



September 28, 2018

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

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

Dear Mr. Fields:

The ETF Committee of the Asset Management Group (the “**AMG**”) of the Securities Industry and Financial Markets Association (“**SIFMA**”)<sup>1</sup> appreciates the opportunity to provide comments to the United States Securities and Exchange Commission (the “**Commission**”) on the Commission’s proposed new Rule 6c-11 under the Investment Company Act of 1940, as amended (the “**Investment Company Act**” or the “**1940 Act**”), that would permit exchange-traded funds (“**ETFs**”) that satisfy certain conditions to operate without having to obtain an exemptive order (the “**Proposed Rule**”). In addition, AMG is also providing comments on the Commission’s proposal to rescind certain exemptive orders that have been granted to ETFs and their sponsors and certain proposed form amendments relating to ETFs (together with the Proposed Rule, the “**Proposal**”).<sup>2</sup>

AMG strongly supports the object of the Proposal – to permit ETFs to operate without the expense and delay of obtaining an exemptive order and to level the playing field for new and existing ETF sponsors. To assist the Commission in finalizing the Proposed Rule, AMG sets forth below a number of specific comments and suggestions regarding the Proposal.

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<sup>1</sup> SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG’s members represent U.S. and global asset management firms whose combined assets under management exceed \$45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit <http://www.sifma.org/amg>.

<sup>2</sup> Exchange-Traded Funds, Release No. IC-33140 (June 28, 2018), 83 Fed. Reg. 37332 (July 31, 2018), available at <https://www.sec.gov/rules/proposed/2018/33-10515.pdf> (the “**Proposing Release**”).

## **A. Background**

### **Overview of the U.S. ETF Industry.**

ETFs provide a number of important benefits to investors including low fees, tax efficiency and intraday liquidity. Since the first U.S. ETF was listed in 1993, the U.S. ETF industry has grown and matured rapidly. Assets in U.S. ETFs have grown to over \$3.6 trillion, and the number of funds has reached over 2,000.<sup>3</sup> Yet the phenomenal growth experienced by the U.S. ETF industry has occurred against the backdrop of a complex, inflexible and often inefficient regulatory system.

### **Current U.S. ETF Regulation.**

ETFs do not fit neatly within the U.S. securities laws. While the 1940 Act explicitly authorizes open-end investment companies (commonly referred to as mutual funds), closed-end investment companies, and unit investment trusts (“UITs”), there currently is no provision made for ETFs. ETFs combine certain of the characteristics of open-end funds (continuous share offering, net asset value struck at the close of trading) and closed-end funds (exchange listing, shares trade on the secondary market at prevailing market prices). Absent a 1940 Act framework, ETFs are forced to operate under modified and ad hoc regulations and laws written for traditional open-end mutual funds, which operate differently.

In order to create a 1940 Act-registered ETF, the ETF sponsor must first apply to the Commission’s Division of Investment Management (“IM”) to obtain a series of exemptions from the 1940 Act (“**Exemptive Relief**”).<sup>4</sup> Exemptive Relief can be costly and time-consuming to obtain, and the inefficient process acts as a high barrier to entry that has hampered innovation for managers that are looking to sponsor ETFs and bring new products to market.<sup>5</sup> In addition to obtaining Exemptive Relief, the ETF sponsor must file a registration statement to register the shares of the ETF.<sup>6</sup>

The final regulatory hurdle to list shares of an ETF on an exchange is to obtain relief from the Commission’s Division of Trading and Markets (“T&M”). To list its shares, an ETF must either meet the “generic” listing standards for one of the primary listing exchanges for ETF shares - NYSE Arca, NASDAQ Stock Market or Cboe BZX Exchange<sup>7</sup> – or if the ETF is unable to meet the

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<sup>3</sup> ETFGI, September 14, 2018.

<sup>4</sup> Exemptive Relief typically consists of exemptions from Section 5(a)(1), Section 2(a)(32), Section 22(d), 22(e) and Rule 22c-1, Sections 17(a)(1) and (2), and Sections 12(d)(1)(A) and (B) under the 1940 Act. See *Request for Comment on Exchange-Traded Products*, SEC Release No. 34-75165, June 12, 2015 at 15 (detailing the different types of exemptive and no-action relief granted to ETFs), available at <https://www.sec.gov/rules/other/2015/34-75165.pdf> (the “ETP Release”).

<sup>5</sup> Further, given that the standards and requirements applicable to ETFs have changed over the years, some ETF sponsors are subject to more onerous restrictions than others, which puts some asset managers at a competitive disadvantage by allowing certain market participants to engage in conduct simply because they sought regulatory relief at a particular historical point in time, while other market participants are not permitted to engage in that same conduct current-day.

<sup>6</sup> For 1940 Act ETFs, the registration statements are filed with IM on Form N-1A. Registration statements for non-1940 Act ETFs (typically currency, commodity and futures-based ETFs) must be filed with the SEC’s Division of Corporation Finance on Form S-1, which is the registration form designed for use by corporations to register shares for sale to the public. ETFs, however, are open-ended and continuously issue new shares as the funds grow.

<sup>7</sup> See, e.g., NYSE Arca Rule 5.2(j)(3); NASDAQ Stock Market Rule 5705; Cboe BZX Rule 14.11.

generic listing standards, the listing exchange must file a rule change proposal with T&M, which may take between 30 and 240 days to be considered.<sup>8</sup> Finally, depending on whether certain “class” relief from various provisions of the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”), is available, ETF sponsors may have to apply to the T&M to obtain “no-action” relief with respect to a number of other issues under the U.S. securities laws given the hybrid nature of ETFs.<sup>9</sup>

## **2018 ETF Rule Proposal.**

On June 28, 2018, the Commission unanimously voted to propose new Rule 6c-11 under the 1940 Act, which, if adopted, would permit ETFs that satisfy certain conditions to organize and operate without the expense and delay of obtaining an exemptive order from the Commission.<sup>10</sup> The Proposed Rule seeks to “create a consistent, transparent, and efficient regulatory framework for ETFs and to facilitate greater competition and innovation among ETFs.”<sup>11</sup> As the Commission noted in the Proposing Release, the Proposal is based on the Commission’s experience in regulating ETFs for more than 25 years, and has been informed by the feedback received in response to the 2008 ETF Rule Proposal and the 2015 ETP Release.<sup>12</sup>

The Proposed Rule would simplify the regulatory framework and remove historical distinctions between actively managed and index-based ETFs. The Proposed Rule also would rescind most of the varying provisions of prior Exemptive Relief that has been granted over time, and instead would be subject to a consistent regulatory framework.<sup>13</sup> In addition, the Proposed Rule would promote the efficient operation of the arbitrage mechanism that supports an ETF’s shares trading at a market price approximating the ETF’s net asset value per share (“NAV”). Furthermore, creating an efficient regulatory framework for ETFs would allow Commission staff and industry participants to focus the exemptive order process on products that do not fall within the scope of the Proposed Rule. The proposals set forth in the Proposing Release would:

- Codify much of the existing Exemptive Relief, permitting ETFs organized as open-end funds, with some exceptions, to operate without obtaining individual Exemptive Relief from the Commission.<sup>14</sup>

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<sup>8</sup> While the 19b-4 process can occur in parallel to the share registration process, the exchanges will not typically file a 19b-4 until the ETF has made its initial registration statement filing.

<sup>9</sup> See ETP Release at 16. See also, Investment Company Institute, *Understanding the Regulation of Exchange-Traded Funds Under the Securities Exchange Act of 1934*, August 2017 at 10 (summarizing the exemptive and no-action relief necessary to list ETF shares), available at [https://www.ici.org/pdf/ppr\\_17\\_etf\\_listing\\_standards.pdf](https://www.ici.org/pdf/ppr_17_etf_listing_standards.pdf).

<sup>10</sup> See, *supra* n. 2. In 2008, the Commission proposed a different version of Rule 6c-11 that would have exempted ETFs from certain provisions of that Act and various rules. The proposed rule received significant industry support, but no further action was taken on the proposed rule due to the advent of the financial crisis in 2008. See Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008), 73 FR 14618 (Mar. 18, 2008), available at <http://www.sec.gov/rules/proposed/2008/33-8901.pdf> (“**2008 ETF Rule Proposal**”).

<sup>11</sup> *Id.* at 6.

<sup>12</sup> See footnote 10 and footnote 4.

<sup>13</sup> Existing Exemptive Relief has created a competitive advantage for early ETF adopters. By providing ETF issuers with the ability to generate custom creation and redemption baskets that are not merely pro-rata slices of the ETF’s portfolio or index, the Proposed Rule will provide significant portfolio management flexibility that can improve outcomes for investors.

<sup>14</sup> ETFs organized as UITs, ETFs structured as a share class of a multi-class fund, and leveraged and inverse ETFs would be unable to rely on the Proposed Rule.

- Rescind most elements of the Exemptive Relief previously granted to those ETFs able to rely on the Proposed Rule.
- Permit an ETF relying on the Proposed Rule to use custom creation and redemption baskets that do not reflect a pro rata representation of the ETF's portfolio and/or that differ from other baskets used in creation or redemption transactions on the same business day.
- Require ETFs relying on the Proposed Rule to disclose certain information on their websites, including: (i) portfolio holdings that will form the basis of the ETF's next NAV calculation; (ii) historical information regarding the ETF's NAV, premiums and discounts, and bid-ask spreads; and (iii) information regarding a basket of securities that the ETF would accept or provide in connection with a creation or redemption, updated at the beginning of each business day.
- Amend Form N-1A and Form N-8B-2 to require disclosure by *all* ETFs (not just ETFs eligible to rely on the Proposed Rule) of ETF-specific information relevant to investors who purchase and sell ETF shares in the secondary market.

Since the Proposed Rule codifies much of the standard 1940 Act Exemptive Relief ETFs rely on presently, ETFs relying on the Proposed Rule should be able to operate under similar conditions and in a manner similar to how they currently operate. The Proposal addresses all of the current Exemptive Relief except the relief from Section 12(d)(1), which would not be rescinded under the Proposal.

*Treatment of ETF Shares as “Redeemable Securities”.*

Unlike existing Exemptive Relief, the Proposed Rule expressly defines an ETF share as a “redeemable security” within the meaning of Section 2(a)(32) of the 1940 Act, notwithstanding that only authorized participants may redeem ETF shares, and then only when shares are aggregated into creation units.

*Trading of ETF Shares at Market-Determined Prices.*

Consistent with existing Exemptive Relief, a dealer in ETF shares is exempt from Section 22(d) of the 1940 Act and Rule 22c-1(a) with regard to purchases, sales and repurchases of ETF shares at market-determined prices.

*Additional Time for Delivering Redemption Proceeds.*

Many ETFs have Exemptive Relief permitting in-kind transactions in certain foreign investments to settle beyond the seven-day period prescribed by Section 22(e) of the 1940 Act. The Proposed Rule would provide this relief for up to 15 days, but would require delivery of redemption proceeds *as soon as practicable in all cases*.<sup>15</sup>

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<sup>15</sup> Under the Proposed Rule, this exemption from Section 22(e) would expire ten years from the effective date of the rule unless the Commission takes action before then.

### *Affiliated Transactions.*

First and second tier affiliates<sup>16</sup> of an ETF may enter into in-kind creation and redemption transactions with the ETF if they are affiliated with the ETF solely because they or their affiliates hold with the power to vote 5% or more of the shares of the ETF or any of the ETF's investment company affiliates.<sup>17</sup>

### *Rescission of Existing Exemptive Orders Held by ETFs That Can Rely on the Proposed Rule.*

All ETFs registered under the 1940 Act currently rely on individual Exemptive Relief issued over the last few decades. The terms of this Exemptive Relief may differ in important respects, with more recent orders typically having tighter restrictions on key ETF operations, such as the creation and redemption basket process. The Commission seeks to remedy that uneven regulatory landscape for ETF sponsors by rescinding existing exemptive relief held by any ETF that can rely on the Proposed Rule one year after the effective date of Rule 6c-11. This rescission does not cover the Section 12(d)(1) fund of funds provisions of the Exemptive Relief.<sup>18</sup> Finally, the Proposed Rule does not incorporate master-feeder relief, and instead would rescind the relief from exemptive orders that include it except in the limited instances where an existing ETF currently relies on the relief.

## **B. AMG Comments**

AMG's comments focus on two principal areas – creation and redemption issues and disclosure issues. In addition, we provide comments on a number of other topics, including the scope of the Proposed Rule, as well as on various other aspects of the Proposal.

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<sup>16</sup> Persons affiliated with the ETF based on their ownership of 5% or more of the ETF's outstanding securities are "first-tier affiliates" and affiliated persons of the first-tier affiliates or persons who own 5% or more of the outstanding securities of one or more funds advised by the ETF's investment adviser are "second-tier affiliates."

<sup>17</sup> This formulation differs from the 2008 ETF Rule Proposal, where the following formulation was proposed: "solely by reason of holding with the power to vote 5 percent or more, or more than 25 percent, of securities issued by the exchange-traded fund (or who is an affiliated person of such a person), or issued by an investment company under common control with the exchange-traded fund, is exempt from sections 17(a)(1) and 17(a)(2)..." Existing exemptive orders may include yet different formulations.

<sup>18</sup> Most existing ETFs have Exemptive Relief that permits other unrelated registered investment companies to make investments in them in excess of the Section 12(d)(1)(A) and (B) limits. The Proposed Rule does not address this aspect of the Exemptive Relief, and ETFs that have this Exemptive Relief may continue to rely on that aspect of the relief, including the related relief from Sections 17(a)(1) and 17(a)(2).

## **Creation and Redemption Issues.**

As the Commission noted in the Proposing Release, the creation/redemption process, particularly the in-kind nature of most ETF creation and redemption transactions, is critical to the efficient functioning of the ETF arbitrage mechanism and facilitates this key feature of ETFs.

Only authorized participants can purchase and redeem shares directly from an ETF at NAV, and then only in creation unit aggregations. These authorized participants (and other market participants transacting through an authorized participant) can take advantage of disparities between the market price of an ETF's shares and the NAV. However, if the arbitrage mechanism is functioning effectively, entities taking advantage of these disparities in market price and NAV ensure that the market price of ETF shares remains at or close to the NAV of the ETF. In the Proposing Release, the Commission recognized the importance of the arbitrage mechanism to ETFs: "The arbitrage mechanism is the foundation for why retail and other secondary market investors generally can buy and sell ETF shares at prices that are at or close to the prices at which authorized participants are able to buy and redeem shares directly from the ETF at NAV."<sup>19</sup>

The Commission expects that permitting ETFs to utilize custom baskets will reduce transaction costs, promote efficient portfolio management and lead to a more efficient and effective arbitrage process. In addition, certain of the new disclosure requirements are intended to enable the Commission, investors and other market participants to evaluate the functioning of an ETF's arbitrage mechanism.

Set forth below are a number of comments relating to creations and redemptions, including custom baskets, that AMG feels may enhance the overall efficiency of ETF creation and redemption transactions without compromising the interests of the ETFs and their shareholders.

### *Custom Baskets.*

AMG applauds the Commission for proposing that all ETFs that rely on the Proposed Rule should be able to engage in custom basket transactions. AMG agrees that having the ability to customize creation and redemption baskets, subject to board oversight and in accordance with clear policies and procedures, will offer numerous benefits to ETFs and their shareholders.

The act of constructing creation and redemption baskets is fundamentally a portfolio management function. In constructing a creation basket, an ETF's portfolio management team is deciding what assets to "purchase" for the portfolio. Similarly, the portfolio management team decides what to "sell" when it constructs a redemption basket. The importance of the portfolio management team's role is even more evident when it is determining whether to accept a custom creation and redemption basket. By permitting all ETFs that rely on the Proposed Rule to utilize custom baskets, not only would the Commission be leveling the playing field, but it would also be increasing the likelihood that ETF investors will experience improved investment outcomes. This is especially true for active ETFs, very few of which have the ability to engage in custom basket transactions. As with many investment management functions, custom basket flexibility will require ETF advisers to adopt policies and procedures to set boundaries and address potential (or actual) conflicts of interest, as well as to provide process oversight and appropriate recordkeeping. In many ways, custom baskets are no different than

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<sup>19</sup> See Proposing Release at 43.

other portfolio management tools, and it is gratifying that the Commission is treating custom baskets this way in the Proposed Rule.

Obtaining flexibility for all ETF sponsors to utilize custom creation and redemption baskets has been a key goal of the ETF industry for many years. As the Commission noted, custom baskets should benefit ETFs and their shareholders by reducing costs, increasing efficiency and improving trading. The Commission acknowledged that “ETFs without basket flexibility typically are required to include a greater number of individual securities within their baskets when transacting in-kind, making it more difficult and costly for authorized participants and other market participants to assemble or liquidate baskets. This could result in wider bid-ask spreads and potentially less efficient arbitrage.”<sup>20</sup> For fixed income ETFs, the ability to customize baskets is crucial since many bonds do not trade frequently and requiring an ETF to include a difficult-to-acquire bond in a redemption basket simply to maintain a basket that reflects the ETF’s portfolio would be counterproductive. By permitting custom baskets, the Proposed Rule will provide newer sponsors the flexibility to compete with some of the more established ETF sponsors for securities, authorized participant transaction interest, creation activity and assets.<sup>21</sup> In addition, custom baskets should enable actively managed ETFs to manage their portfolios in a more efficient and cost-effective way.

The Proposed Rule would require all ETFs relying on the rule to adopt and implement written policies and procedures that govern the methodology used by the ETF in the construction of creation and redemption baskets and the process that will be used for the acceptance of baskets. These policies and procedures would govern “typical” basket construction activities, including generating pro rata and representative sample baskets. The requirement to adopt basket construction policies and procedures is consistent with other investment and portfolio management processes that require guidelines, oversight and recordkeeping, such as Rule 10f-3 transactions or affiliated in-kind redemption (Signature)<sup>22</sup> transactions.

The Proposed Rule will permit all ETFs eligible to rely on it to utilize custom creation and redemption baskets. There are two types of custom baskets contemplated by the Proposed Rule. The first includes baskets that consist of a non-representative selection of the ETF’s portfolio holdings, which would include baskets that do not reflect: (i) a pro rata representation of the ETF’s portfolio holdings, (ii) a representative sampling of the ETF’s portfolio holdings, or (iii) changes due to rebalancing or reconstitution of the ETF’s securities market index, if applicable.

The second type of custom basket arises when different baskets are used on the same business day. Thus, any basket that differs from any other basket used by the ETF on a given day would be a custom basket, including different baskets applicable to different authorized participants on a single day or baskets including cash in lieu of a portion of the basket assets for a single authorized participant.

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<sup>20</sup> See Proposing Release at 93.

<sup>21</sup> The vast majority of ETF assets today are managed by sponsors that are authorized to utilize customized creation and redemption baskets. The largest ETF sponsors (BlackRock, Vanguard, SSGA and Invesco), representing 85+% of all U.S. ETF assets, all are able to manage their index ETF portfolios using flexible customized baskets.

<sup>22</sup> *Signature Financial Group*, December 28, 1999, available at (<https://www.sec.gov/divisions/investment/noaction/1999/signaturefinancial122899.pdf>).

### *Custom Basket Policies and Procedures.*

The Proposed Rule would require all ETFs relying on it to use custom baskets to adopt written policies and procedures relating to the use of custom baskets (“**Custom Basket Policies**”). The Custom Basket Policies must:

- Set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for revising, or deviating from, those parameters; and
- Specify the titles or roles of the employees of the ETF’s adviser (or sub-adviser) who are required to review each custom basket for compliance with the established parameters.

Under the Proposed Rule, provided that an ETF has adopted appropriate Custom Basket Policies, the ETF would be permitted to construct creation and redemption baskets using cash, securities, or other positions and to substitute cash, securities, or other positions for basket assets in certain prescribed circumstances. The Proposing Release also states that the Custom Basket Policies should include provisions for testing compliance with the Custom Basket Policies and assessing (including through back testing or other periodic reviews) whether the parameters continue to result in baskets that are in the best interests of the ETF and its shareholders. Custom Basket Policies must also provide a process to govern revisions to, or deviations from, the custom basket parameters. In addition, the Commission suggested that ETFs consider utilizing non-portfolio manager employees to review the components of custom baskets before approving a creation or redemption transaction.

Since accepting custom creation and redemption baskets is largely a portfolio management function, having policies and procedures designed to ensure that these customized transactions fall within specific, enumerated parameters and that their use is in the best interests of the ETF makes perfect sense. In designing Custom Basket Policies, ETF sponsors should consult not only the ETF’s portfolio management team, but also compliance, risk, capital markets and operational personnel, as appropriate. Importantly, the Proposed Rule does not suggest any specific parameters that must be utilized, and each sponsor (or even each portfolio management team) can devise parameters to fit its own unique circumstances.

### *Recordkeeping.*

For each basket exchanged with an authorized participant, including non-custom baskets, an ETF would be required to maintain a record identifying the names and quantities of positions comprising the basket, the cash balancing amount, if any, and the identity of the authorized participant transacting with the ETF. For each custom basket used, such record would also be required to identify the basket as a custom basket and state that the custom basket complies with the ETF’s Custom Basket Policies. These records would include supporting materials designed to evidence the basis for any determination to accept a specific custom basket under the Custom Basket Policies.

### **Committee Comments on Custom Basket Issues.**

AMG strongly supports providing ETFs with custom basket flexibility. As noted previously, custom baskets provide for more efficient portfolio management, enable ETFs to reduce transaction costs, help facilitate the ETF’s tax efficiency and reduce bid-ask spreads for investors. As with many



portfolio management techniques, having compliance policies and procedures to provide parameters for use and to ensure oversight and recordkeeping is standard. With active engagement by compliance, risk and operational professionals, appropriate board oversight, and clear, auditable records that enable the Commission staff to monitor custom basket usage and its impact on the ETF arbitrage process, an ETF can demonstrate that the use of custom baskets, including each individual custom basket, is in the best interests of the ETF and its shareholders.

With respect to the last point – the best interests of the ETF and its shareholders – AMG seeks clarity regarding whether the “best interests of shareholders” relates to the ETF as a whole or to the individual ETF shareholders. Commissioner Peirce has commented on the inclusion of “and its shareholders” in the best interest standard, and noted that the adviser to an ETF owes a fiduciary duty only to the ETF it manages. She also highlighted the difficulty any adviser would have in assessing the individual tax and other circumstances of each shareholder, and noted that even redeeming shareholders fall within the population of shareholders whose interests seemingly must be considered under that standard. AMG agrees that ETFs are in no position to evaluate the best interests of individual shareholders. Therefore, AMG interprets the “best interests of the ETF and its shareholders” to include the ETF’s shareholders collectively rather than individually, and requests that the Commission confirm this understanding or otherwise provide guidance on how an ETF could meet this standard with respect to individual shareholders.

AMG supports the requirement to have detailed Custom Basket Policies. Given the benefits of custom baskets, AMG believes that all ETFs should have the ability to manage their portfolios as efficiently as possible using custom creation and redemption baskets. It is appropriate to establish written guidelines and appropriate oversight to ensure that any transactions under the policies meet the prescribed requirements. This type of oversight regime is typical, and AMG appreciates that the Commission has allowed ETF sponsors the flexibility to design Custom Basket Policies that are best suited to their individual circumstances. This principles-based approach recognizes the diversity of portfolio management practices and approaches and acknowledges that there is no “one size fits all” solution that would work for every ETF.

However, AMG does not support the provision of the Proposed Rule that requires ETFs to identify the titles and roles of the employees of the investment adviser<sup>23</sup> who are required to review each custom basket for compliance with the ETF’s Custom Basket Policies. AMG believes that it is impractical to have individual employees review each custom basket prior to approval. Instead, AMG recommends that ETFs be required to identify the titles and roles of the employees who are responsible for approving custom baskets that deviate from the parameters set forth in the Custom Basket Policies, but which are nevertheless in the best interest of the ETF and its shareholders. In addition, AMG believes that if any employees must be identified by the ETF, those employees should be portfolio management employees. Because the use of custom baskets is a portfolio management function, portfolio management employees would be in the best position to evaluate the merits of each custom basket or the merits of each proposed deviation from the parameters set forth in the Custom Basket Policies.<sup>24</sup>

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<sup>23</sup> AMG has assumed that the term “ETF’s investment adviser” in the Proposed Rule would encompass any sub-adviser to an ETF, and we hereby request that the Commission confirm this understanding.

<sup>24</sup> AMG believes that an ETF’s compliance, risk, capital markets and operational personnel, along with portfolio management personnel, have important roles to play in the custom baskets process, including identifying the parameters

Despite AMG’s strong support of the Proposed Rule’s inclusion of custom basket flexibility, AMG does not support the Proposed Rule’s apparent treatment of partial cash and/or “cash in lieu” baskets as custom baskets.

Traditional mutual fund portfolio management involves accepting cash when investors purchase fund shares, and allowing the fund’s portfolio manager to hold the cash or to purchase the securities or other assets that they desire to include in the fund’s portfolio. Similarly, when a mutual fund’s shares are redeemed, the portfolio managers decide which securities or other assets to sell (or whether to use cash reserves) to meet the redemption. These processes are subject to the mutual fund adviser’s general fiduciary duty to act in the best interests of the fund. The decision by an ETF portfolio manager whether to utilize cash, including cash in lieu of basket securities, should be treated the same way. An ETF portfolio manager should be able to determine how to make use of cash in the ordinary course.<sup>25</sup> AMG believes that the use of cash or cash in lieu in creation and redemption baskets does not present the same potential for “cherry picking” and “dumping” by authorized participants.<sup>26</sup> The treatment of partial cash or cash in lieu baskets as “custom baskets” subject to Custom Basket Policies elevates a routine portfolio management prerogative to the same level as transactions that present a greater potential for conflicts and overreach. Since one of the Commission’s goals in advancing the Proposal is to level the playing field, it makes little sense to create an un-level playing field between mutual funds and ETFs when it comes to the ability to use cash for portfolio management purposes.<sup>27</sup>

#### *Affiliated Transactions.*

Section 17(a) of the 1940 Act generally prohibits an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security or other property to or purchasing any security or property from the company. Purchases and redemptions of ETF creation units are typically effected in kind, and Section 17(a) prohibits these in-kind purchases and redemptions by affiliated persons of the ETF. Therefore, ETFs have obtained Exemptive Relief to enable authorized participants that are affiliated with an ETF solely by virtue of an ownership interest to engage in in-kind creation and redemption transactions with the ETF.

In granting this Exemptive Relief, the Commission has noted that first- and second-tier affiliates are not treated differently from non-affiliates when engaging in purchases and redemptions of creation

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pursuant to which custom baskets may be accepted, modeling custom basket impacts before acceptance, testing compliance after basket acceptance, and ensuring that custom basket transactions function as intended.

<sup>25</sup> In many cases, the use of cash is driven by restrictions applicable to authorized participants, restrictions on in-kind transactions in certain markets, or authorized participants’ inability to access individual securities. For example, in certain countries, ETFs are unable to transfer securities in-kind, so it is necessary to engage in cash transactions. In addition, some ETF sponsors may be more expert in acquiring certain types of basket securities than the authorized participants, so they may require an authorized participant to contribute cash so they can acquire the desired securities directly. In addition, individual authorized participants may be restricted from transacting in certain securities or may not have access to all basket securities, so it may be necessary to substitute cash for individual securities for that authorized participant.

<sup>26</sup> Proposing Release at 92.

<sup>27</sup> This is especially true when the Proposing Release identifies scenarios where the Commission seeks to treat ETFs and mutual funds equally. For example, on page 27 of the Proposing Release, the Commission states that eliminating the distinction between index and active ETFs “would be consistent with our regulation of other types of open-end funds, which does not distinguish between actively managed and index-based strategies.”

units, all purchases and redemptions of creation units are at an ETF's next-calculated NAV pursuant to Rule 22c-1, and the securities deposited or delivered upon redemption are valued in the same manner, using the same standards, as those securities are valued for purposes of calculating the ETF's NAV.

The Commission has acknowledged that without Section 17 relief, an authorized participant or other market participant that becomes an affiliated person of the ETF due to its holdings would be prevented from engaging in arbitrage using an in-kind basket, which, in turn, could have the adverse effect of limiting the pool of market participants that could engage in arbitrage activities. This may result in the deviation between market price and NAV widening in cases where there are very few authorized participants or other market participants actively engaged in transactions with the ETF.<sup>28</sup>

### **Committee Comments on Affiliated Transaction Issues.**

AMG strongly supports the inclusion of this Section 17 relief in the Proposed Rule, and agrees that expanding the number of authorized participants and other market participants that may transact in an ETF's shares is beneficial to the effective functioning of the arbitrage mechanism. AMG also agrees with the Commission that where there are very few authorized participants or other market participants actively engaged in transactions with the ETF, premiums and discounts to NAV may increase. Therefore, AMG believes that an increase in the number of entities eligible to transact with an ETF could better facilitate the arbitrage mechanism and reduce concentration risk, and that the scope of the Proposed Rule should be expanded to permit authorized participants and other market participants that are affiliated with an ETF for reasons other than holding with the power to vote 5% or more of the ETF's shares to transact in-kind with the ETF. The conditions of the Proposed Rule, including compliance with the required policies and procedures that will govern the construction of baskets and the process used for the acceptance of baskets, will effectively protect the ETF from overreaching by an affiliated person irrespective of the reason for the affiliation. In addition, having more parties willing and able to transact in the ETF's shares should lead to narrower bid-ask spreads, reduced premiums and discounts, increased share liquidity, and greater competition among authorized participants.

AMG also seeks clarity on two other items pertaining to Section 17 relief. First, we note that the Proposed Rule uses a formulation that would permit "an affiliated person of an ETF (or who is an affiliated person of such a person) solely by reason of: (i) holding with the power to vote 5% or more of an ETF's shares; or (ii) holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF" to engage in in-kind transactions with an ETF. However, recent Exemptive Relief contained a formulation permitting in-kind transactions with parties who are affiliated persons by virtue of "(1) holding 5% or more, or in excess of 25% of the outstanding Shares of one or more Funds; (2) an affiliation with a person with an ownership interest described in (1); or (3) holding 5% or more, or more than 25% of the shares of one or more Affiliated Funds". We request that the Commission clarify that there was no intent to change the scope of the prior Section 17 relief in drafting the language of the Proposed Rule, and confirm that

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<sup>28</sup> The Commission adds that: "The arbitrage mechanism for newly launched ETFs could be particularly challenged without this relief because every purchaser of a creation unit would be considered an affiliated person of the ETF so long as there are fewer than twenty creation units outstanding." Proposing Release at 52.

the Section 17 relief in the Proposed Rule would extend to affiliates that own more than 25% of an ETF's shares.

Second, ETFs are often launched with seed capital provided by third parties, especially authorized participants and market makers.<sup>29</sup> This means that these firms will often hold a significant percentage of a new ETF's outstanding shares for a period of time as the ETF attempts to grow assets and improve liquidity.<sup>30</sup> As noted by the Commission, until an ETF has 20 creation units outstanding, every purchaser of a creation unit would be an affiliated person of the ETF. By clarifying that authorized participants and other market participants who provide seed capital to new ETFs and who may hold large numbers of shares during the post-launch period fall within the scope of the Section 17 relief contained in the Proposed Rule, the Commission will help facilitate capital formation and improved investor choice by encouraging a more diverse array of ETFs for investors and enhancing their investing experience through the improved tradability of new ETFs. If entities that provide seed capital to ETFs were to fall outside of the scope of the Section 17 relief, there would likely be a significant negative impact on new ETFs, as there would likely be fewer authorized participants willing and able to transact in the ETFs' shares, which could lead to wider spreads, larger premiums and discounts and increased concentration concerns.

#### *Portfolio Holdings and Basket Disclosure Issues.*

The Proposed Rule requires all ETFs relying on the rule to provide full portfolio transparency. Each ETF must disclose prominently on its publicly available website the portfolio holdings<sup>31</sup> that will form the basis for the ETF's next calculation of NAV (*i.e.*, the ETF's portfolio holdings as of the close of business on the prior business day).<sup>32</sup> The portfolio holdings disclosure must be provided each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting creation and redemption orders. In addition, ETFs must publish a basket of securities that the ETF would accept or provide in connection with a creation or redemption, updated at the beginning of each business day before the ETF accepts creation and redemption orders.

Broadly speaking, AMG is supportive of the Commission's efforts to make additional information available to market participants. Most ETFs currently make portfolio holdings and basket information available to market participants through a central clearing organization or other means, and the availability of this information improves the ETF arbitrage process, enabling authorized participants and market makers to narrow bid-ask spreads and make better markets. AMG applauds the Commission's desire to improve the functioning of the arbitrage mechanism in the Proposed Rule and agrees with the Commission's promotion of custom baskets and making certain types of additional information available as keys to this effort. However, AMG does have several concerns

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<sup>29</sup> To list an ETF, exchange listing rules typically require that the ETF have at least 100,000 shares outstanding upon its initial listing. *See, e.g.*, Cboe BZX Rule 14.11(b)(3)(D).

<sup>30</sup> In the case of authorized participants, most authorized participant agreements contain a provision which provides that the authorized participant gives an irrevocable proxy to a third party (often the ETF's distributor), meaning the authorized participant does not have a right to vote the ETF's shares in the event of a shareholder meeting.

<sup>31</sup> Portfolio holdings include securities, assets or "other positions." Other positions include cash, as well as other holdings that are not securities or assets, including short positions or written options.

<sup>32</sup> "Business day" means any day the ETF is open for business, including any day when it satisfies redemption requests.

regarding the information to be made publicly available, as well as the timing requirements for making such information available.

### **Committee Comments on Portfolio Holdings and Basket Disclosure Issues.**

First, AMG is concerned that the requirement to post portfolio holding and basket information prior to accepting creation and redemption orders will result in significant operational challenges, particularly for ETFs that invest in non-U.S. securities. Many global and international ETFs, especially those that invest in Asian markets that are closed during the U.S. trading day, require authorized participants to submit orders on the day prior to the transaction date (i.e., T-1). For example, many such global and international ETFs will accept orders between 4 pm and 6 pm Eastern time on T-1. Doing so enables authorized participants and market makers to transact in local market securities while the local markets are open and to build creation units and construct hedges without having to worry about price slippage during the hours while those local markets are closed. This lack of temporal overlap with U.S. markets makes acquiring basket securities and constructing hedges more vulnerable to price volatility and therefore, more costly for investors as market participants widen bid-ask spreads to protect against market exposure.<sup>33</sup> If these global and international ETFs must delay acceptance of creation and redemption orders until after local markets are closed, market participants will tend to widen spreads to limit their exposure to local market volatility.<sup>34</sup>

Alternatively, ETFs could seek to publish basket information significantly in advance of the next day's market open, but this will present operational challenges. For example, on a typical day, ETFs calculate NAV as of 4 pm Eastern time, but the NAV calculation is not completed and "published" until after 7 pm Eastern time. As noted above, many global and international ETFs accept orders for creations and redemptions only between 4 pm and 6 pm on T-1, which is prior to the time NAV is calculated. This would make publishing portfolio holdings and basket information prior to a 4 pm-6 pm order window challenging, and potentially could lead to NAV errors or other operational errors as fund administration personnel rush to calculate NAV and make portfolio holdings and baskets available in a compressed time frame.

AMG recommends that the Commission revise the Proposed Rule to require that ETFs to publish portfolio holdings as soon as practicable, but in no event later than the opening of the U.S. trading markets (typically, 9:30 am Eastern time) rather than prior to accepting creation or redemption orders. This is the most common market practice today, and AMG is not aware of any problems resulting from these practices. In fact, there is ample evidence that many ETFs that have T-1 order windows trade very efficiently, with narrow bid-ask spreads despite the fact that these ETFs make portfolio holdings available, if at all, only after the T-1 order window closes. For example, the iShares MSCI Emerging Markets ETF (EEM) has an order window that opens at 4:15 pm Eastern time on T-1, and typically publishes its portfolio holdings and basket information by approximately

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<sup>33</sup> "Without the ability to hedge, market makers may widen spreads or be reluctant to make markets because doing so may require taking on greater market risk than the firm is willing to bear." Proposing Release at 77.

<sup>34</sup> AMG has heard from several authorized participants that they do not typically use portfolio holdings information for purposes of engaging in arbitrage transactions. Instead they use information about daily changes and corporate actions to be reflected in the ETF's portfolio (a so-called "delta file") to evaluate arbitrage opportunities.

7 pm Eastern time on T-1. Nevertheless, EEM has an average 30-day spread of \$.01 (as of August 15, 2018) and has been trading at an average spread of 10 basis points or less for the past 10 years.<sup>35</sup>

While AMG does not object to making portfolio holdings information available on ETF websites, we believe that making portfolio holdings information available to retail investors is unnecessary and will not have an impact on how ETF shares trade. With regard to basket information, however, AMG questions whether making basket information available on the ETF's publicly-available website is necessary. As with portfolio holdings, the principal consumers of basket information are authorized participants, market makers, and other institutional investors. AMG does not believe that basket information will be of any particular use to retail investors, and as discussed below, may be confusing or misleading to retail investors.

AMG is also concerned that the details and format of information provided consistent with Article 12 of Reg S-X is not practical for making daily holdings disclosure. Because the Article 12 disclosures include information such as appreciation and depreciation for derivatives, it will be difficult and impractical to calculate and disseminate holdings in this format on a daily basis.<sup>36</sup> AMG recommends that the Commission prescribe a more useful subset of information rather than requiring all of the information in Article 12. For example, the Commission could require ETFs to publish the same information that is required to be disclosed under the generic listing rules applicable to active ETFs.<sup>37</sup> With respect to published baskets, AMG recommends that ETFs be required to provide the only following: (a) ticker symbol, (b) security identifier (CUSIP or ISIN), (c) description of the holding (i.e., security name), and (d) the quantity of each security or other asset per creation unit (number of shares for equity, par value for debt and cash amount). The ETF industry has functioned effectively under the current portfolio holdings disclosure regime, and there is no reason to think that market participants, including retail investors, need the level of detail about portfolio holdings suggested in the Proposing Release on a daily basis.

AMG also has a number of other concerns about the requirement in the Proposed Rule that an ETF publish a basket on its website that it would exchange for orders to purchase or redeem creation units. Each ETF that relies on the Proposed Rule must post on its website information regarding a published basket at the beginning of each business day, as well as the estimated cash balancing amount.<sup>38</sup> The ETF must publish a single basket for creations and redemptions representing "a basket that it would accept if presented by any authorized participant in exchange for creation units

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<sup>35</sup> Other ETFs that utilize a T-1 order window also evidence tight spreads. For example, the SPDR MSCI ACWI ex.-US ETF (CWI) has had an average spread over the 5-year period from 9/17/13 to 9/17/18 of \$.02. Similarly, the Vanguard FTSE Emerging Markets ETF (VWO) has had an average spread over the period from 8/30/13 to 8/31/18 of \$.01.

<sup>36</sup> As noted above, this will be particularly challenging for global and international ETFs with T-1 order windows, and AMG has concerns about jeopardizing the accuracy of holdings information in a rush to publish the information on T-1.

<sup>37</sup> See, e.g., Cboe BZX Rule 14.11(i)(3)(B) relating to Managed Fund Shares, which requires disclosure of the following information, if applicable: (1) Ticker symbol; (ii) CUSIP or other identifier; (iii) Description of the holding; (iv) Identity of the security, commodity, index, or other asset upon which the derivative is based; (v) The strike price for any options; (vi) The quantity of each security or other asset held as measured by: (a) Par value; (b) Notional value; (c) Number of shares; (d) Number of contracts; and (e) Number of units; (vii) Maturity date; (viii) Coupon rate; (ix) Effective date; (x) Market value; and (xi) Percentage weighting of the holding in the portfolio.

<sup>38</sup> Current Exemptive Relief does not require index-based ETFs (other than self-indexed funds, 130/30 funds or long/short funds) to post their portfolio holdings daily, although most ETFs do so.

(or present to an authorized participant redeeming creation units).”<sup>39</sup> The published basket need not represent a pro rata selection of the ETF’s portfolio holdings.

First, AMG does not support the requirement to publish a custom basket if the ETF “planned to use only custom baskets” on a given day. While ETF sponsors will likely be aware of the fact that they will use only custom baskets on a given day, especially for certain types of fixed income ETFs, there appears to be relatively little value in publishing a speculative custom basket compared to other forms of disclosure designed to facilitate the arbitrage process. Instead, AMG suggests that ETFs be required to publish either a pro-rata, representative sample or optimized transactional basket each day. Custom basket components on a given day are unpredictable, so a pro-rata, representative sample or optimized transactional basket that mirrors the attributes of the ETF’s portfolio will be more useful to market participants. This is largely consistent with current practices, which have served the industry well, and which will not require operational process changes.

AMG also seeks clarity about whether sponsors would be required to honor the published basket throughout the entire day. As the Commission acknowledged in the Proposing Release, especially in authorizing the use of custom baskets, on any given day the published basket may not be one that authorized participants and market makers can act upon. In fact, in the Proposing Release, the Commission indicates that the Proposed Rule does not “prevent an ETF from changing the assets on a published basket to respond to market conditions after the basket is published.”<sup>40</sup> This calls into question the utility of requiring publication of custom baskets under any circumstances – if the published basket can be changed in response to market events, publication may result in the public having unhelpful information that they can choose to act upon. Instead, as detailed above, AMG suggests that the Proposed Rule be revised to require publication of only a pro-rata, representative sample or optimized transactional basket.

Finally, AMG does not support a requirement to make public disclosure of custom baskets accepted by the ETF. Publication of custom basket information will serve no useful purpose for retail investors who lack the context and expertise to understand the reasons why a particular custom basket was accepted. Moreover, AMG believes the publication of custom basket information could be detrimental to the effective functioning of the ETF arbitrage mechanism. If information about individual custom baskets is made available publicly, trading strategies of individual authorized participants or market makers may be revealed, which will make these market participants less inclined to engage in custom transactions.<sup>41</sup> Having concluded that ETFs will benefit from having the ability to engage in custom creations and redemptions, it would be counterproductive to enact a different policy that has the opposite effect.

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<sup>39</sup> See Proposing Release at 104.

<sup>40</sup> See Proposing Release at footnote 269. We note that certain ETFs publish a basket that could only be used under normal creation-redemption circumstances (e.g., for the first 10 creation units on a given day). If the number of orders for creation units exceeds this amount, these ETFs will change the creation-redemption basket to protect the ETF from experiencing under- and overweight positions or other attribute mismatches in the portfolio.

<sup>41</sup> AMG understands that these market participants are concerned that public disclosure of custom baskets may enable third parties to mine custom basket transaction data to attempt to replicate their trading strategies or to gain an information advantage that will ultimately be used against them.

## Other Creation/Redemption Issues.

In addition to the foregoing concerns, AMG has several other comments related to ETF creations and redemptions. First, AMG is concerned that language in the Proposing Release that limits an ETF's ability to suspend creations may prohibit a fund from implementing a "soft close" in certain circumstances. Under the Proposed Rule, creations may be suspended only for a limited time and only due to extraordinary circumstances, such as when the markets on which the ETF's portfolio holdings are traded are closed for a limited period. However, AMG believes that in limited circumstances where an ETF is unable to meet its investment objective due to external circumstances, such as where an ETF is subject to investment limits imposed by corporate issuers, regulators or foreign governments or where there is an extended market close like the closure of Egyptian markets in 2011, the ETF should be able to close to new creations if the closure is approved by the ETF's board and is in the best interest of the ETF. AMG also recommends that the Commission make it clear that an ETF can always reject individual creation orders when in the best interest of the fund to do so.

AMG supports the elimination of the requirement to establish minimum creation unit sizes. Creation unit sizes are relevant only to authorized participants, market makers and other institutional investors who transact directly with the ETF in large share aggregations. These market participants will be fully aware of the ETF's minimum creation unit size when placing creation and redemption orders based on information available to them from the ETF's ordertaking procedures, authorized participant guidelines and other sources inapplicable to retail investors. However, since certain exchange listing rules and Exchange Act class relief provisions require an ETF to establish a minimum creation unit size, AMG recommends that the Commission consider eliminating the requirement to establish and publish minimum creation unit sizes across both the 1940 Act forms and regulations and the Exchange Act listing and class relief rules.<sup>42</sup>

Finally, AMG seeks clarification regarding the definition of "foreign investments." For purposes of the Section 22(e) relief in the Proposed Rule, "foreign investment" is defined as any security, asset or other position of the ETF issued by a foreign issuer (as defined by Rule 3b-4 under the Exchange Act)<sup>43</sup> for which *there is no established U.S. public trading market* (as that term is used in Regulation S-K under the Securities Act).<sup>44</sup> Many foreign issuers issue stock in U.S. public trading markets (e.g., stock registered on Forms F-1 or F-3). These U.S. versions of foreign stocks would not be included in the proposed definition of foreign investment. However, if an ETF holds foreign securities of a foreign issuer that are traded in the local foreign market and that foreign issuer also has common stock trading in the U.S., the ETF should still receive the benefit of the extended settlement period since it is holding the foreign-traded security, not the U.S.-traded version of the

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<sup>42</sup> Certain Exchange Act class relief letters require ETFs to adopt a minimum creation unit size of 50,000 shares. *See, e.g.,* Letter from James A. Brigagliano, Division of Trading and Markets, Securities and Exchange Commission, to Stuart M. Strauss, Clifford Chance US LLP, re: Class Relief for Exchange Traded Index Funds (Oct. 24, 2006), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/etifclassrelief102406-msr.pdf>. However, some more recent relief has required only 10,000 share creation units. *See* John Hancock Exchange-Traded Fund Trust, Release No. 34-82234 (Dec. 7, 2017) available at <https://www.sec.gov/rules/exorders/2017/34-82234.pdf>.

<sup>43</sup> Rule 3b-4 of the Exchange Act defines foreign issuer as "any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country".

<sup>44</sup> 17 CFR 229.201(a).



security.<sup>45</sup> Most ETFs that hold foreign securities hold the local version of such securities. For example, most MSCI international indexes include the foreign version of the security rather than the U.S. version because the foreign version tends to be much more liquid (i.e., with higher trading volumes) than U.S.-traded securities of the foreign issuer.

## **Disclosure Issues.**

One of the main elements of the Proposed Rule is the new website and registration statement disclosure requirements. The Proposed Rule and related form amendments would require ETFs to disclose certain information on their websites and in their registration statements to increase transparency, including historical information regarding premiums and discounts, bid-ask spread information and information regarding a published creation/redemption basket. Specifically, the Proposed Rule requires disclosure of certain information on an ETF's websites for all ETFs that rely on the Proposed Rule. In addition, the Release proposes certain disclosure amendments to Form N-1A and Form N-8B-2 that would apply to *all* ETFs, including UITs and other ETFs unable to rely upon the Proposed Rule.

### *Website Disclosure.*

The Proposed Rule expands the website disclosure requirements applicable to ETFs. In addition to the portfolio holdings and basket information discussed in the prior section, each ETF (as a condition of relying on the Proposed Rule) must also disclose, among other things, the following information on its website:

- The ETF's NAV, market price,<sup>46</sup> and premium or discount, each as of the end of the prior business day (daily);
- Historical information regarding the median bid-ask spreads for the ETF's shares over the most recent fiscal year;
- A table and line graph describing the ETF's premiums and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year; and
- If the ETF's share premium or discount is greater than 2% for more than seven consecutive trading days, a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount. Also, this information must be posted on the website on the day immediately after the disclosure is triggered (*i.e.*, the eighth trading day) and must remain on the ETF's website for one year after its initial posting.

The stated purposes of these disclosures include providing investors with a "snapshot" into the difference between an ETF's NAV and market price.

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<sup>45</sup> This treatment is not necessary for American depositary receipts ("ADRs") and global depositary receipts ("GDRs"), which AMG agrees should not receive the benefit of extended settlement.

<sup>46</sup> Market price means (i) the official closing price of the ETF share, or (ii) if it more accurately reflects the market value of the ETF at the time the ETF calculates its NAV, the midpoint between the national best bid-offer (NBBO) at the NAV calculation time. The definition of "market price" in the Proposed Rule differs from the existing definition in Form N-1A, but the Proposed Rule would amend Form N-1A to remove the conflicting definition.

### *Registration Statement Disclosure.*

The Proposing Release details several new prospectus disclosure requirements designed to provide investors who purchase ETF shares on the secondary market with additional information, including information regarding costs associated with investments in ETFs. For example, the disclosure proposals would require ETFs to include registration statement disclosures that investors may be subject to brokerage and other fees when buying or selling ETF shares. These registration statement disclosures would apply to all ETFs, including those that fall outside of the Proposed Rule.

The disclosure proposals would also require additional fee and expense disclosure under a revised Item 3 of Form N-1A, which would be formatted as a series of Q&As designed to provide information about bid-ask spreads and other trading costs. Pursuant to revised Item 3, an ETF would be required to disclose its median bid-ask spread over the most recent fiscal year and to describe how the bid-ask spread would affect an investor's return on a hypothetical \$10,000 investment. ETFs would also be required to disclose mid-range and high-end spread costs. An ETF would be required to provide a cross-reference or hyperlink to its website, which would be required to provide an interactive calculator that would allow investors to test the hypothetical impact of such costs on their planned trading behavior. These new disclosure obligations would not apply to ETFs that have been in operation for less than one full fiscal year. In order to ensure consistent disclosure by ETFs that are organized as UITs (which are not otherwise covered under the Proposed Rule), the disclosure proposals also would revise Form N-8B-2 to require ETFs that are organized as UITs to provide the same information as is required by the revised Form N-1A.

### **Committee Comments on the Proposed Disclosure Requirements.**

AMG is generally supportive of providing additional information to investors regarding the costs of investing in ETFs. Along these lines, many ETF sponsors publish educational materials urging investors to consider the total cost of investing in ETF shares.<sup>47</sup> These efforts include advising investors to consider costs beyond the ETF's total expense ratio, such as bid-ask spreads and brokerage costs. Nevertheless, AMG has a number of comments and concerns regarding specific aspects of the Proposal, principally the required bid-ask spread disclosure and the interactive bid-ask spread calculator.

AMG agrees with the Commission that an understanding of the impact of bid-ask spreads is important to gaining an understanding of the costs of investing in ETF shares. However, bid-ask spreads represent only one element of ETF trading costs, and AMG fears that the Commission's disclosure proposals place too much emphasis on bid-ask spreads. Moreover, because the ETF does not have knowledge of investors' brokerage costs, retail investors will only have a partial and potentially misleading sense of ETF costs. As a result, retail investors may act on incomplete information and may not appreciate the true cost of acquiring and disposing of ETF shares.

AMG believes that rather than requiring prospectus disclosure of historical bid-ask spread information, retail investors would be better served by having clear disclosure regarding the potential impact of bid-ask spreads and brokerage costs on their purchases and sales of ETF shares.

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<sup>47</sup> See, e.g., To Determine an ETF's Total Cost of Ownership, Go Beyond the Expense Ratio, *available at* <https://global.spdrs.com/blog/post/2017/nov/to-determine-an-etfs-total-cost-of-ownership-go-beyond-the-expense-ratio.html>.

ETFs should be required to advise investors that they may incur brokerage fees and will bear the impact of bid-ask spreads when acquiring or disposing of any equity security, including ETF shares. If, however, the Commission requires ETFs to supply historical data regarding bid-ask spreads, AMG believes that there should be a number of changes to the Proposal to make the information provided to investors more consistent, more relevant and more comparable across ETFs, and more timely.

First, AMG is concerned with the utility of including the proposed historical bid-ask spread disclosures in ETF prospectuses.<sup>48</sup> AMG believes that the one-year look back might not be informative since backward-looking bid-ask spread disclosure does not inform a retail investor about what their costs will be now. Therefore, AMG recommends that the Commission reconsider the one-year historical bid-ask spread disclosure requirement. If the Commission elects to adopt any bid-ask spread disclosure requirement, AMG recommends that the Commission instead adopt a shorter, more relevant look back period, such as the most recent 45 days. This requirement would provide more meaningful information to retail investors since more recent data will be more likely to provide a realistic picture of likely bid-ask spreads. Moreover, if the 45-day historical bid-ask spread information is required, AMG recommends that the required information be made available on the ETF's website (subject to appropriate narrative disclosures). AMG believes that this website disclosure, which could be updated on a regular basis, will provide retail investors with more useful and more timely information about recent bid-ask spreads than static, stale prospectus disclosure.

AMG is also concerned that the bid-ask spread disclosure may vary from firm to firm and may be susceptible to manipulation and/or misuse due to differences in data sourcing. Bid-ask spread data is not data that ETFs control, so it will be necessary for ETFs to obtain the data from third parties such as the exchanges. To the extent that there is potential variability in the sources of data used to calculate bid-ask spread information, ETFs should disclose that although bid-ask spreads are calculated pursuant to a standardized formula, different data sources may result in bid-ask spreads that are not necessarily comparable over any given time period. AMG recommends that to the extent ETF bid-ask spread data must be disclosed at all, the disclosure should be made by the entities that generate the data – the exchanges on which ETFs trade.<sup>49</sup>

The proposed interactive bid-ask spread calculator raises additional challenges for ETF sponsors. AMG believes that for many of these reasons discussed above, including that bid-ask spread information represents only one element of ETF trading costs, the bid-ask spread calculator would be of limited utility to retail investors and should be removed from the Proposal.

AMG believes that unless the Commission mandates or creates a specific bid-ask spread calculator, there is the potential that each sponsor would create its own version and that each would vary slightly from each other. The potential for a lack of uniformity and consistency, as with the bid-ask

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<sup>48</sup> AMG also recommends that the Commission consider modifying the formula for the bid-ask spread information to be disclosed in the prospectus from a median bid-ask spread to another measure that provides more meaningful information (e.g., time-weighted average bid-ask spread).

<sup>49</sup> AMG also recommends eliminating the requirement in Q&A question 5 to disclose the impact of 25 round-trip transactions based on the Form N-1A Item 3 historical bid-ask spread disclosure. In AMG's view, 25 round-trips reflects an unrealistic estimate of typical ETF investor behavior. Instead, an investor could single round-trip example and multiply it by whatever number of round-trips he or she desires. If this disclosure requirement is retained, however, we recommend that the Commission reduce the number of round-trips in the example to a more realistic representation of likely investor behavior (which may vary by ETF sponsor).

spread data sourcing discussed above, could result in information that is not only not comparable between ETFs, but also potentially misleading to investors. If the Commission were to create an interactive calculator that would be hosted on [www.sec.gov](http://www.sec.gov) and supplied with bid-ask spread data from the exchanges on which ETF shares trade, retail investors would be better able to evaluate bid-ask spread information across ETFs. This would also eliminate the potential for manipulation and inconsistencies between ETF sponsors.

Consistent with the modifications described above, AMG supports the inclusion of new Q&As regarding trading costs. However, AMG believes that any remaining Q&A disclosures should be in the statutory prospectus rather than in the summary prospectus. The summary prospectus is designed to provide concise disclosures regarding an ETF's investment objective, principal policies and risks, estimated expenses and historical performance. In this regard, we note that the fee table disclosure in the summary prospectus provides comparability across different ETFs and even mutual funds while the Q&A disclosures may not even be comparable across ETFs. Therefore, AMG believes that placing the Q&A disclosures in the statutory prospectus is more appropriate.

#### *IIVs.*

As noted in the Proposing Release, intraday indicative values (“IIVs”) are not typically utilized by authorized participants and market makers.<sup>50</sup> These sophisticated market participants instead calculate their own measures of value. Accordingly, the Commission has proposed to eliminate the IIV dissemination requirement and AMG supports the elimination of the requirement. While the Proposed Rule will not require ETFs to make the IIV available, other types of relief necessary to operate an ETF under the Exchange Act may continue to require it, such as exchange listing rules, 19b-4 filings and certain types of Exchange Act class relief. AMG recommends that the Commission eliminate the requirement to calculate and disseminate the IIV under the Exchange Act rules.

#### **Other Issues Raised by the Proposal.**

In addition to the preceding comments on creation and redemption and disclosure issues, AMG has a number of comments on a variety of other topics raised by the Proposal.

#### **Committee Comments on the Scope of the Proposed Rule**

##### *ETFs as Redeemable Securities.*

AMG supports classifying all ETFs, including those that cannot rely on the Proposed Rule, as “redeemable securities” for purposes of Section 2(a)(32) of the 1940 Act. Since ETFs require exemptive relief beyond that provided by the Proposed Rule to operate, the Proposed Rule's provisions defining ETF shares as redeemable securities will have a positive impact on an ETF's ability to fit within or otherwise obtain class relief under the Exchange Act. To the extent that ETFs no longer have to seek relief from various Exchange Act provisions, the new ETF launch process should be further streamlined.

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<sup>50</sup> Proposing Release at 73.

### *Use of the Term “ETF”.*

AMG hopes that the Commission will confirm supplementally that UITs and other ETFs that cannot rely on the Proposed Rule can nevertheless be called “ETFs.” However, as noted by Commissioner Stein, the Proposed Rule does not directly address the establishment of standard classifications for various types of exchange-traded products such as ETFs. Often, the term “ETF” is used generically to refer to products that are exchange-traded regardless of the features, exposures and regulatory treatment of the products. While the Proposed Rule clearly defines what constitutes an ETF for purposes of the Proposed Rule, it does not attempt to limit the use of the term to those products relying on the Proposed Rule.

### *Simplification of the ETF Regulatory Regime.*

AMG is in favor of the Commission’s efforts to simplify the ETF regulatory regime by creating a consistent, transparent and effective regulatory framework. The proposed provisions relating to custom baskets provide the most obvious example of the Commission’s efforts to create such a framework. While AMG understands the exclusion of certain types of ETFs from the scope of the Proposed Rule at this time, we encourage the Commission to continue to evolve ETF regulation over time and to create consistent conditions across the Federal securities laws for all ETFs.

### *Suspension or Delisting.*

Under the Proposed Rule, ETFs that are delisted or suspended from their listing exchange, even ETFs subject to temporary trading suspensions, may no longer rely on the Proposed Rule. AMG recommends changing this provision. ETFs that are temporarily suspended from listing on an exchange, or that are engaged in an orderly delisting and liquidation process, should not fall outside of the scope of the Proposed Rule. ETF listing suspensions are often short-term in nature, so removing suspended ETFs from the scope of the Proposed Rule seems inappropriately harsh. Instead, ETFs should fall outside the scope of the Proposed Rule only when they are delisted.

### *Index Issues.*

ETFs that seek to track the performance of an index represent the vast majority of ETFs in both numbers of ETFs and in assets under management held in ETFs. Significantly, the Proposed Rule does not distinguish between index-based and actively managed ETFs, and does not incorporate the special requirements applicable to self-indexed ETFs under some current Exemptive Relief. The Release states that “index-based and actively managed ETFs that comply with the Proposed Rule’s conditions function similarly with respect to operational matters, despite different investment objectives or strategies, and do not present significantly different concerns under the provisions of the [1940] Act from which the proposed rule grants relief.”<sup>51</sup> Further, the Release notes that the distinction between index-based ETFs and actively managed ETFs has been blurred due to the “proliferation of highly customized, often methodologically complicated, indexes.”<sup>52</sup> Accordingly, the Commission suggests in the Proposing Release “that eliminating the regulatory distinction

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<sup>51</sup> See Proposing Release at 24.

<sup>52</sup> *Id.* at 26.

between index-based ETFs and actively managed ETFs would help to provide a more consistent and transparent regulatory framework for ETFs organized as open-end funds”<sup>53</sup> and would be consistent with the way other types of open-end funds are regulated. As a result, all ETFs relying on the Proposed Rule, whether index-based or actively managed, must comply with the same conditions. In addition, because the Proposed Rule does not distinguish between index-based and actively managed ETFs in its conditions (or otherwise), transparent actively managed ETFs would be able to take advantage of custom basket flexibility previously available only to a handful of ETF sponsors.

### **Committee Comments on Index Issues.**

AMG supports the Commission’s efforts to eliminate the needless distinction between index and active ETFs and to create a more level playing field between index and active ETFs. Related to this, AMG does not support requiring website disclosure of index tracking error for index ETFs. Having just proposed eliminating the distinction between index and active ETFs, it makes little sense for the Commission to immediately create and enforce a burdensome distinction between ETFs. Index ETFs currently provide information comparing fund to index performance in periodic financial reports and prospectuses. There is no need to create a new reporting requirement applicable to only to some ETFs. Moreover, to the extent that certain ETFs fall outside the scope of the Proposed Rule, they would not have to make such disclosures.<sup>54</sup>

### *Exchange Act Issues.*

ETFs require exemptive relief beyond that provided by the Proposed Rule to operate. In order to list shares on an exchange, ETFs must meet the requirements of the exchange listing rules. Most new ETFs meet the generic listing standards of their listing exchange, but some novel or complex ETFs do not. For ETFs that do not meet the generic exchange listing standards, it may be necessary to seek an Exchange Act rule change under Rule 19b-4 to enable the ETF's shares to list on an exchange. This process, which is overseen by T&M and driven by the exchange, can be lengthy, with complex or novel products taking upwards of nine months before being approved or disapproved for listing.

In addition, ETFs currently require relief from certain Exchange Act and other trading rules, including Regulation M Rules 101 and 102, Rule 10b-17, Rules 15c1-5 and 15c1-6, Rule 14e-5, Section 11(d) and Rule 11d1-2, Rule 200(g) of Regulation SHO and Rule 10b-10, unless they are eligible to rely upon certain “class relief letters” issued by T&M. While most ETFs come within the parameters of the class relief letters, those that do not have had to seek individual no-action or exemptive relief, which can take several months to obtain.

By defining ETFs as “redeemable securities” under the 1940 Act, the Proposed Rule addresses several issues raised in the class relief letters, including the issues raised under Regulation M, Rule 10b-17 and Rule 11d1-2. However, the Commission also requested comment on whether it should provide relief from Exchange Act Rules 10b-10, 15c1-5 and 15c1-6, as well as certain other

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<sup>53</sup> *Id.*

<sup>54</sup> As an example, all leveraged and inverse ETFs that are index-based and would fall outside of the scope of the Proposed Rule.

provisions. The class relief that ETFs currently rely on is subject to a variety of conditions, including minimum creation unit sizes, frequent dissemination of the IIV, restrictions on the payment of certain cash compensation or economic incentives to broker-dealers, minimum levels of diversification in the ETF's portfolio, and whether the ETF is managed to track an index. If relief from these other Exchange Act provisions were available to ETFs under the Proposed Rule, significant regulatory burdens would be removed, further paving the way for new and existing sponsors to bring products to market more rapidly and at a reduced cost.

### **Committee Comments on Exchange Act Issues.**

AMG strongly supports the Commission's efforts to provide expanded Exchange Act relief (e.g., Rule 14e-5, etc.). The complex nature of the ETF regulatory scheme will be greatly streamlined once the Proposed Rule takes effect, yet the number and complexity of the other regulatory requirements applicable to ETFs will remain significant without further Commission action. Even though any action the Commission takes on these Exchange Act issues falls outside of the Proposed Rule, AMG is eager to continue to work with the Commission and the T&M staff to streamline the various requirements of the ETF class relief letters to ensure that ETFs are subject to clear and logical regulations rather than the confusing, inconsistent mix of rules that exists today.

The Proposed Rule also does not address the ETF exchange listing (Exchange Act Rule 19b-4) process, which is overseen by T&M and is outside the scope of the Proposed Rule. However, as Commissioner Peirce noted in her statement on the Proposed Rule, the exchange listing rules add complexity and potentially lengthy delays to the ETF launch and listing process that should be addressed by future Commission action. AMG agrees wholeheartedly, and strongly supports future Commission reform of the ETF listing (Rule 19b-4) process. AMG believes that adopting the Proposed Rule without also addressing the challenges of the exchange listing process (as well as streamlining the various other Exchange Act trading issues discussed above) would amount to a half measure. This is not to say that AMG does not enthusiastically support the aims of the Proposed Rule, but rather that we believe that the Commission should take a holistic approach to ETF regulatory reform. AMG is looking forward to working with the Commission and the T&M staff to help frame a new approach to ETF listing and regulation under the Exchange Act.

As noted previously, AMG supports the elimination of the IIV publication requirement. Currently, IIV dissemination is required under various Exchange Act and exchange listing rules. If the principal regulatory scheme applicable to ETFs (the 1940 Act) no longer requires calculation and dissemination of IIVs, it seems illogical to continue to require it elsewhere. This is especially true in light of the Commission's conclusion that authorized participants and market makers do not make use of IIVs.

### **C. Conclusion**

AMG believes that the Proposal and the Proposed Rule reflect the careful, thoughtful consideration of the Commission and the IM staff, and represent an important milestone in the development of the U.S. ETF market. AMG is looking forward to discussing these comments with the Commission and the IM staff, as well as to working with the Commission and the IM and T&M staffs regarding further ETF regulatory reform to ensure that the U.S. ETF industry remains the most dynamic, innovative and safe ETF industry in the world.



SIFMA AMG sincerely appreciates the opportunity to comment and your consideration of these views. We stand ready to provide any additional information or assistance that the Commission might find useful. Please do not hesitate to contact either Timothy Cameron at 202-962-7447 ([tcameron@sifma.org](mailto:tcameron@sifma.org)) or Lindsey Keljo at 202-962-7312 ([lkeljo@sifma.org](mailto:lkeljo@sifma.org)), or our outside counsel, Edward Baer, Ropes & Gray LLP, at 415-315-6328 ([edward.baer@ropesgray.com](mailto:edward.baer@ropesgray.com)), with any questions.

Sincerely,

A handwritten signature in black ink, appearing to read 'T. Cameron', with a long horizontal flourish extending to the right.

Timothy W. Cameron, Esq.  
Asset Management Group – Head  
Securities Industry and Financial  
Markets Association

A handwritten signature in blue ink, appearing to read 'L. Keljo', with a large, stylized initial 'L'.

Lindsey Weber Keljo, Esq.  
Asset Management Group – Managing  
Director and Associate General Counsel  
Securities Industry and Financial  
Markets Association

cc: Honorable Jay Clayton, Chairman, U.S. Securities and Exchange Commission  
Honorable Kara M. Stein, Commissioner, U.S. Securities and Exchange Commission  
Honorable Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission  
Honorable Robert J. Jackson, Jr., Commissioner, U.S. Securities and Exchange Commission  
Honorable Elad L. Roisman, Commissioner, U.S. Securities and Exchange Commission  
Ms. Dalia Blass, Director, Division of Investment Management, U.S. Securities and  
Exchange Commission