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United States Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Attn: Nancy M. Morris, Secretary

**Re: Exchange-Traded Funds: Proposed Rule: File No. S7-07-08.**

Ladies and Gentlemen:

We are pleased to submit this letter in response to a request for comment by the Securities and Exchange Commission ("Commission") in proposing several new rules[1] under the Investment Company Act of 1940 ("Act") that would relate to certain exchange-traded funds ("ETFs").[2] We commend the Commission for proposing the New Rules and believe that their adoption would spur more competition and increased innovation in this product class by eliminating the costly and time consuming regulatory process now experienced by most new ETFs. We appreciate the opportunity to comment on the New Rules and note that terms used in this letter which are not specifically defined herein are as defined in the Proposing Release. For ease of reference, our comments appear in the same sequence as the questions contained in the Proposing Release.

## A. Scope of Proposed Rule 6c-11

### *1. Index-Based ETFs*

[1] Proposing Release Nos. 33-8901; IC-28193 (March 11, 2008) ("Proposing Release").

[2] The Commission is proposing for public comment new rules 6c-11 and 12d1-4, as well as amendments to rule 12d1-2, under the Act and amendments to Form N-1A under the Act and the Securities Act of 1933 ("Securities Act") (collectively, "New Rules").

As discussed in the Proposing Release, the establishment and operation of all ETFs thus far has been predicated upon application for, and receipt of, individual exemptive relief, whether granted directly by the Commission or via delegated authority through its Division of Investment Management ("Division"). We believe that commencing with the SPDR Trust launch in January 1993,[3] the Commission has had ample experience with the structure and operation of index-based ETFs and has become familiar with the regulatory issues raised by these products.[4] In codifying this relief, the Commission would make it much more efficient for new ETFs to commence operation by eliminating the need to obtain individual exemptive orders in most circumstances. Therefore, we strongly support the Commission's decision to codify existing ETF exemptive relief by adopting Proposed Rule 6c-11 and agree that such determination meets the statutory requirements of Section 6(c) of the Investment Company Act of 1940 that it is

> ...necessary or appropriate in the public interest and consistent with the protection of investors and purposes fairly intended by the policies and provisions of [the Act][5]... ("Section 6(c) Standards").

*2. <u>Transparent Actively Managed ETFs</u>*

We have no specific recommendations, nor have we identified any particular concerns, with respect to the inclusion of Transparent Actively Managed ETFs ("TAMEs") in the scope of Proposed Rule 6c-11, in part because of the paucity of their actual operating history. We note that there are approximately the same number of UIT ETF exemptive orders as there are TAME[6] exemptive orders and the Commission has had fifteen years to observe the operations of UIT ETFs but only a few months in the case of TAMEs. We expect that TAMEs should operate in a manner similar to index-based ETFs because TAMEs will be required to completely disclose the components of their investment portfolios.

The Commission should analyze all existing ETF structures in a similar manner when determining whether they will be subject to the Proposed Rule 6c-11. For example, the Proposing Release makes no mention of any operational or regulatory issue

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[3] The SPDR Trust, organized as a unit investment trust ("UIT"), was the first ETF to receive relief from various provisions of the Act, *see,* <u>In the Matter of SPDR Trust, Series 1</u>, Investment Company Release No. 18959 (September 17, 1992) (notice) and Investment Company Release No. 19055 (October 26, 1992) (order) (collectively "SPDR Trust Order").

[4] The Division has reviewed separate ETF applications relating to 61 exemptive orders since 1992. *See* Proposing Release at 8.

[5] 15 U.S.C §80a-6(c).

[6] The Proposing Release in note 20 identifies the four (4) TAMEs that had been granted exemptive relief as of the date of publication of the Proposing Release.

experienced either by TAMEs over their brief history[7] or by UIT ETFs over their extensive history yet, Proposed Rule 6c-11 as currently drafted would cover the former but exclude the latter. Arguably, regulatory efficiency dictates that the Proposed Rule should cover TAMEs because the Division has received recent applications for such ETF structures[8] and can be expected to receive more in the future. This may be a reasonable assumption since no one can predict the future development of ETFs. Nevertheless, we think it unlikely that the Division will be deluged with TAME applications given that many active fund managers do not wish to disclose their specific portfolio investments any more frequently than they are required to do under the current regulatory scheme. We therefore suggest that the Commission give further consideration to whether Proposed Rule 6c-11 should cover TAMEs, or whether a continuation of the individual exemptive order process is warranted for any ETF structure other than an index-based ETF.

If the Commission decides to include TAMEs in the scope of Proposed Rule 6c-11, we support their determination that full, daily portfolio transparency should facilitate an arbitrage mechanism comparable to that now experienced by existing index-based ETFs, with similar efficiencies. We therefore strongly oppose extending the scope of Rule 6c-11 to cover actively managed ETFs providing other than fully transparent portfolio disclosure. We contend that each non-transparent ETF should be required to submit an individual exemptive application to the Commission for a grant of relief. Such applications would specify how, and to what extent, the arbitrage mechanism would function in each individual case. The Proposing Release makes clear that the Commission will continue to review applications and grant appropriate relief for actively managed ETFs that cannot meet all of the requirements of the Proposed Rule.[9]

*3. Unit Investment Trusts.*

We take strong exception to the text of Proposed Rule 6c-11(e)(4) which, as drafted, applies only to ETFs organized as open-end investment management companies ("Fund ETFs"). We believe that the scope of the Proposed Rule is unnecessarily narrow in its exclusion of ETFs organized as UITs ("UIT ETFs").[10] No useful purpose would be

[7] In the case of TAMEs, there was no operational history to discuss. Currently there are eleven (11) TAMEs portfolio that have listed and commenced trading their shares since the publication of the Proposing Release: the Bear Stearns Current Yield Fund which listed and commenced trading on the American Stock Exchange on March 25, 2008, as well as four (4) PowerShares Actively-Managed ETFs and six (6) WisdomTree Actively-Managed ETFs which listed and commenced trading on NYSE Arca on April 11, 2008 and May 20, 2008, respectively.

[8] *See* footnote 6, *supra.*

[9] *See* Proposing Release at 21.

[10] *See*, Proposing Release at 22. We note that existing UIT ETFs have submitted subsequent applications for additional relief, *see* for example, SPDR Trust Series 1 et al., First Amended and Restated Application for relief from Section 12(d)(1) of the Act submitted to the Commission on March 17, 2004 and the resulting order. *See* footnote 15, *infra*.

served by preventing UIT ETFs from relying upon the Proposed Rule. We recognize that the vast majority of ETFs are organized as Fund ETFs and that the Commission has not received an exemptive application from a UIT ETF applicant since 2002.[11] Nevertheless, we are unaware that the Commission has observed any operational or regulatory issue experienced by UIT ETFs since their introduction in 1993 that would warrant their exclusion from the Proposed Rule; indeed, the Proposing Release makes no mention of any such problems.

Undoubtedly, innovation in the structure and end-use applications of ETFs will continue to evolve, hence the need for Proposed Rule 6c-11. No one, however, can predict the type and form of new products that may be desired by ETF users and investors. A new ETF might elect to be structured as a UIT to meet a particular set of goals or requirements not currently envisioned. Therefore, we strongly urge the Commission to permit UIT ETFs to rely upon Proposed Rule 6c-11 rather than requiring them to continue to submit individual applications to the Division for the very same exemptive relief provided to Fund ETFs under Proposed Rule 6c-11. We believe that this disparate treatment would result in an unwarranted and an unnecessary expenditure of the Division's resources as well the UIT ETF sponsors' and investors' time and money.

Further, we contend that Proposed Rule 6c-11 as drafted does not meet the Section 6(c) Standards;[12] rather it would have the unintended consequence of favoring Fund ETFs' investors over UIT ETF investors for no discernable reason. A Fund ETF upon reliance on Proposed Rule 6c-11 could implement changes to its current funds, as well as offer new series, not contemplated or discussed in its original exemptive application and order. In contrast, a UIT ETF desiring to make the same changes or introduce similar new series would be required to submit to the Division an application for a new order or an amendment to its existing order.[13] Given that the Commission has not identified any regulatory purpose for excluding UIT ETFs from the scope of Proposed Rule 6c-11, we believe it would needlessly force UIT ETFs either to forgo useful innovations that their Fund ETF counterparts could adopt immediately or incur the legal costs and time delays associated with obtaining the requisite exemptive relief. This

[11] *Ibid*. There are five UIT ETFs that have been granted exemptive relief. *See:* SPDR Trust Order; In the Matter of MidCap SPDR Trust, Series 1, ("MidCap Trust") Investment Company Act Release Nos. 20797 (January 3, 1995) (notice) and 20844 (January 18, 1995) (order); In the Matter of Diamonds Trust, et al. ("DIAMONDS Trust"), Investment Company Act Release Nos. 22927 (December 5, 1997) (notice) and 22979 (December 30, 1997) (order); In the Matter of the Nasdaq-100 Trust, et al., Investment Company Act Release Nos. 23668 (January 27, 1999) (notice) and 23702 (February 22, 1999) (order); and In the Matter of BLDRS Index Funds Trust, et al., Investment Company Act Release Nos. 25772 (October 17, 2002) (notice) and 25797 (November 8, 2002) (order).

[12] *See* footnote 5, *supra.*

[13] It is not clear that the Commission would continue to entertain applications for exemptive relief submitted by ETFs structured as a UIT. The Proposing Release is silent as to this issue, but *see* footnotes 10, *supra* and 15, *infra*, and accompanying text.

result would be antithetical to the letter and spirit of the Section 6(c) Standards which must be met if Proposed Rule 6c-11 is to be adopted.

We recognize that certain provisions of Proposed Rule 6c-11 as currently drafted may need to be revised or "tweaked" to the extent that UIT ETFs, due to their unmanaged structure,[14] may require additional or different conditions then those relating to Fund ETFs.[15] The Commission, in analyzing the legal, market, economic and policy implications of the first ETF structure as presented by the SPDR Trust, was thoroughly familiar with its UIT structure. The MidCap Trust, also structured as a UIT, received exemptive relief and commenced exchange trading before the advent of Fund ETFs.[16] We believe that the Commission has amassed sufficient experience through the exemptive process and has established precedents necessary to codify any provisions that are peculiar to the UIT ETF structure. We are confident that the exemptive applications and the resulting orders granting relief to UIT ETFs should provide all necessary guidance and conditions for codification. In conclusion, we strongly urge the Commission that Proposed Rule 6c-11 be redrafted to permit UIT ETFs to rely upon its provisions.

## B. Comments with Respect to Selected Portions of Proposed Rule 6c-11

### *1. Specified minimum size for Creation Units*

Proposed Rule 6c-11 does not specify a minimum number of shares or dollar cost for each creation unit, and the Proposing Release asks if there should be stated minimum or maximum numerical thresholds. We observe that the composition of a creation unit is largely driven by:

(a) the number and cost of the component securities in an ETF's underlying index;

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[14] An example of these differences can be readily observed by comparing the conditions contained in 12(d)(1) relief granted to ETFs structured as UITs to those in 12(d)(1) orders received by Fund ETFs. Taking into account that UITs have no directors or trustees, the Commission modified the conditions imposed on Fund ETFs receiving 12(d)(1) orders in granting the same relief to UITs.

[15] For example, the conditions contained in the 12(d)(1) orders for both types of ETFs are very similar and accomplish the same goals, but the language is tailored to reflect the differences between the UIT and Fund structures. Compare, for example, conditions 2-3, 4 and 5 in The Matter of SPDR Trust et al., Investment Company Act Release Nos. 26392 (March 23, 2004) (notice) and 26419 (April 19, 2004) (order) with conditions 2-3, 6 and 9 in iShares Trust, et al., Investment Company Act Release Nos. 25969 (Mar. 21, 2003) (notice) and 26006 (April 15, 2003) (order).

[16] The first international equity ETFs were launched in 1996 and were structured as Fund ETFs. *See,* In the Matter of The Foreign Fund, Inc., et al, Investment Company Act Release Nos. 21737 (Feb. 6, 1996) (notice) and 21803 (March 6, 1996) (order) and In the Matter of CountryBaskets Index Fund, Inc., et al, Investment Company Act Release Nos. 21736 (Feb. 6, 1996) (notice) and 21802 (March 5, 1996) (order).

(b) the portfolio management technique(s) employed by the ETF; and

(c) the desired trading price for its individual shares.

For example, an ETF using a portfolio replication technique to track a broad-based "large cap" index comprised of hundreds of securities components and desiring a $10 per share trading price will specify a larger and more costly basket of assets and a greater number of individual shares for its creation unit than will an ETF using portfolio sampling or optimization techniques to track a narrow-based index with a relatively small number of securities components and desiring a $100 per share trading price. Given these variables, we concur with the Commission that Proposed Rule 6c-11 should not specify numerical thresholds, and we agree that the standard should be as articulated in the Proposing Release:

> The creation unit must be reasonably designed to facilitate the purchase (or redemption) of shares from the [ETF] with an offsetting sale (or purchase) of shares on a national securities exchange at as nearly the same time as practicable for the purpose of taking advantage of a difference in the current value of basket assets on a per share basis and the current market price of the shares.[17]

Not all ETFs accept specific securities as basket assets or redeem in-kind but rather use cash in connection with all creation and redemption transactions.[18] As the size and cost of a creation unit for such an ETF is not tied to the number and cost of the component securities of its underlying index, its creation units theoretically could be much smaller and cheaper than has been the case to date.[19] This result also could occur in connection with creation units of TAMEs, which similarly will not be tied to the components of an underlying index and may be comprised of a comparatively small number of portfolio securities.

The Commission should continue to take the position that it has in past ETF orders and require that a creation unit should be sufficiently large and costly enough to

[17] Proposing Release at 137.

[18] *See,* for example, In the Matter of ProShares Trust et al., Investment Company Act Release Nos. 27323 (May 18, 2003) (notice) and 27394 (June 13, 2006) (order) and In the Matter of Rydex ETF Trust, Investment Company Act Release Nos. 27703 (February 20, 2007) (notice) and 27754 (March 20, 2007) (order).

[19] Currently, Creation Units for ProShares are comprised of 75,000 individual shares and Creation Units for Rydex are comprised of 50,000 individual shares. *See* ProShares Trust, Statement of Additional Information dated October 1, 2007 at 46 and Rydex ETF Trust, Statement of Additional Information dated November 1, 2007 at 35.

preclude a retail investor from dealing directly with the ETF.[20] The Commission has recognized that there are meaningful differences between authorized participants and retail investors. In this context, for example, authorized participants deal with an ETF directly and create/redeem creation units in exchange for an in-kind basket of securities valued once daily at NAV. In contrast, retail investors are not permitted to deal directly with the ETF but buy and sell individual ETF shares intraday in the secondary market at current prices. The arbitrage mechanism at the heart of the ETF structure was designed to reduce the price difference in acquisition/disposition of ETF shares experienced by these two groups. This mechanism eliminates large trading premiums or discounts, so that the retail investor will receive a current market price not far different than actual NAV. The Commission wanted to ensure that the secondary market activity would be much larger than that of creation and redemption transactions by authorized participants, and it desired that all similarly situated market participants were to be treated equally. Thus, the Commission determined that creation units should be costly enough to prevent retail investors from acquiring shares in creation unit size at NAV from the ETF itself, rather than buying and selling individual shares in the secondary market. Indeed, early ETF applications included forecasts about the estimated size of the secondary market activity compared to that of the primary market.[21] Although this discussion is no longer required, present day ETF applications continue to explain that "substantial dollar amounts required to reconstitute a Creation Unit (over a $1,000,000 for each of the Funds) represent a formidable barrier for most investors." [22]

If the Commission is convinced that it is necessary to utilize a numerical and/or dollar value threshold in Proposed Rule 6c-11, it could be revised to include such a requirement, so long as it was indexed for inflation or was otherwise subject to automatic increase in some manner. Nevertheless, we believe that tying the creation unit size to the arbitrage function, as discussed in the next section of this letter, is reasonable and sufficiently clear to meet the Section 6(c) Standards.

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[20] See the discussion in Amendment No. 2 to the Application for relief by MidCap SPDR Trust et al. dated January 18, 1995 at 99-100, which projected that "the level of secondary market trading in MidCap SPDRs [would] outweigh greatly the primary market activity of creating MidCap SPDRs in Creation Unit size aggregations". This was based upon the applicants' belief that retail investors buying individual MidCap SPDRs for $100 or less "typically will not be capable of or interested in creating MidCap SPDRs in Creation Unit size aggregations...worth approximately $900,000."

[21] *Ibid*.

[22] *See* Second Amended and Restated Application of the NETS Trust ("NETS Trust") dated February 29, 2008 ("NETS Trust Application") at 69 and In the Matter of NETS Trust, et al, Investment Company Act Release Nos. 28166; February 25, 2008 (notice) and 28195, (March 17, 2008) (collectively, "NETS Order").

*2. Liquidity Requirements*

The Proposing Release requests comment as to whether specific liquidity requirements should be contained in Proposed Rule 6c-11.[23] We do not believe that specific liquidity standards should be required for ETFs to rely upon the Proposed Rule. Neither Fund ETFs nor UIT ETFs hold in excess of 15% of their net assets in illiquid securities. This result is not due to limitations contained in the exemptive relief granted but rather by virtue of existing Commission liquidity guidelines.[24] Given that all ETFs are subject to the same guidelines, we do not believe that new ETFs relying upon Proposed Rule 6c-11 should be subject to any new or different liquidity restrictions than those of the ETFs now operating. We also note, as a practical matter, additional liquidity restrictions would be unnecessary. Since robust liquidity is of paramount interest to all ETFs, an illiquid portfolio would not provide the requisite arbitrage opportunities, placing an ETF holding such a portfolio at a distinct competitive disadvantage.

*3. Definition of Arbitrage*

The Proposing Release also requests comment as to whether a description of arbitrage should be contained in the definition of a creation unit. We do not believe that it should. As described in ETF exemption order applications and many publications, journals, websites and seminars as well as in the Commission's Actively Managed Exchange-Traded Funds, Investment Company Act Release No. 25258 (Nov. 8, 2001) ("2001 Concept Release") and the Proposing Release, the arbitrage mechanism is fundamental to the operation of all ETFs. The arbitrage mechanism results from a number of different transactions executed by a variety of market participants with differing motivations. For example, certain arbitragers may acquire an ETF's underlying basket of securities in the secondary market and tender them to the ETF for an in-kind exchange of its shares, or it may do the reverse, depending upon the current market conditions. Other market participants may enter into transactions to hedge their ETF positions or to acquire ETF shares using underlying securities held in inventory. Authorized participants may execute agency transactions on behalf of clients who provide the appropriate basket securities in exchange for a creation unit of ETF shares. Specialists and market makers, in response to supply and demand for ETF shares in the secondary market, also acquire or sell ETF shares, and may profit in connection with the transactions. This variety of transactions makes the drafting of a simple, all-encompassing definition of "arbitrage" extremely difficult. In addition, the term

[23] *See* Proposing Release at 14.

[24] *See* Proposing Release at note 34 citing "Statement Regarding 'Restricted Securities'", Investment Company Act Release No. 5847 (Oct. 21, 1969); and Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992).

arbitrage enjoys a simple and widely understood common definition.[25] Proposed Rule 6c-11 providing that an ETF must establish "creation unit sizes the number of which is reasonably designed to facilitate arbitrage"[26] should suffice for this purpose.

*4. Transparency of Portfolio Holdings*

As a general matter, we support the Commission's decision to permit an ETF the option to disclose either the identities and weightings of its portfolio securities (Proposed Rule 6c-11(e)(v)(A)) or the identities and weightings of the portfolio securities of its stated underlying index (Proposed Rule 6c-11(e)(v)(B)). We note, however, that there may be practical difficulties encountered in following the Proposed Rule's provisions, as drafted. Index providers are not required to publish the identities and weightings of their index components on their websites, and they may not agree to do so, at least not without charge. In addition, all existing index-based ETFs have entered into license agreements with their index providers, which likely do not contain such provisions. Further, existing license agreements may prohibit disclosure of some or all of the index components except under certain circumstances, or may contain other provisions designed to protect the intellectual property subject to the license grant. Index-based ETFs with existing licenses falling into one or more of these categories would be required to re-negotiate their existing agreements which could result in higher licensing fees charged to the ETFs and ultimately paid by their investors. Therefore, the Commission may wish to revise the current text of Proposed Rule 6c-11(e)(v) so that the definition of an "exchange-traded fund" does not include conditions that must be fulfilled by third party index providers who are not governed by the Proposed Rule.

*5. Listing on a National Securities Exchange*

We strongly agree with the Commission's proposal that ETF shares must be listed on a national securities exchange. We believe that the exchange listing of ETF shares greatly benefits individual investors. Among other things, listing has reliably provided an organized and continuous trading market for ETF shares at current, negotiated prices. Both the individual and "generic" ETF listing rules reviewed by the Commission and adopted by the exchanges require the implementation of surveillance procedures. Such rules also impose various conditions and requirements relating to initial and continuous listings of ETFs. In addition, the ETF arbitrage mechanism, so central to the ETF structure and operation, is greatly enhanced by the transparent and timely dissemination of trading information, functions of the specialists and market makers and the oversight of the listing exchange. This experience has been replicated around the globe, as several

[25] Webster's Dictionary defines arbitrage as "simultaneous purchase and sale of the same or equivalent security in order to profit from price discrepancies."

[26] Proposing Release at 37.

US ETFs have been cross-listed on international exchanges[27] and many exchange-traded fund products established under local law have been listed on international exchanges.[28] We believe that these features are necessary to protect the interests of individual investors as well as the integrity of the trading markets as a whole and therefore endorse the Commission's proposal requiring ETF shares to be listed on a national securities exchange.

*6. Dissemination of Intraday Value*

We support the Commission's proposal to require dissemination of Intraday Value[29] at "regular intervals." We do not believe that the Proposed Rule need require dissemination of IIV through a national securities exchange, provided, however that the IIV for any ETF must be widely disseminated by one or more major market data vendors at regular stated intervals during the entirety of the trading day. This standard recently has been approved by the Commission,[30] and it should suffice to enable those market participants wishing to know the IIV to receive such information in a reliable manner.

*7. Marketing*

We support the conditions in Proposed Rule 6c-11 which codify the provisions in existing ETF exemption orders designed to prevent confusion between ETFs and traditional mutual funds. The conditions prohibiting ETFs from advertising or marketing as traditional mutual funds or open-end funds and requiring a clear explanation that ETF shares are not individually redeemable are useful and succeed in their desired result.

*8. Affiliated Index Providers*

We concur with the Commission's proposal not to include in Proposed Rule 6c-11 the specific conditions from exemptive applications relating to affiliated index providers. We also agree with the Commission's belief that the requirements under current federal securities laws as well as exchange rules are sufficient to protect against the misuse of non-public information. ETFs and their advisers should be aware of the facts and circumstances that could result in a potential misuse of non-public information with

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[27] *See*, for example, SPDRs issued by the SPDR Trust, which are listed on the AMEX and are cross-listed on the Singapore stock exchange, and DIAMONDS issued by the DIAMONDS Trust, which are also listed on the AMEX and are cross-listed on the Singapore and Euronext NV stock exchanges.

[28] "By the close of 2007, there were 423 European ETFs as compared to 601 US ETFs." P. Amery, European ETF Market: An Outline, April 1, 2008 at http://www.indexuniverse.com/sections/features/12/3904-european-etf-market-an-outline.html.

[29] Also referred to as "IOPV", "intraday indicative value" or "IIV".

[30] In accordance with the exchange listing and trading rules recently approved by the Commission for actively managed ETFs, the IIV may be disseminated "by one or more major market data vendors." *See* NYSE Arca Equities Rule 5.2(j)(3).

respect to transactions involving an affiliated index provider. Therefore, ETFs, as well as their advisers, affiliated index providers and other related parties, will adopt necessary procedures designed to prevent conflicts of interest as well as misuse of non-public information, tailored to their particular circumstances, as is presently required under Rules 17j-1 and 38a-1 under the Act and Rule 206(4)-7 under the Investment Advisers Act of 1940. We think the inclusion of specific conditions is therefore unwarranted.

### 9. *In-Kind Transactions Between ETFs and Certain Affiliates*

We concur with the Commission's decision to provide relief from Sections 17(a)(1) and (2) to permit first-tier and second-tier affiliates of ETFs by reason of share ownership to transact with the ETFs is appropriate and necessary. The primary rationale for the adoption of Section 17(a) was to prevent affiliates of a fund from engaging in transactions with the fund that would benefit the affiliate and harm the fund's shareholders. The Commission has granted exemptions to first-tier and second-tier affiliates of ETFs because it has determined that there is no opportunity for these affiliates to benefit in the creation and redemption process to the detriment of other fund shareholders and because these affiliates are not treated differently from non-affiliates when engaging in purchases and redemptions of creation units.[31] In granting relief to first-tier and second-tier affiliates of ETFs, the Commission has considered the fact that all authorized participants are treated the same in terms of the securities they must deliver or receive and the method for valuing those securities. The identity of these securities is made available to all authorized participants and the valuation methodology is the same as is used for calculation of the NAV. We agree with the Commission that codification of this relief in Proposed Rule 6c-11 is appropriate.

The Proposing Release requests comment on whether this relief should be extended to other affiliates. We believe that the reasons mentioned above apply equally to other affiliates, including broker-dealers. Like affiliates by reason of ownership, these broker-dealer affiliates would purchase and redeem creation units in exactly the same manner, on the same terms, and at the same value as other authorized participants. Therefore, we recommend that this relief be expanded to encompass other affiliates, including broker-dealers that are affiliated with an ETF's adviser, with the exception of those affiliates that are specialists or market makers on the primary listing exchange for such ETF, as discussed below.

Further, we believe that ETFs and their investors are likely to benefit from this relief, which will have the effect of increasing the number of authorized participants that may transact in their shares. An increase in the number of authorized participants that may transact directly with the ETF will serve to enhance the arbitrage mechanism. All ETF shareholders stand to benefit equally from any additional strengthening of the arbitrage mechanism.

[31] Proposing Release at 42.

We contend that there should be no opportunity for affiliated broker-dealers to engage in transactions detrimental to ETF shareholders[32] and therefore no useful purpose would be served by prohibiting an affiliated broker-dealer from making in-kind purchases or in-kind redemptions. As noted in the discussion in the Proposing Release regarding affiliated index providers, registered investment advisers, broker-dealers and ETFs, ETFs "...well understand the potential circumstances and relationships that could give rise to misuse of non-public information, and can develop appropriate measures to address them."[33]

As mentioned above, we do not believe that specialists or market makers for an ETF should be covered by Proposed Rule 6c-11 because they are unlike other broker-dealers. Due to their position, these broker-dealers have a different relationship to the ETF and the market, and may have other conflicts of interest. We note that to date, no ETF specialists/market makers have requested relief from Sections 17(a)(1) and (2). The Commission, therefore, has not had the opportunity to thoroughly examine this issue. We do not believe that it would be in the best interest of ETF investors for the Commission to permit specialists/market makers to rely upon the Proposed Rule 6c-11 where there is no prior relief to codify. Such entities, of course, would be free to submit individual applications for relief from Sections 17(a)(1) and (2).

#### *10. Extension of Time Beyond Seven Calendar Days for Delivery of Redemption Proceeds*

We strongly support the Commission's decision to codify existing exemptive relief from Section 22(e) of the Act provided to ETFs holding foreign securities. The Commission has reviewed extensive data contained in ETF applications for permission to delay delivery in certain circumstances, including information related to the components of foreign securities indexes, local settlement and delivery cycles and foreign holiday schedules. To date, the Commission has permitted delayed delivery of redemption proceeds of up to 14 calendar days when warranted.[34] We therefore suggest that the Proposed Rule codify the longest settlement period that has been permitted by order and allow a 14 calendar day, rather than a 12 calendar day, delay for ETFs holding portfolio securities that are subject to such schedule.

### C. Disclosure Amendments

#### *1. ETF Prospectus Delivery*

We have been advised on numerous occasions that many broker-dealers deliver a full statutory prospectus to their clients who purchase ETF shares in secondary market

[32] Proposing Release at 42.

[33] Proposing Release at 33.

[34] *See* NETS Order.

transactions rather than provide them with the shorter product description expressly permitted in certain ETF exemptive orders. We see no reason, however, to mandate the use of a statutory prospectus and the elimination of a product description; rather, we believe that broker-dealers should be able to choose the document that best meets the needs of their customers as well as their own. This arrangement would preserve the current state of affairs and permits flexibility without compromising any regulatory objectives. For this reason, we support a requirement that all ETFs must deliver either a statutory prospectus or a product description unless and until the Commission makes a final determination with respect to the summary prospectus in the Enhanced Disclosure Proposing Release ("Summary Prospectus").[35] Similarly, we oppose the adoption of amendments to the format of the statutory prospectus pending the final decision on the Summary Prospectus. The Proposing Release makes no mention of problems or abuses that have occurred as a result of providing either a statutory prospectus or product description in its existing format to investors and therefore we believe that the current arrangements should continue.

2. *Revisions to the Content of an ETF Prospectus*

Historically, the statutory prospectus for an ETF was designed to serve a different audience than was its product description.[36] Both the Commission and ETF sponsors viewed the function of the statutory prospectus as that of providing information to authorized participants and other institutional investors who directly or indirectly created and redeemed creation units. Hence, detailed descriptions of the creation and redemption mechanism, transaction fees, the NSCC process and the like, were prominent features of the prospectus. In addition, the prospectus was conceived of and designed as an instructional document to help educate institutional investors about the mechanics of a new product class. Thus, the applications for each ETF order included a representation that such ETF's prospectus contain specific disclosures, for example, alerting broker-dealers that certain ETF purchasing and trading activities could subject them to the prospectus delivery and liability provisions of the Securities Act.[37] In contrast, the novel product description permitted by ETF exemption orders was designed for use by retail investors purchasing ETF shares in the secondary market. This document was intended to contain a short description of the characteristics of the ETF as well as a concise explanation of purchasing and selling ETFs in the secondary market.[38] Therefore, the product description contained disclosures not relevant to authorized participants, such as a discussion of brokerage commissions.

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[35] *See* Proposing Release at 46-51 and note 142.

[36] *See* footnotes 20-22, *supra,* and accompanying text.

[37] *See,* for example, SPDR Trust's Fourth Amended and Restated Application dated as of August 7, 1992 ("SPDR Trust Application") at 37-38 and Prospectus dated February 25, 2008 at 54-55. *See* also NETS Trust Application at 39-40 and Prospectus dated March 17, 2008 at 96-97.

[38] See SPDR Trust Application at 38-39.

We support the Commission's proposal to eliminate the discussion of the creation and redemption mechanism and other related elements from an ETF's statutory prospectus, since, as discussed above, most retail investors now receive prospectuses rather than product descriptions and most institutional investors understand the mechanics of the ETF structure. Moving the discussion of these topics from the prospectus to the SAI would be most useful because not all investors understand or need to understand ETF mechanics and those institutional and retail investors wishing to learn more should be able to find supplemental information in the same document where all other such disclosures are located.

*3. Index Comparisons*

We believe that an index-based ETF should continue to compare its performance to a broad-based index in addition to its referenced or underlying index so that its investors will have an objective standard against which they can compare the performance of the ETF as well as that of other ETFs or investment companies should they desire. We note that an index-based ETF might choose to provide additional useful information to its investors, such as a comparison of its performance to that of its underlying index and therefore, we suggest that the Commission permit this as an optional disclosure element.

*4. Disclosure with Respect to Derivatives and Leverage*

We believe that daily disclosure of ETF liabilities on ETF websites[39] is unwarranted since the IIV calculation used by arbitrageurs during the trading day already includes this information.[40] We note that the daily disclosure of liabilities would serve as an imperfect proxy for disclosing the degree to which an ETF is engaged in leveraged transactions. However, we do recommend that Proposal Rule 6c-11 be drafted to "regularize" the level of portfolio disclosure now provided to investors in index-based ETFs that hold "derivative" as well as actual securities, and apply the resulting standards to all ETFs, including TAMEs.

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[39] Proposing Release at 26.

[40] *See,* for example, the description in ProShares' Statement of Additional Information dated October 1, 2007, as supplemented on November 13, 2007, December 13, 2007 and May 1, 2008 at 6: "The AMEX will calculate and disseminate the IIV throughout the trading day for each Ultra ProShares by (i) calculating the current value of all Equity Securities held by a Fund; (ii) calculating the estimated amount of the value of cash and Money Market Instruments held in the Fund's portfolio ("Estimated Cash"); *(iii) calculating the marked-to-market gains or losses from the Fund's total return swap exposure based on the Underlying Index percentage change, the swap costs determined by the daily imbedded weighted interest rate and the notional value of the swap contracts, if any; (iv) calculating the marked-to-market gains or losses of the futures contracts and other Financial Instruments held by the Fund, if any;* (v) adding the current value of Equity Securities, the Estimated Cash, *the marked-to-market gains/losses from swaps and the futures contracts and other Financial Instruments*, to arrive at a value; and (vi) dividing that value by the total shares outstanding to obtain current IIV." (Emphasis added)

Portfolio managers of ETFs use derivative instruments to accomplish a variety of purposes, such as creating hedges for portfolio securities, optimizing a creation basket or executing leverage strategies. We would not recommend disclosure of leverage strategies that do not, in fact, expose an ETF to leverage, such as buying futures of a component of the underlying index rather than the actual security. We believe that an ETF, whether index-based or TAME, should be required to disclose its use of derivatives when it engages in strategies or techniques designed to produce leveraged ETFs.[41] We also believe that all ETFs employing derivative instruments as a principal investment strategy should be held to the same disclosure standards all other registered investment companies observe. For example, when an index-based ETF utilizes total return swaps as the principal method of obtaining exposure to index component securities or index returns (e.g., a swap on specific securities or a swap on the ETF's underlying index), disclosure of such investment strategy should be specific in its prospectus and product description. Merely listing swaps, for instance, among a variety of derivatives that could be used by the ETF seems inadequate to inform investors about portfolio management and the materiality of counterparty risks. This level of disclosure would be applicable to any registered investment company whose principal strategy depends on the use of derivatives.

We do not recommend that the Commission specify numerical or other thresholds above which such disclosure would be mandatory, because we believe that facts and circumstances of each ETF may dictate different results for similar-seeming arrangements. Where the specific derivative disclosure is indicated, the Commission should refrain from imposing overly specific standardized disclosure requirements, for instance, disclosures concerning specific derivative counterparties and should, instead, focus on disclosure of how the ETF intends to manage counterparty risk (e.g., counterparty creditworthiness standards utilized by the ETF, derivative reset provisions that prevent the ETF's net asset exposure to a derivative contract from exceeding certain levels or other appropriate risk mitigation techniques). This approach would be in accord with the Commission's goal of providing meaningful investor disclosure while preserving portfolio management flexibility for the ETF.

*5. Rescission of Previously Issued Exemptive Orders*

We strongly oppose the rescission of exemptive orders previously granted to existing ETFs. Proposed Rule 6c-11 does not codify all aspects of previously granted exemptive relief and therefore we do not agree that most existing ETFs would be able to rely on the Proposed Rule. Certain index-based Fund ETFs have broader or different relief than that contained in the Proposed Rule. For example, Vanguard's ETF share classes of their traditional mutual funds would not be able to rely on the Proposed Rule.[42]

[41] Certain ETFs issued by ProShares and Rydex, for example.

[42] *See,* In the Matter of Vanguard Index Funds et al, Investment Company Act Release Nos. 24680 (Oct. 6, 2000) (notice) and 24789 (December 12, 2000)(order).

Furthermore, were existing index-based ETFs unable to rely upon their existing orders, they might not be able to rely upon Proposed Rule 6c-11 or they could be subject to additional costs that would otherwise not occur, as discussed in Section B.4 of this letter. We do not see any regulatory reason necessitating the rescission of prior ETF orders. For all of these reasons, we strongly oppose the rescission of exemptive orders previously granted to existing ETFs.

**D. Comments with Respect to Selected Portions of Proposed Rule 12d1-4**

We commend the Commission for proposing to include in Proposed Rule 12d1-4 the relief from limitations on investments in ETFs imposed by Sections 12(d)(1)(A) and 12(d)(1)(B), which we believe is appropriate and necessary. Thus far, the Commission has granted fifteen exemptive orders to ETF applicants providing relief from certain provisions of Section 12(d)(1) of the Act) ("12(d)(1) Orders") similar to those that the Commission has issued to traditional mutual funds investing in other unaffiliated traditional mutual funds.[43] The 12(d)(1) Orders permitted open-end funds and UITs to invest in ETFs in excess of the limits imposed by Section 12(d)(1). The adoption of Proposed Rule 12d1-4 would codify the relief provided in the existing 12(d)(1) Orders, and in some instances would simplify certain conditions contained in such orders.

As the Commission observed in the Proposing Release, registered and unregistered investment companies alike are subject to Section 12(d)(1)(A)'s limitations with respect to investments in ETFs.[44] The Proposing Release also requests comment on whether the scope of this relief should be expanded beyond that granted by exemptive orders to registered management investment companies and UITs, and asks whether closed-end investment companies, including business development companies ("BDCs") should be permitted to acquire ETFs beyond the limits of Section 12(d)(1).[45] Historically, the Commission has conditioned the grant of 12(d)(1) relief to an ETF upon an undertaking that its prospectus and product description disclose that the acquisition of shares of such ETF

> by investment companies is subject to the restrictions of section 12(d)(1) of the Act**,** except as permitted by an exemptive order that *permits registered investment companies* to invest in a Fund beyond the limits in section 12(d)(1), subject to certain terms and conditions....[46]. (Emphasis added)

We do not have an opinion as to whether the scope of this relief should be expanded but observe that the text of Proposed Rule 12d1-4 would cover far more than BDCs.[47] The

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[43] Proposing Release at 78.

[44] *See* note 194 of the Proposing Release.

[45] Proposing Release at 78 through 79 and notes 235-238.

[46] *See,* for example, condition 6 of the NETS Trust Order.

[47] See text of Proposed Rule 12d1-4 which provides, in part,

language, as drafted, would apply to all unregistered investment companies, including those relying on sections 3(c)(1) and 3(c)(7) of the Act, as well as all registered investment companies.[48] We encourage the Commission to address specifically this issue in the release that will accompany the adoption of rule 6c-11 as adopted.

We support the Commission's decision to codify the relief contained in the 12(d)(1) Orders to allow investment companies complying with the requirements of Proposed Rule 12d1-4 to take full advantage of the features offered by ETFs as well as to provide ETFs with access to an increased pool of potential investors. We also agree the Commission's decision to simplify and streamline in Proposed Rule 12d1-4 the relief contained in the 12(d)(1) Orders.

We also concur with the Commission that Proposed Rule 12d1-4 should prohibit an acquired ETF from itself being a fund of funds. This is consistent with the Commission's long-held position that a three-tiered fund arrangement increases structural complexity as well as the likelihood of possible abuses that Section 12(d)(1) was designed to prevent.[49]

We also agree with the Commission that requiring an ETF to disclose its policy about investing in other funds will help potential acquiring funds more easily determine if they may invest in the ETF.

Finally, we support the Commission's proposal to place limits on sales charges and service fees imposed by the acquiring fund. We believe that this limitation is consistent with preventing the abuses that Section 12(d) was designed to prevent and is consistent with the Section 6(c) Standards.

## E. Comments with Respect to Proposal Rule 12d1-2

We strongly support the Commission's proposal to allow funds relying on Rule 12d1-2 to invest in assets other than securities. Prior to the adoption of Rule 12d1-2, the Commission granted individual exemptive orders that orders permitted affiliated funds of funds to invest in "other financial instruments"[50] Many funds that otherwise rely on Rule

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(a) Notwithstanding sections 12(d)(1)(A), 17(a)(1), and 57(a)(1) of the Act..., an *investment company* ("acquiring fund") may acquire exchange-traded fund shares if :... (Emphasis added)

[48] We note that the Commission has preserved the restrictions contained in the 12(d)(1) Orders that ETFs "may not invest in shares of other funds (including companies relying on 3(c)(1) and 3(c)(7) of the Act) in excess of the limits in Section 12(d)(1)(A) of the Act...." Proposing Release at note 207.

[49] Proposing Release at 74-76.

[50] See, for example, In the Matter of Morgan Grenfell Investment Trust, Investment Company Act Release Nos. 25063 (July 13, 2001) (notice) and 25105 (August 9, 2001) (order) (permitting investments in "certain securities and financial instruments").

12d1-2 continue to seek such relief.[51] These funds typically desire the flexibility to invest, consistent with their investment objectives, in assets such as financial futures, forwards, options, swaps and other derivative instruments. The Commission has had ample opportunity to consider the policy and practical implications of investments in such assets by affiliated funds of funds both through the exemptive process as well as the observation of such fund's actual operations. We are not aware, and the Proposing Release makes no mention, of other issues raised or actual concerns experienced by such funds. Consequently, codification of the existing relief in Proposed Rule 12d1-2 is consistent with the Section 6(c) Standards.

## Conclusion

We respectfully request that the Commission consider our recommendations set forth above. We are prepared to meet and discuss these matters with the Commission and the Division and to respond to any questions. Please do not hesitate to contact Kathleen H. Moriarty at (212) 940-6304 or Peter J. Shea at (212) 940-6447 if we can be of further assistance.

Respectfully submitted,

Katten Muchin Rosenman LLP
Financial Services Group

cc: The Honorable Chairman Christopher Cox
The Honorable Commissioner Paul S. Atkins
The Honorable Commissioner Kathleen L. Casey
Andrew J. Donohue, Director, Division of Investment Management

[51] *See,* for example, In the Matter of Vanguard Star Funds, et al., Investment Company Act Release Nos. 28009 (September 28, 2007) (notice) and 28024 (October 24, 2007) (order) and In the Matter of JP Morgan Trust I, et. al., Investment Company Act Release Nos. 28183 (March 4, 2008) (notice) and 28230 (April 1, 2008) (order).