Comment Letter on Issues Raised by Actively Managed ETFs, January 2002

January 14, 2002

Mr. Jonathan G. Katz
Securities and Exchange Commission Secretary
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Actively Managed Exchange-Traded Funds
(File No. S7-20-01)

Dear Mr. Katz:

The Investment Company Institute[1] is writing in response to the Commission's request for comment on issues relating to actively managed exchange-traded funds (ETFs).[2] The Institute is pleased that the Commission is soliciting public comment on the issues that may be raised by these products that, for the most part, are still in development. Such an approach will allow the Commission to consider a variety of views on these products to better enable it to determine the appropriate means by which to regulate them, consistent with the protection of investors and the Commission's interest in not stifling new and innovative investment products.

As noted in the Commission's Release, the type of ETF on which the Commission seeks comment does not currently exist. As such, it is not yet clear how such a product will be structured and operated. Accordingly, once such a product is created and its issuer files an application for exemptive relief from the relevant provisions of the Investment Company Act of 1940, there may be additional issues that would warrant additional comment. In the meantime, however, we have identified at least three particular areas in which actively managed ETFs may raise investor protection concerns not present with existing ETFs: portfolio holdings disclosure, the impact of adding an actively managed ETF class to a traditional mutual fund, and the potential for additional conflicts of interest. Each of these is discussed below.

I. Portfolio Holdings Disclosure

Disclosure of portfolio holdings is likely the most significant issue the Commission will need to consider in determining whether to extend to actively managed ETFs the exemptive relief that has been provided to date to ETFs. To the extent that all or part of an ETF's portfolio is not transparent, it could raise significant investor protection concerns that are not present with existing ETFs. These concerns include the potential for disparate treatment of investors and the potential for the ETF to trade at significant premiums and discounts. Because of the importance of these concerns, the Commission should proceed cautiously before approving any application for exemptive relief filed on behalf of an actively managed ETF whose portfolio is not transparent.

Unlike traditional mutual funds, ETFs have two distinct groups of investors—those that acquire the ETF shares directly from the fund and those that acquire them in the secondary market. The group that acquires the shares directly from the fund, the creation unit holders, acquires them by depositing a basket of securities that replicates or substantially replicates the fund's portfolio holdings and/or cash with the fund, in return for which they receive ETF shares that may be traded on an exchange.[3] The other group of investors, which are primarily retail investors, acquires their shares through a broker-dealer in the secondary market from the shares that have been traded by the creation unit holders on an exchange. Of these two groups of investors, only the creation unit holders may redeem their shares;[4] retail investors must trade them in the secondary market, much as they would any exchange-listed security.

Notwithstanding this difference in how ETF shares are acquired and disposed of, in the case of the outstanding index-based ETFs, both types of investors can, at any time, determine the contents of the ETF's portfolio. This is because the content of the portfolio is available on a daily basis and the portfolios track various market indices whose contents are known to investors. In addition, a proxy for intraday NAV per share is available continuously throughout each trading day to both groups of investors, thereby enabling them to check the reasonableness of bids and offers on an exchange. These features, together with the ability of a creation unit holder to create or redeem ETF shares at each day's NAV, help ensure that the ETF shares do not trade at a material premium or discount, but rather, maintain a price that tracks NAV.[5] Thus, the ability of existing ETFs, through arbitrageurs, market makers, and exchange specialists, to maintain a price that tracks NAV is directly related to the transparency of the fund's portfolio.[6]

At this point in time, it is far from clear how this mechanism could work in the case of an ETF whose portfolio is actively managed. For a variety of reasons, including logistical burdens and increased trading costs associated with disclosing an ETF's portfolio holdings on a real-time basis,[7] it is likely that all or part of the fund's portfolio will not be publicly disclosed. As a result, an actively managed ETF may be unable to maintain a market value that tracks NAV.[8] This is because arbitrageurs, market makers, and exchange specialists will likely be reluctant or unable either to make a market in funds within unknown portfolios or to hedge positions in such funds.[9]

It is possible that, in order to avoid this problem, an actively managed ETF might seek to selectively disclose its portfolio, i.e., to the creation unit holders but not to retail investors. The Institute believes that any such disparate treatment of investors would be contrary to the public interest. Selectively disclosing information to one group of investors—and allowing them to trade on the basis of this information—while keeping other investors in the dark would be fundamentally at odds with the core principles of the federal securities laws.

For these reasons, the Institute urges the Commission not to grant exemptive relief to any actively managed ETF that would disclose information about its portfolio holdings on a disparate basis to different groups of shareholders. We also believe that the Commission should proceed cautiously in granting relief to any actively managed ETF whose portfolio is not transparent, as it is highly unclear whether these funds will be able to reasonably ensure that their shares will trade at prices close to NAV. At the very least, any such "opaque" funds should be required to furnish investors with clear and prominent disclosure that highlights this risk, and in doing so, notes the differences between these funds, traditional ETFs, and traditional mutual funds.[10]

II. Adding a Class of ETF Shares to an Existing Mutual Fund

For a variety of reasons that are raised in the Release,[11] the addition of an actively managed ETF class to a fund likely would have a more significant impact on the fund's operations and shareholders than the addition of those ETF classes that the Commission has permitted to date. Of particular concern is the potential conflict between maximizing performance and facilitating arbitrage through disclosure of portfolio holdings. In order to address this and other concerns, we recommend that the Commission condition any exemptive relief involving the addition of such a class to an existing fund on the fund's board of directors finding that the addition of this class would not adversely impact existing shareholders.[12] Such a requirement should ensure that the board fully considers and vets the impact of the proposed class on the fund's other shareholders.

III. Conflicts of Interests

The Institute shares the Commission's concern with the conflicts of interest that may arise from the increased investment discretion of an adviser to an actively managed ETF.[13] Indeed, because such an adviser would have greater discretion to designate securities to be included in a creation unit holder's portfolio deposit or redemption basket, it would appear to be possible for the adviser to cause the fund to engage in activities indirectly that it cannot engage in directly under the Investment Company Act. For example, a fund that is prohibited under the Act from acquiring in an underwriting a security that is being underwritten by an affiliate of the fund, might be able to avoid this prohibition by including the security in the ETF's creation unit basket. By doing so, the adviser would, in effect, be requiring the creation unit holders to purchase the security. To address concerns such as this, we recommend that the Commission impose any prohibitions or conditions under the Act that would apply to transactions directly effected by the adviser on any transactions effected at the adviser's direction. So, for example, an adviser that is prohibited from acquiring a security directly from an affiliate should be prohibited from including such security in the ETF's deposit basket.

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The Institute appreciates the opportunity to provide these comments to the Commission. If you have any questions concerning these comments, please contact the undersigned at 326-5824 or Tamara Reed at 326-5825.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye, Director

David B. Smith, Associate Director
Division of Investment Management

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes9,063 open-end investment companies ("mutual funds"), 485 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.598trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] SEC Release No. IC-25258 (November 8, 2001), 66 Fed. Reg. 575614 (Nov. 15, 2001) (the “Release”).

[3] In accordance with no-action relief previously granted by the Commission to ETFs, fund shares are only to be issued or redeemed in creation unit aggregations of 50,000 shares or more and the value of each creation unit must be at least $1 million at the time of issuance. See The American Stock Exchange, SEC No-Action Letter (Aug. 17, 2001) (hereinafter “the 2001 AMEX letter”). This letter sets forth relief that “extends to all ETFs trading on any registered national securities exchange that have obtained Rule 19b-4(e) listing approval from the Commission.”

[4] The creation unit holders typically redeem in-kind.

[5] The no-action relief granted to ETFs by the SEC has, in part, also required that the intra-day proxy value of the ETF and the value of the “benchmark” index be publicly disseminated throughout the trading day in order to facilitate these arbitrage opportunities and to better ensure that the retail shares do not trade at a premium or discount to net asset value. See the 2001 AMEX letter.

[6] Also essential to the ability of the price of an ETF s to track NAV is the substantial similarity between the ETF’s creation and redemption baskets and the ETF’s total portfolio holdings.

[7] For example, such real-time disclosure may signal the intent of an adviser to a large actively managed ETF to buy or sell a large block of a particular security. This signal could cause other market participants to trade the security, thereby impacting the price of the security for the ETF’s adviser.

[8] We note that the relief that has been provided to ETFs to date has, in part, been conditioned on representations that the market price of the ETFs will trade at or very close to NAV.

[9] Some sponsors of actively managed ETFs may attempt to disclose the ETF’s portfolio holdings on a real-time basis. This, however, introduces a potential conflict between the goals of maximizing performance, on the one hand, and facilitating the arbitrage process, on the other. These potential conflicts would be greatly magnified if the ETF were organized as a separate class, as the interests of the shareholders in the ETF class could conflict with the interests of shareholders in other classes. See Section II, infra.

[10] Moreover, it might be appropriate for the Commission to require these funds to comply with the prospectus delivery requirements of Section 24(d) of the Investment Company Act, rather than treating purchasers of their shares as dealer transactions under Section 4(3) of the Securities Act of 1933.

[11] See Release at pp. 57623-57624.

[12] Consistent with the exemptive relief provided to an ETF class by the Commission to date, we also recommend that any future relief be subject to conditions designed to avoid any potential investor confusion between the traditional mutual share classes and the ETF class. See, e.g. Vanguard Notice of Application, 65 Fed. Reg. 61005, 61008 (October 13, 2000).

[13] See Release at p. 57622.