bought and sold by APs and individual investors in the secondary market. The securities comprising the creation basket must be bought on the secondary market by the AP<sup>30</sup> or sourced

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<sup>26</sup> See Exchange-Traded Funds, Investment Company Act Release No. 33646 (Sept. 25, 2019), 84 Fed. Reg. 57162, 57177 (Oct. 24, 2019), available at <https://www.govinfo.gov/content/pkg/FR-2019-10-24/pdf/2019-21250.pdf> (“With respect to redemptions, an ETF may suspend the redemption of creation units only in accordance with section 22(e) of the Act[, which requires that no registered investment company shall suspend the right of redemption for more than seven days except for specified exceptions described in the statute or pursuant to SEC order.]”); *id.* at 57178 (“[W]e believe that an ETF generally may suspend the issuance of creation units only for a limited time and only due to extraordinary circumstances, such as when the markets on which the ETF’s portfolio holdings are traded are closed for a limited period of time.”). Under extraordinary circumstances, the SEC has permitted an ETF to suspend creations or redemptions. *See, e.g.,* VanEck Russia ETF and VanEck Russia Small-Cap ETF, Series of VanEck ETF Trust, and Van Eck Associates Corporation; Notice of Application and Temporary Order, Investment Company Act Release No. 34793 (Dec. 28, 2022) (permitting suspension of redemptions in certain ETFs focused on investing in Russian securities after Russia invaded Ukraine and it became illegal under United States law to transact in Russian securities).

<sup>27</sup> See Rule 6c-11(c)(3) under the 1940 Act (requiring that “[a]n exchange-traded fund must adopt and implement written policies and procedures that govern the construction of baskets and the process that will be used for the acceptance of baskets[.]”) As an example, most US equity ETFs require orders to be received before 4 p.m. ET on a day the NYSE is open for trading, while certain foreign and emerging market ETFs may require orders to be received on a T-1 basis. However, regardless of the cutoff time established by the ETF issuer for receipt of orders, orders must be received prior to NAV being struck, as NAV can only be calculated after orders are received. *See supra* note 25 (discussing Rule 22c-1).

<sup>28</sup> See Item 11(a)(2) of Form N-1A, available at <https://www.sec.gov/files/formn-1a.pdf> (requiring a prospectus to include a “statement as to when calculations of net asset value are made and that the price at which a purchase or redemption is effected is based on the next calculation of net asset value after the order is placed”). NAV is generally struck at 4 p.m. ET on days that the NYSE is open.

<sup>29</sup> Thus, the ETF portal is not the entity “establishing” any non-discretionary methods governing the submission by an AP of creation and redemption requests. As stated in Section 1.2.1, we support the SEC’s suggested revisions to Proposed Rule 3b-16, in particular changing “makes available” to “establishes.”

<sup>30</sup> Depending on restrictions on certain securities listed in a basket, an AP may request to submit or receive cash in lieu or request cash with execution instead of receiving a particular security. For example, an AP may not be allowed to purchase or sell certain securities, such as when an AP is a subsidiary of a bank and the AP generally cannot purchase or sell securities issued by the bank. To the extent such a security is part of the creation or redemption basket, the AP will generally post or receive cash and ask the ETF portal operator to facilitate the trade of the restricted security. However, the execution of the transaction occurs through a broker-dealer, not through the portal.

from the AP's inventory.<sup>31</sup> Only primary issuances and redemptions between the ETF issuer and APs occur through the ETF portal. No other entities may transact in the portals. APs enter into AP agreements with the ETF, or one of the ETF's service providers on behalf of the ETF, prior to engaging in creation and redemption transactions with the ETF. ETF portals do not perform functions generally associated with exchanges and are not open to other participants to transact.

## **Section 2.2. ETF Portals Are Not Exchanges Within the Meaning of Proposed Rule 3b-16**

The SEC asks whether "ETF Portals fall within the criteria of existing Exchange Act Rule 3b-16(a) or Rule 3b-16(a), as proposed to be amended?"<sup>32</sup> We do not believe that they do, based on prior statements made by the SEC.

ETF portals provide a platform whereby ETF issuers can issue their securities to, and redeem from, APs in a primarily in-kind exchange for securities obtained by the AP outside of the ETF portal. Other than this in-kind exchange mechanism, ETF portals are analogous to any platform whereby an issuer sells its own securities to investors. Further, while multiple APs may be looking to buy and/or redeem an ETF issuer's securities in the portal, the only counterparty to such transactions is the ETF issuer.<sup>33</sup>

Rule 3b-16 currently only applies to a system that "[b]rings together the orders for securities of **multiple buyers and sellers**[".] As explained by the SEC in 1998:

[A] system must bring together orders of multiple buyers and multiple sellers. [This clarifies] that systems in which there is only a single seller, such as systems that permit issuers to sell their own securities to investors, would not be included within Rule 3b-16. While such systems have multiple buyers (*i.e.*, investors), they have only one seller for each security (*i.e.*, issuers) and, therefore, do not meet the multiple buyers and sellers test. ... In addition, systems designed for the purpose of executing orders against a single counterparty ... would not be considered to

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The ETF portal operator will either make the trade, if a broker-dealer, or send the order out to be executed through its broker-dealer. This trade is not made through the portal and is only done to comply with regulatory requirements. The ETF receives the basket of securities and generally does not know that an "accommodation" trade has occurred.

<sup>31</sup> APs may have securities necessary for a creation basket in their inventory and do not necessarily need to go out and actively buy securities. Regardless, if the AP does have securities necessary for a creation basket in their inventory, such securities would have previously been purchased by the AP and are not purchased or otherwise obtained through the ETF portal.

<sup>32</sup> Reopening Release, 88 Fed. Reg. at 29463 (Question 29).

<sup>33</sup> From this perspective, ETFs on an ETF portal operate very similar to a single-dealer system, which are explicitly exempt from Rule 3b-16 and Proposed Rule 3b-16, except for the fact that ETF issuers are transacting primarily in-kind and only for shares that they issue. *See infra* note 34 and accompanying text (quoting the text from the Regulation ATS Adopting Release discussing single-dealer systems being excluded under Rule 3b-16).

have multiple buyers and sellers. Thus a single counterparty that buys and sells securities through a system, where other parties entering orders only execute against the single designated counterparty, would not meet the requirements of the first part of Rule 3b-16.<sup>34</sup>

While Proposed Rule 3b-16 would remove the word “multiple,” the SEC proposes to codify the above quoted issuer exclusion guidance at Proposed Rule 3b-16(b)(3) and maintain the existing above quoted single-dealer exclusion guidance currently codified at Rule 3b-16(b)(2).<sup>35</sup> The SEC specifically stated in the Original Proposal that Proposed Rule 3b-16 is “not intended to change the existing scope of Rule 3b-16(a) but only to clarify its application.”<sup>36</sup> Because ETF portals are merely platforms through which ETF issuers issue and redeem their own securities and each ETF issuer must be the counterparty to any issuance or redemption of its shares, we do not believe ETF portals would meet the definition of “exchange” under Rule 3b-16, either currently or as proposed to be amended.<sup>37</sup>

### **Section 2.3. The SEC Should Provide an Explicit Exclusion for ETF Portals**

The SEC requests comment on whether it should provide “an exclusion that applies only to ETF Portals that fall within this definition: ‘a system that allows one or more issuers from the same sponsoring entity to solicit creation or redemption requests for their own securities submitted by

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<sup>34</sup> Regulation ATS Adopting Release, 63 Fed. Reg. at 70849.

<sup>35</sup> Proposed Rule 3b-16(b)(3) would specifically exclude from the definition of “exchange” any system that “[a]llows an issuer to sell its securities to investors.” Original Proposal, 87 Fed. Reg. at 15646. While we support the exemption, the SEC should change the exemption to reflect that an issuer may “sell or buy” as opposed to just “sell,” as many funds use systems to buy and sell their securities from and to investors as required by law. While the Regulation ATS Adopting Release made this explicit with the use of the word “multiple,” “multiple” is no longer part of Proposed Rule 3b-16(a)(1). To provide greater certainty to the market, the Commission should revise the language of Proposed Rule 3b-16(b)(3) to reference both selling and buying by issuers.

<sup>36</sup> Original Proposal, 87 Fed. Reg. at 15505.

<sup>37</sup> In addition to not meeting the definition of “exchange,” ETF portals do not perform exchange functions. As described in Section 2.1, ETF portals do not allow for secondary market trading nor are they available to a broad range of market participants. Transactions within the portal are limited to primary market offerings and redemptions between an AP and an ETF issuer for the ETF issuer’s securities. Additionally, price and size are not negotiable as creation unit size is set by the ETF issuer, must be standardized across all transactions with all APs with respect to a specific ETF, and ETF shares must always be issued at NAV. The only element potentially negotiated through the ETF portal is the security constituents of a custom creation or redemption basket, and such negotiation is highly bespoke, discretionary, and not generally considered part of any traditional understanding of “terms of a trade” as used in Proposed Rule 3b-16. Further, ETF portals do not contribute to price discovery as there is no competition for orders in the portals. So long as an order is submitted in proper form, ETF issuers must, subject to SEC guidance, accept creation or redemption requests. The timing of when orders must be submitted by the AP for the basket exchange and when NAV is struck is set in accordance with the ETF’s policies and procedures and is not a negotiated term. Finally, to the extent anything is deemed a “non-discretionary” method in the ETF portal, the ETF issuer, and not the administrator of the ETF portal, is the entity “establishing” those methods.

authorized participants for those securities[.]”<sup>38</sup> While ETF portals do not meet the definition of “exchange” under Proposed Rule 3b-16 for the reasons above, given the importance of ETF portals to the efficient management of the ETF arbitrage process, the Commission should, for the avoidance of doubt, provide an explicit exclusion from Proposed Rule 3b-16 for ETF portals or explicitly clarify in any adopting release that an ETF portal would not be deemed an “exchange” within the meaning of any amended Rule 3b-16.

We generally agree with the SEC’s proposed definition of “ETF Portals,” subject to the following recommendations. First, the Commission should use the term “issuer portals” rather than “ETF Portals.” This change would recognize that there are exchange-traded products (ETPs) that are registered solely under the Securities Act of 1933, and not registered as investment companies under the 1940 Act. These ETPs, like ETFs, engage in creation and redemption transactions through portals that operate in substantially the same manner as ETF portals and should be treated analogously for purposes of Rule 3b-16. Further, using the term “issuer portals,” rather than “ETF Portals,” also would provide more flexibility in the future in the event portals develop to facilitate in-kind transactions between mutual funds and large investors. Second, we recommend that the SEC delete from the proposed definition the phrase “from the same sponsoring entity” because, as discussed in Section 2.1, many ETF portals are operated by third-parties and permit participation by ETFs from multiple sponsors.<sup>39</sup> Revising the proposed definition in this manner would avoid any uncertainty about the use of third-party ETF portals, which are very common.

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<sup>38</sup> Reopening Release, 88 Fed. Reg. at 29463 (Question 29).

<sup>39</sup> As mentioned in Section 2.1, multiple ETFs from multiple sponsors on a third-party ETF portal does not allow for multiple-to-multiple trading. An ETF issuer cannot transact with other ETF issuers or issue or redeem other ETF issuers’ shares. Each ETF issuer redeems or issues only its own shares and may engage in issuances and redemptions only with APs with which it has entered into AP agreements.

Ms. Vanessa Countryman

June 13, 2023

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## Conclusion

We hope that our comments are helpful to the Commission and staff as they further refine their approach to crafting a regulatory framework that encourages growth and innovation while being appropriately tailored to promote transparency, investor protection, and resiliency. If you have any questions or require further information regarding our comments, please do not hesitate to contact either Sarah Bessin at [REDACTED] or Kevin Ercoline at [REDACTED].

Sincerely,

/s/ Sarah A. Bessin

Sarah A. Bessin  
Deputy General Counsel

/s/ Kevin Ercoline

Kevin Ercoline  
Assistant General Counsel

cc: The Honorable Gary Gensler  
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