CFA Institute

915 East High Street
Charlottesville, VA
22902-4868 USA

+1 (434) 951 5499 tel
+1 (434) 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

15 November 2018

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

Re: Exchange-Traded Funds (RIN 3235-AJ60; File No. S7-15-18)

Dear Mr. Fields:

CFA Institute[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC") on its proposal to allow exchange-traded funds ("ETFs") to operate without the need to first obtain exemptive orders from the SEC. CFA Institute speaks on behalf of its members and advocates for investor protection and market integrity before standard setters, regulatory authorities, and legislative bodies worldwide. We focus on issues affecting the profession of financial analysis and investment management, education and competencies for investment professionals, and on issues of fairness, transparency and accountability of global financial markets.

Executive Summary

CFA Institute supports efforts to bring the regulation of ETFs under an efficient and consistent regulatory framework through the creation of new Rule 6c-11. We believe that most of the proposed conditions and requirements under which the ETFs will operate provide transparency to the market and reasonable protections for investors.

We do encourage the SEC to engage in future steps to address issues involved in leveraged ETFs. Many investors currently do not fully understand the risks posed by these instruments.

We also encourage the SEC to study issues that may arise when the portfolios of ETFs trade on international markets that may not sync with the timing of the US market on which the ETF is listed. In particular, we are concerned with potential destabilizing effects that may occur with derivative instruments like ETFs.

[1] CFA Institute is a global, not-for-profit professional association of nearly 160,000 investment analysts, advisers, portfolio managers, and other investment professionals in 165 countries, of whom more than 152,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 151 member societies in 73 countries and territories.

Discussion

The SEC is proposing new Rule 6c-11 under the Investment Company Act of 1940 ("Investment Company Act" or "Act") that will allow ETFs that are organized as open-end funds to operate under the Act without first having to obtain an exemptive order from SEC staff. Instead, ETFs (except for those organized as leveraged or inverse ETFs, unit investment trusts (UIT), or as a share class of a multi-class fund) will operate under a consistent regulatory regime. The proposal will require enhanced disclosure requirements to investors wishing to purchase and sell in the secondary market. We support this proposal on a number of levels.

When reviewing new regulations pertaining to investment vehicles, we focus on, among other things, whether they provide transparency to the market and investing public and that investors are provided with ample disclosure to allow them to make informed investment decisions. These concerns are particularly pronounced when the investment vehicles are relatively new to the investment marketplace or have been relatively unregulated. But given how long ETFs have been actively used and regulated even on a piecemeal basis, the risks, differences from other investment vehicles and their potential benefits for investors have become apparent.

Moreover, the SEC staff's experience with ETFs over the last 25 years from reviewing applications and granting exemptions on a case-by-case basis has provided it with an understanding of the ETF process and the conditions on ETFs need to operate in order to provide adequate investor protection. This substantial experience has allowed staff to explore the ongoing regulatory and market issues ETFs raise, the costs to investors relative to other products and the challenges of selling in the secondary market.

Through this experience and education, SEC staff has been able to craft a proposal aimed at continuing access to ETFs through a streamlined process focused on transparency and enhanced disclosure. We believe that the approach taken in this proposal will strengthen the regulatory process by making it more consistent and efficient, level the playing field among ETFs, reduce unnecessary costs and time delays for new ETF providers, and allow for better monitoring and enforcement. We also appreciate the additional information that ETFs under Rule 6c-11 would have to provide investors who buy and sell ETF shares on the secondary market.

Clear and Consistent Framework

Rather than continuing an exemptive order process, requiring registration under the Investment Company Act will allow for more consistency in regulation. As noted in the release, the issuance of individual exemptive orders over the years has resulted in an inconsistent system that required different conditions for some individual ETFs. Through this proposal, staff has been able to remove various conditions that they have determined are unnecessary, as well as prior distinctions between actively managed and indexed-based ETFs. Requiring all ETFs to register in accordance with set regulations not only streamlines the process but also will provide a clearer and more level playing field for all ETFs. We believe this more consistent framework will benefit the marketplace, investors and SEC enforcement efforts.

Scope of Rule

We support the proposed approach that extends Rule 6c-11 only to ETFs that are organized as open-end funds and excludes UIT ETFs, which, as in a UIT structure, is a closed-end fund that issues a fixed number of shares, thereby distinguishing them from more traditional open-end ETF structures. We agree that the rule contemplates an ongoing management process (including board oversight), which is not wholly applicable to how ETF UITs operate. Based on these factors, we agree these structures do not have the same characteristics as open-ended ETFs, and therefore we support the proposal that ETF UITs would remain subject to a system where they would need individual exemptive orders to come to market.

We also support the approaches taken with respect to index-based and actively managed ETFs in terms of bringing them both under Rule 6c-11 subject to the same conditions, in light of their similar operational functions. We agree that this helps to provide a level playing field among market participants.

Given the different considerations applicable to leveraged ETFs—both in how they seek to achieve targeted returns and the potential for unexpected losses—we also support the proposed condition that would preclude leveraged ETFs' reliance on Rule 6c-11. Because of these concerns, we encourage future rulemaking for leveraged ETFs to consider additional requirements relating to investor protections for retail investors. In particular, we support requiring marketing materials for such ETFs to contain language to put retail investors on notice of the particular risks of investing in these instruments.

Even "plain vanilla" ETFs may warrant standardized language in marketing materials to warn of certain risks. Depending on their structure (e.g., physical vs. synthetic), there are differences in complexities and potential risks. For example, physical ETFs may involve counterparty risks. We encourage consideration of ways to highlight these differences and risks, as the lack of such risk disclosure may imply to investors that they are "safe" or non-risky investment instruments and thus convey a false sense of security.

Exemptions from Investment Company Act

Proposed Rule 6c-11 would impose conditions on ETFs operating in reliance on the rule that substantially track the conditions that the SEC staff have imposed on them through the exemptive order process. In addition, many aspects of the proposed rule aim to reconcile ETF regulation with rules applicable to open end funds under the Investment Company Act.

In other respects, however, the proposed rule would continue exemptions from certain open-end fund regulations. ETFs meeting the proposed conditions would benefit from exemptions from Investment Company Act allowing them to:

- Redeem shares in "creation unit" aggregations;
- Have shares purchased and sold at market prices (instead of at NAV);
- Engage in in-kind transactions with some affiliates; and

- Pay proceeds from redemption requests later than seven days, in some circumstances.

We believe these are reasonable approaches to ETF oversight. The long history of regulating ETFs has given staff experience at understanding how ETFs function in real-world situations, rather than how they theoretically work. This, in turn, allows development of a regulatory scheme to oversee the investment product in a realistic manner that considers its specific operational features and any additional requirements for protecting investors. In this respect, this proposal serves as a model whereby it avails itself of existing regulations while imposing additional conditions, where necessary. We believe this approach augers for consistency and efficiencies.

We note, in particular, that the proposed rule would allow ETF shares to be purchased and sold at market value, rather than at NAV, as required for open-end companies. With respect to trading ETF shares at market prices, the release notes that the arbitrage function of ETFs has historically been effective in keeping the market price and NAV per share relatively in sync. This is important, given that individual retail shareholders (as distinct from authorized participants) cannot buy and redeem individual shares of ETFs at NAV prices.

Conditions Under Proposed Rule

Proposed Rule 6c-11 would impose a number of conditions on ETFs, most of which we find reasonable, in keeping with investor protections and the intended purposes of the Investment Company Act. Some of these track the conditions imposed by staff through the exemptive order process used over the years, while others depart from that process, based on staff's experience in monitoring this area.

These conditions include:

- Issuance of creation units to, and redemption of units only from, authorized participants;[2]
- Suspension of issuance of units only for a limited time and under extraordinary circumstances;
- Transaction fees cannot be so high as to suspend the issuance of creation units;
- Listing of shares for trading on a national securities exchange;
- Daily disclosure of portfolio holdings (rather than dissemination of intraday estimate of NAV per share);
- Daily website disclosure of portfolio holdings that form the basis for NAV per share calculations;
- Written policies and procedures for the construction of baskets and the process for accepting baskets;

[2] Under the proposed rule, ETFs could sell or redeem individual shares in limited circumstances--on the day of the consummation of a reorganization, merger, conversion or liquidation. Individual shares of an ETF could also be redeemed when an ETF is terminating.

- Website publication at beginning of each business day of information on its published basket, and the estimated cash balancing amount, if there is any;
- Website disclosure of the ETF's NAV per share, market price, premium or discount at end of prior business day, bid-ask spreads, and historical information relating to premiums and discounts; and
- Maintenance of copies of agreements between ETFs and authorized participants.

Disclosures

We generally support the proposed conditions noted above. The one condition with which we take exception is the requirement for a daily disclosure of portfolio holdings, instead of use of the intraday estimate of NAV per share. We believe that investors rely upon that data when trading, and encourage the SEC to keep and improve, rather than replace, the intraday data. If the SEC chooses to maintain the daily disclosure of portfolio holdings, however, it should note the need for additional disclosures. For example, a funded swap-based ETF will need to disclose the identity of the third-party collateral agent for the cash. It also may necessitate disclosure of the swap counterparty, among other things.

We also suggest that in addition to disclosure of historical deviations from NAV based on daily closing numbers, the rule require intraday information on derivatives. In some instances of market disruption, ETFs may deviate substantially from their intraday NAVs. Supplying this additional data will provide useful information to investors, especially where exposure to multiple global markets is involved.

Clear and transparent information not only serves to facilitate the smooth functioning of ETFs,[3] but also alerts investors to aspects of the ETF market that may differ from mutual funds. Thus, we strongly support disclosure requirements that ETFs provide pertinent information on their websites and that will provide investors in the secondary market with information they need to make informed investment decisions.

For example, proposed Rule 6c-11 would require ETFs to post on their websites:

- On each business day before trading begins on the ETF's primary listing exchange the portfolio listing forming the basis for the calculation of each NAV share;
- All portfolio holdings forming the basis for the *next* calculation of NAV per share (including securities, assets, cash holdings, and holdings that aren't securities or assets);
- At the beginning of each business day before the start of trading, information on the published basket that will be used in connection with purchases and redemptions of creation units;
- Per share price, market price, and premium or discount at the end of the prior business day;
- Median bid-ask spread for the most recent fiscal year; and

[3] As the release notes, the staff believes "that portfolio transparency is an effective means to facilitate the arbitrage mechanism." (p. 29)

- Historical information about premiums and discounts for most recently completed calendar year and most recently completed calendar quarters in the current year (in both table and line graph format) (new ETFs would provide this information for the life of the fund).

We appreciate and support proposed rule provisions that are aimed at giving additional information to investors who buy and sell shares of ETFs in the secondary market. As the popularity of ETFs has increased over the years, many investors have chosen to use ETFs in their investment portfolios, despite a question remaining as to whether all fully understand the risks associated with them.

We agree that secondary market investors may be significantly affected during times of market stress as the market price and NAV per share price spread widens. While the SEC believes that the arbitrage mechanisms in play eventually help to close this spread, we believe it is important that investors be made fully aware of the potential risks. To this end, we strongly support the proposed requirement that ETFs be required to disclose on their websites historical information about the size and frequency of premiums and discounts, as well as the most recent fiscal year's median bid-ask spread. In addition to disclosures of these kinds, we encourage accompanying plain-English disclosures about the potential effects of market stress on market price/NAV per share price spreads, in terms of highlighting risks to investors.

We do note one area in which we urge the SEC to require additional information. As proposed, ETFs would no longer have to provide language in their sales literature explaining that they do not buy or sell or redeem individual shares; nor do they have to further explain how to purchase and sell individual shares. In eliminating this disclosure, the staff reasons that investors are familiar enough with ETFs to understand that individual shares are handled through the secondary market. While we do not disagree, we do urge the SEC to require ETFs to include in their sales literature clear language noting that investors may pay/receive more/less than the NAV when selling shares. A simple statement to this effect, prominently placed, would help to put investors on notice that the ETF pricing mechanism works differently than that of mutual funds.

Amendments to Form N1-A would require ETFs to make additional disclosures that should help investors in the secondary market understand the operation of ETFs and how costs differ from mutual funds. We strongly support the proposed amendment that would require disclosure of trading information and costs specifically related to ETFs and agree that this is necessary information for helping investors understand their total investment costs. In particular, the proposed question-and-answer format provides a clear and engaging method for identifying specific costs, as well as providing a useful context in which to consider issues relating to trading in ETFs on the secondary market.

We also support the proposed amendment that would require a statement that applies to both ETFs and mutual funds that investors may incur expenses that are in addition to those reflected in the expense table. This puts investors on notice to seek additional information.

Additional Issues

We wish to note two additional issues that we believe merit attention.

We encourage the SEC to study issues that may arise when ETFs listed on the US market have underlying portfolio instruments that trade on an international market that is closed during US market trading hours. In particular, we believe it would be useful to better understand the potential destabilizing effects or flash crash vulnerabilities of a derivative instrument, like an ETF, when it is not synchronized with the tradability of its underlying basket.

In addition, we agree with Commissioner Jackson that while this proposal is a step in the right direction, the SEC needs to expand its attention to issues posed by leveraged ETFs. While leveraged ETFs are investment vehicles used by investors, we believe they may not fully understand the particular risks these instruments may pose. We encourage the Commission to address what steps are appropriate to ensure education and full disclosure, and that adequate investor protections are fully in place.

Conclusion

We welcome proposed Rule 6c-11 as a positive step to create a more consistent regulatory framework for ETFs that continue, and in some cases, enhances important disclosures to investors. Should you have any questions about our positions, please do not hesitate to contact Kurt Schacht, CFA, [redacted], or Linda Rittenhouse at [redacted], [redacted].

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director,
CFA Institute Advocacy

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
Director, Capital Markets
CFA Institute Advocacy