Structured Products Association

August 14, 2015

Via email: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-11-15
Release No. 34-75165
Request for Comment on Exchange-Traded Products

The Structured Products Association (the "Association") appreciates the opportunity to provide its views in response to the request for comments by the Securities and Exchange Commission (the "Commission") in its June 12, 2015 release referenced above (the "Request").[1]

The comments presented in this letter represent the views of the Structured Products Association, which is the trade group for the U.S. structured products industry. The Association is committed to promoting the development and growth of the structured products market in the United States, and to ensuring that investors in structured products understand the risks and potential benefits of their investments. The Association was formed in August 2003, was the first trade organization for structured products in the United States, and is comprised of nearly 12,000 professionals, including members from securities exchanges, self-regulatory organizations, law firms, compliance professionals, family offices, investment advisers, issuers and underwriters ("manufacturers"), and distributors of structured products. The Association is committed to advocating for the structured products investment class, engaging with regulators and educating the investment community.

The Request states that the Commission is seeking comments with respect to its oversight of exchange-traded products ("ETPs") under the Securities Exchange Act of 1934 (the "Exchange Act") in the following areas:

- To help inform the Commission's review of the listing and trading of new, novel or complex ETPs, including requests by ETP issuers for exemptive and no-action relief under the Exchange Act and filings by exchanges to adopt listing standards applicable to ETPs;

[1] 80 Fed. Reg. 34,729 (2015).

- The ways that broker-dealers market ETPs, especially to retail investors; and
- Investor understanding of the nature and uses of ETPs, particularly by retail investors.

The Association welcomes the opportunity to respond to the Request specifically with respect to exchange-traded notes, or "ETNs". The Association believes that the market for ETNs is efficient and operates in the manner contemplated by the existing no-action letters described in the Request. The Association believes that limiting the relief under Regulation M granted by the Staff in respect of ETNs to particular offerings of ETNs with specified characteristics (*e.g.*, no limit on issuances and redemptions or no divergence in the trading price from the price of the underlying asset) would provide little to no benefit to investors. The Association also believes that the existing listing rules of the exchanges provide sufficient protection for investors in ETNs. Finally, the Association believes that existing disclosure standards highlight the difference between trading prices and other indicative values that are published by issuers and agents for the benefit of investors and arbitrageurs. These views are discussed further below.

Exchange-Traded Notes

ETNs are senior unsecured debt obligations that are listed on a national securities exchange. ETNs provide a return based on the performance of an underlying reference asset. Under the applicable listing rules, an ETN may be linked to equity indices, commodities, currencies, fixed income securities, futures or any combination of two or more of the foregoing underlying reference assets.[2]

ETNs provide investors with a means to invest in a debt security of an issuer with a credit rating of their choice, access to a variety of reference assets that are otherwise difficult to invest in, and the liquidity of an exchange listed product. ETNs incorporate an annual fee, which may be charged upon a redemption at the request of the ETN holder, upon a call by the issuer or at maturity. Issuers create new ETNs and sell them to investors, and may sell previously repurchased or redeemed ETNs out of inventory. ETNs are redeemable by investors on a daily or weekly basis. Investors can also sell ETNs in the secondary market.

The relief from Rules 101 and 102 of Regulation M provided by the existing no-action letters should not be limited or made subject to additional conditions.

Question 19 of the Request asked how Rules 101 and 102 of Regulation M should apply to ETNs, including among other things:

- Should relief from these rules be limited to ETNs where there is a clear, independent index, where there is no limitation on issuances or redemptions, or where an ETN's secondary market price does not vary substantially from the relevant reference index?
- What effect would such a change have?
- Should relief for ETNs contain different conditions than relief for other ETPs?

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[2] See NYSE Arca Equities Rule 5.2(j)(6)(i)-(vi); NASDAQ Stock Market Rule 5710; BATS Exchange Rule 14.11(d).

The Existing No-Action Landscape

Persons who are deemed to be participating in a distribution of ETNs rely on the no-action position regarding Rule 101 of Regulation M provided by the Barclays Bank PLC, Staff No-Action Letter (July 27, 2006) (the "iPath Letter"), which permits such persons to bid for or purchase ETNs during their participation in such distribution. The iPath Letter based the position "particularly [on the representations that the ETNs] are redeemable at the option of the holder on a weekly basis (in quantities of 50,000 or more) and that the secondary market price of [the ETNs] should not vary substantially from the value of the relevant underlying index."

Issuers and their affiliated purchasers rely on the no-action position regarding Rule 102 of Regulation M provided by the iPath Letter, which permits ETN issuers and their affiliated purchasers to redeem ETNs while engaged in a continuous offering of ETNs.

Divergence of Trading Price

In connection with both no-action inquiries discussed above, counsel noted that the combined effect of the potential arbitrage opportunities inherent in the ETNs' structure, and assuming that the redemption features function as intended, the secondary market price of the ETNs should not vary substantially from the value of the underlying indices.[3] The incoming inquiry relating to the iPath Letter noted that the level of the underlying reference asset was expected to have the most influence on the trading price of the ETNs, although other factors also were expected to influence the trading price of the ETNs. Market experience demonstrates that the iPath Letter correctly predicted the result of the regulatory relief it sought.

As a general matter, ETN arbitrageurs generally keep the trading price of the ETN from diverging significantly from the value of the underlying reference asset through seeking issuer redemptions, when the ETN is trading at a discount to its indicative value, or by selling the ETN in the secondary market, when the ETN is trading at a premium to its intraday indicative value. However, when other factors are present in the market, such as those noted by the iPath Letter, [4] the trading price of the ETNs and the value of the underlying reference asset diverge. This divergence has sometimes been acute when discrepancies between supply of and demand for the ETNs as a result of issuer suspensions of new issuances have occurred. These suspensions do not affect the ability of investors to redeem the ETNs on the terms provided by the ETNs.

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[3] As the Request itself demonstrates, the no-action positions in which representations concerning a greater degree of effectiveness of arbitrage activity were required were issued in the ETF context, not in the context of ETNs. See Request Section I.D.1(a) and accompanying notes.

[4] "[O]ther factors may include, but would not be limited to, supply and demand for the particular class of iPath Securities; the volatility of the relevant underlying index; the market price of the components of the relevant underlying index; the rate of interest on Treasury Bills; the volatility of commodities; prices, economic, financial, political, regulatory or judicial events that affect the value of the relevant underlying index or the market price of its components; the general interest rate environment; and the perceived creditworthiness of Barclays Bank." (iPath Letter, incoming inquiry of Sullivan & Cromwell, n. 11); *see also* Deutsche Bank AG, Staff No-Action Letter (October 11, 2007, incoming inquiry of Davis, Polk & Wardwell, n. 7 ("Other factors that may influence the market value of the ETNs include: the time remaining to the maturity of the ETNs; supply and demand for the ETNs, including inventory positions with any market maker; economic, financial, political, regulatory or judicial events that affect the level of the Index; the prevailing rate of interest; and the creditworthiness of Deutsche Bank.")

Regulation M Relief Should Not Be Limited to Circumstances Where There Is No Limit on Issuances and Redemptions or Where the Trading Price Does Not Diverge from The Underlying Reference Asset

An issuer's suspension of future issuances of an ETN has no effect on the ability of a holder to redeem the ETNs on the terms stated in the security. Once an issuer suspends issuances of its ETN, the distribution is complete and issuer redemptions and affiliated broker-dealer market making activities no longer rely on the relief provided by the iPath Letter. As a result, the limitation proposed by the request would not affect issuers and their affiliates with respect to ETNs for which new issuances have been suspended. In addition, such a limit on Regulation M relief would not prevent divergence of ETN trading prices from the underlying reference assets for ETNs that have suspended future issuances. Because the limitation would apply only to temporary suspensions of ETN issuances, such a limitation would place short temporary suspensions – suspensions following which arbitrage activity *could* bring the trading price in line with the underlying reference asset once the issuer again begins issuances – at a regulatory disadvantage, which seems, to us, to be an undesired result.[5]

The effect of a mismatch in the supply of and demand for ETNs that is created by suspensions – whether permanent or temporary - of future issuances has been noted as an important factor affecting the trading price of ETNs since the initial no-action positions. This importance was reaffirmed in comment 2 of the February 2014 "sweep letter" sent by the Division of Corporation Finance, Office of Capital Market Trends, to various ETN issuers (the "Sweep Letter"), which instructed issuers to revise their disclosure to highlight the risk of issuance suspensions to investors. The Association understands from its members that issuers have revised their disclosure for new issuances as requested.

In addition, The New York Stock Exchange requires issuers to notify the market if issuances of ETNs will be suspended[6] and maintains a list of ETPs that have suspended issuances of new shares at: https://www.nyse.com/products/etp-closed-creation. That site also warns of the potential for the ETP's market price to deviate from the net asset value, and increased volatility. The Association believes that the additional disclosure guidance of the Sweep Letter as well as the NYSE's procedures provide adequate safeguards for investors regarding the price divergence. The Association further believes that temporary suspensions should not be placed at a regulatory disadvantage to permanent suspensions.

Regulation M Relief Should Not Be Limited to ETNs Involving a "Clear, Independent" Index

As an initial matter, the meaning of a "clear, independent index" is unclear from existing regulation. Index regulation has historically been within the scope of the exchanges and other SROs, who have provided requirements for listed ETNs as well as other exchange-traded

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[5] ETN issuers may suspend ETN issuances for any number of reasons, including internal position limits resulting in the inability to hedge further exposure to an underlying reference asset and regulatory constraints.
[6] Listed ETP Compliance Guidance (January 9, 2015) (available at: https://www.nyse.com/publicdocs/nyse/regulation/nyse-arca/2015_ETP_Compliance_Reminders.pdf).

products, such as ETFs. The Association further notes in this regard that the Request does not ask the same question with respect to ETPs other than ETNs, although the generic listing standards for ETNs were subject to the same review and approval by the SEC as the listing standards for other ETPs.

The standards for an index or any other permissible reference asset underlying an ETN are set out in the listing rules of the relevant national securities exchange.[7] Those rules set forth the minimum requirements for the underlying reference asset. The listing rules also require that firewalls be maintained to generally prevent interference by broker-dealer personnel with personnel maintaining and calculating the index and that procedures be in place to prevent the misuse of material, non-public information.[8] The listing rules do not prohibit linking an ETN to an index sponsored or calculated by an affiliate of the ETN issuer.

The Effects of Limitations on Existing Regulation M Relief Would Be Undesirable

As noted above, if Regulation M relief were limited to certain types of ETNs, those limits would apply only where the ETNs remain in continuous distribution. Therefore, issuers, their broker-dealer affiliates and distribution participants would be incentivized not to issue additional ETNs if the class of ETNs issued did not meet the limitation criteria. This would mean, as a practical matter, that certain classes of ETNs would have the potential for significant divergence between trading price and the value of the underlying reference asset without providing any meaningful arbitrage opportunities to correct that divergence. This is because arbitrage needs both additional issuances and redemptions to operate effectively. If, for example, the limitations were designed to limit relief to ETNs based on simple indices or with simple payout formulas, the limitations would result in no additional issuances, and therefore have the effect of creating the potential for significant price divergence, for more complex ETNs. The Association does not believe that this would be in the interest of issuers, investors or the public.

Regulation M Relief for ETNs Should Not Require Proof of the Effectiveness of Arbitrage Activity

As noted above, the iPath Letter required only that secondary market prices “should not vary substantially” from the underlying reference asset, and indeed, those prices typically do not. Also, as noted above, more robust representations are required concerning the effectiveness of arbitrage activity for ETFs and other ETPs. The Association believes this variance was appropriate when granted and continues to remain so today. ETNs are unique and subject to other market pressures that other ETPs, such as ETFs, do not experience, such as supply and demand, issuer credit, and other factors. The Association believes these differences in the market should continue to be reflected in the Regulation M relief ETNs currently enjoy. As noted above, discontinuation of this relief may lead to price variant impacts greater than those short-term impacts currently experienced (and expected) by the market and disclosed by issuers.

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[7] See note 2, supra.
[8] See NYSE Arca Equities Rule 5.2(j)(6)(C); NASDAQ Stock Market Rule 5710(g)(i); BATS Exchange Rule 14.11(d)(2)(G)(i).

ETN issuers disclose in their prospectuses the ETNs' intraday indicative value and the difference from other trading prices.

The intraday and closing indicative values, which are values of the ETN based on intraday and closing underlying reference asset values, respectively, and take into account the applicable investor fees at the time of calculation, are used by market participants as a close approximation of the redemption value of an ETN (without giving effect to any redemption fee) or the payment at maturity, assuming maturity at the time of the calculation of the indicative value. Indicative values are one of the tools used by arbitrageurs and other investors in determining whether to hold, sell, purchase or redeem an ETN when there is a price differential between the trading price and the indicative value.

In the Sweep Letter, issuers were asked to review their disclosure relating to, among other things, intraday indicative value, how intraday indicative value is calculated, why it is valuable to investors, and the relationship between intraday indicative value, the trading price and the redemption price. The Sweep letter asked issuers to include a risk factor about the potential for the ETN trading at a premium or discount in relation to the intraday indicative value or redemption price of the ETN.

Partly in response to the Sweep letter, ETN prospectuses clearly disclose the differences between the trading price, intraday indicative value and redemption price, and warn investors that they may not be able to take advantage of, and may actually lose money with respect to, price disparities between the trading price and indicative value. Investors are also warned that they are subject to market risk when they redeem their ETNs, because the redemption price will be set at the close of the trading day after their redemption request is accepted. Accordingly, if the ETN is trading at a discount (the trading price is less than the indicative value) and an ETN holder exercises its redemption right, if the trading price increases during the day after the redemption request is accepted, the ETN holder will have lost the opportunity to take advantage of the discount.

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Conclusion

The Association believes that the market for ETNs is efficient and that the market operates as contemplated by the iPath Letter. As explained herein, the Association believes that limiting the iPath Letter relief to ETNs where there is no limit on issuances and redemptions or where there is no divergence in the trading price from the price of the underlying asset would not create any new protections for ETN investors other than those already existing in the marketplace, nor would it prevent disparities between the trading price of the ETN from the price of the underlying reference asset. ETN issuers that are forced to temporarily suspend issuances for valid reasons would be placed at a regulatory disadvantage.

The Association also believes that the existing listing rules of the exchanges provide sufficient protection for investors in ETPs, and that the iPath Letter relief should not be limited to ETNs linked to "clear, independent" indices.

Issuers are disclosing to investors, in a thorough manner, the differences between an ETN's intraday and closing indicative value, the trading price on an exchange and the redemption price of the ETN. Issuers also clearly disclose that ETN issuances may be suspended, and the consequences to liquidity and potential differences between the trading price and the indicative value.

The Association believes that the ETN market would be materially affected in a negative manner if the Regulation M relief granted by the iPath Letter were to be restricted in the manner suggested by the Request.

The Association appreciates the opportunity to submit these responses. We are available to meet and discuss these matters with the Commission and its staff and to respond to questions.

Very truly yours,

/s/ Keith Styrcula

Keith Styrcula
Chairman and Founder
Structured Products Association