MFDF

MUTUAL FUND DIRECTORS FORUM

The FORUM for FUND INDEPENDENT DIRECTORS

October 1, 2018

Mr. Brent J. Fields
Secretary
United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

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

Dear Mr. Fields:

The Mutual Fund Directors Forum ("the Forum")[1] welcomes the opportunity to comment on the Commission's recent rule proposal regarding Exchange Traded Funds.[2]

The Forum is an independent, non-profit organization for investment company independent directors and is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Our membership includes many directors who sit on the boards of and oversee exchange traded funds ("ETFs"). Through education and other services, the Forum provides its members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern.

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I. Introduction

ETFs have come to play an important role in our capital markets. Specifically, ETFs offer investors access to a broad range of investment strategies in the form of registered investment companies that are tradeable throughout the day on national securities exchanges. ETFs have been a critical source of price competition among investment products, and not only offer investors attractively priced options, but have also incentivized other competing and complementary investment products to lower the prices they charge to investors. Finally, ETFs

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1 The Forum's current membership includes over 887 independent directors, representing 122 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

2 Proposed Rulemaking: Exchange Traded Funds, Release No. IC-33140, 83 Fed. Reg. 37332 (July 31, 2018) ("Proposing Release").

often offer investors tax and other advantages typically unavailable through traditional mutual funds.

We strongly agree that the exemptive relief necessary to introduce and manage ETFs should be codified. At this point, ETFs are well-established in the market, and the processes by which they are organized, managed and traded are well-understood. From our perspective, there is little reason that advisers should not be able to create and offer ETFs with the same relative ease available to other types of registered investment companies. As we stated in our comment on the Commission's 2008 ETF rule proposal, codifying the relief "relieves funds and their shareholders of the unnecessary cost of applying separately for routine relief that the Commission is almost certain to grant."[3] We are therefore pleased that the Commission now appears committed to finalizing an exemptive rule governing ETFs.

We also strongly agree with the goal of creating a level playing field for ETF advisers through issuance of this rule. A rule would eliminate the need for advisers to go through an expensive and potentially lengthy exemptive process prior to establishing ETFs. Further, it would place advisers that do and do not have exemptive relief on the same footing, fostering more competition and innovation in the fund industry to the benefit of shareholders. Additionally, given the importance of a level playing field, we also strongly support the Commission's intention to withdraw existing relief for ETFs and require their sponsors to rely on the requirements of the proposed rule.

Finally, we hope the proposal and ultimate promulgation of an ETF rule represents a signal from the Commission that other forms of routine exemptive relief will be converted to rule form. Once the Commission has issued a specific type of exemptive relief multiple times, and hence has presumably determined that the relief is in the interest of fund shareholders, there is little reason to withhold that relief from the remainder of the fund industry.[4] Moreover, codifying routine exemptive relief will simplify the industry, lead to more uniform regulation of funds and will reduce costs by eliminating the need for every fund or fund group that desires to rely on routine relief to file its own application to obtain that relief.

II. Proposed Rule

The overarching objective of an ETF rule should be to enable ETFs to continue to provide benefits to the investors who use them. To do this, an ETF rule should do two things:

3 The Commission originally proposed rules to govern the formation, distribution and operation of ETFs in 2008. *See* Proposed Rulemaking: Exchange Traded Funds, Rel. No. 34-8901, 73 Fed. Reg. 14618 (Mar. 18, 2008) ("2008 Rule Proposal"). We fully supported the 2008 proposal. *See* Letter re: Proposed Rulemaking Regarding Exchange Traded Funds to Nancy Morris, Secretary, U.S. Securities and Exchange Commission from David B. Smith, Executive Vice President, Mutual Fund Directors Forum (May 21, 2008) (*available at* https://www.sec.gov/comments/s7-07-08/s70708-13.pdf) ("2008 Comment Letter").

4 *See, e.g.*, 2008 Comment Letter at 1-2 (noting that codifying routine exemptions "help[s] to ensure that beneficial relief … is available to all funds" and "relieves funds and their shareholders of the unnecessary cost of applying separately for routine relief that the Commission is almost certain to grant.").

seek to ensure that ETFs can operate as efficiently and effectively as possible in a manner that is in the best interest of their shareholders and second, it should provide effective disclosure to investors and potential investors in each individual ETF. We commend the Commission for proposing a rule that, broadly speaking, accomplishes both of these goals.

A. Proposed Regulatory Structure

From the perspective of trustees, the rule proposed by the Commission is relatively simple and straightforward. We welcome the fact that the proposed rule does not impose specific new duties on trustees, but rather relies on directors to provide oversight of the operation of the ETFs on whose boards they sit. As the representatives of fund shareholders, trustees are committed to overseeing ETFs for the benefit of those shareholders. That oversight includes ensuring, pursuant to their duties under rule 38a-1 under the Investment Company Act of 1940, that ETFs adopt policies and procedures designed to prevent those ETFs from violating the federal securities laws. The clarity of the proposed rule's requirements will allow trustees to fulfill this function.

More specifically, we broadly support the approach that the Commission has proposed for custom baskets, the one part of the proposed rule in which the Commission notes that trustees will have a specific role. As the Proposing Release notes, when used appropriately, custom baskets can serve a variety of purposes that make management of the ETF simpler and allow it to be operated more effectively in the interest of its shareholders. While we believe that the risk that custom baskets will be abused is low, we agree that ETFs should generally be permitted to use them only when doing so is "in the best interests of the ETF and its shareholders."[5]

The Commission applies this approach even to those provisions of the proposed rule that most directly affect trustees. Significantly, rather than imposing specific requirements on boards with respect to the use and oversight of custom baskets, the rule proposal instead requires that ETFs adopt policies and procedures governing the use of custom baskets. As we discussed more generally above and in other comment letters to the Commission, we strongly believe that boards are most effective when they adopt policies and procedures regarding fund compliance and then, working together with the fund CCO, are able to oversee compliance with and the potential need to amend those policies and procedures. We believe that the Commission's reliance on this approach – as opposed to the approach in some recent rulemakings of requiring boards to be directly involved in making findings or appointing compliance personnel – represents a positive step forward.

B. Disclosure Issues

We also support the Commission's approach to disclosure. In general, we believe that disclosure on the ETF's website of information including an ETF's NAV, its portfolio holdings, the historical premiums and discounts at which it has traded, and its published basket for creations and redemptions will provide all market participants, including shareholders and

[5] Proposing Release at 88.

potential shareholders, with important information on a regular basis. We also agree that the regular electronic publication of this information, combined with the increased tendency of sophisticated market participants to compute the intraday value of an ETF's portfolio independently, supports the Commission's decision to not require dissemination of IIVs.[6] Combined with the prospectus disclosure requirements proposed by the Commission – including, most notably, information about the brokerage and trading costs associated with investing in ETFs[7] – we believe that this information will provide all interested parties with sufficient information on which to base investment decisions.

C. Other Regulatory Issues

While we support the Commission's approach to codifying the regulation of ETFs, we do have concerns about a number of other issues that the proposal fails to address.

First, we question why the Commission did not propose relief under section 12(d) to permit unrelated registered investment companies to make investments in ETFs in excess of the statutory limits on fund-of-funds arrangements. Many ETFs already have this relief by order (and the Commission notes that funds with this relief may continue to rely upon it).[8] There is no apparent evidence that this relief is being abused, and indeed, the Commission proposed providing this relief to all ETFs by rule in its 2008 rule proposal. We strongly supported the proposed relief at that time[9] and continue to believe that the Commission should grant it by rule. Doing so would free all registered investment companies to make full use of ETFs as part of their investment strategies and, given that many funds already possess the relief, would further the goal of establishing a level competitive playing field among advisers offering ETFs.[10]

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6 Virtually all ETF orders require the ETF to disseminate its IIV, that is, its intraday indicative value, as a means for investors to compare the market price of the ETF to its net asset value. *See* Proposing Release at 72-76.

7 While we believe that it is important that investors and prospective investors in ETFs understand the impact of trading costs, including bid-ask spreads, on the overall cost of investing in ETFs, we recognize that there are numerous potentially effective ways to provide this information, including through the use of hypothetical examples. We also recognize the potential complexity in compiling and presenting historical information about bid-ask spreads. In finalizing the disclosure requirements, we encourage the Commission to choose a method that minimizes the costs incurred by funds and their shareholders, that results in information that can be understood by the average investor, and that presents information that is truly comparable across all ETFs.

8 *See* Proposing Release at 143 n.344 & accompanying text.

9 *See* 2008 Comment Letter at 2 (noting, among other things, that acquiring funds would be unlikely to use their investments in ETFs to influence the ETFs' operations or otherwise harm the ETFs' shareholders).

10 We recognize that broadly-based fund-of-funds relief is on the Commission's rulemaking agenda for next year, *see* Securities & Exchange Commission, Agency Rule List (Spring 2018) (*available at* https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201804&RIN=3235-AM29), and we hope that that rulemaking will resolve this issue. However, given the well-established basis for this specific relief from 12(d) for ETFs, we still believe that it would be preferable for the SEC to have included it in this rulemaking. In any case, we strongly support the Commission's intention to permit ETFs that have

Second, we encourage the Commission to address and resolve two issues raised in the Proposing Release – the use of share classes linking ETFs to traditional mutual funds[11] and the future of leveraged funds.[12] While we agree with the Commission that few ETF sponsors have sought the relief necessary under section 18(f) to permit share class structures, the Commission has granted that relief in the past, and we encourage the Commission to explore more fully whether granting that relief broadly to the fund industry would be appropriate.

We believe that this is even more important with respect to leveraged ETFs. We recognize that leveraged ETFs raise important disclosure and investor protection issues, including how the day-to-day and longer-term return characteristics of such ETFs can be adequately explained to investors. We also recognize that the Commission's intent to further consider, in a broad-based manner, the use of derivatives by registered investment companies will have an impact on the future of leveraged ETFs. However, over the longer term, we do not believe that it serves the interests of the fund industry, of the markets or of individual investors for the Commission implicitly to criticize the appropriateness of leveraged ETFs and prohibit new sponsors from offering leveraged products while at the same time permitting sponsors of leveraged ETFs to maintain and even grow their businesses. While we believe that there are ways to address these concerns, particularly the disclosure and investor protection concerns, we strongly encourage the Commission to initiate proceedings, whether as part of its consideration of derivative usage or otherwise, to determine what its future approach to leveraged ETFs will be.

III. Conclusion

For the reasons outlined above, we strongly support the Commission's proposed ETF rule and encourage the Commission to move promptly toward adopting a final rule. We would welcome the opportunity to further discuss our views with you. Please feel free to contact Susan Wyderko, the Forum's President, at [redacted] or David Smith, the Forum's General Counsel, at [redacted] if you should like to do so.

Sincerely,

David B. Smith, Jr.
Executive Vice President and General Counsel

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already obtained this relief via exemptive order to continue to rely on their orders. *See supra* n.8 & accompanying text.

11 *See* Proposing Release at 137-139.

12 *See id.* at 28-36.