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August 26, 2005

Ms. Catherine McGuire
Associate Director and Chief Counsel
Division of Market Regulation
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Request for Exemptive Relief Regarding Exchange-Traded Funds

Dear Ms. McGuire:

The Derivative Products Committee of the Securities Industry Association,[1] with the support of Barclays Global Investors, N.A.,[2] is writing to seek relief from the requirements of Section 11(d)(1) under the Securities Exchange Act of 1934 (the "Exchange Act") in connection with certain extensions of credit on exchange-traded fund ("ETF") shares. Specifically, we request that the Securities and Exchange Commission (the "Commission"), pursuant to its authority under Section 36(a) of the Exchange Act, exempt from Section 11(d)(1) broker-dealers involved in the issuance and redemption of ETF shares that extend, maintain or arrange for the extension or maintenance of credit on such shares subject to the conditions described herein. For the reasons described more fully below, we believe the proposed exemption is necessary and appropriate in the public interest and is consistent with the protection of investors.

I. Background.

A. Overview of ETFs.

ETFs are investment companies registered under the Investment Company Act of 1940 (the "1940 Act") either as unit investment trusts or as open-end investment companies.[3] Shares of ETFs are traded by both institutional and retail investors on

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1 The Securities Industry Association ("SIA") brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. (More information about SIA is available at: www.sia.com.)

2 Barclays Global Investors, N.A., through its affiliate Barclays Global Fund Advisors, is the sponsor or investment advisor for over 100 exchange-traded funds with total assets of over $140 billion at July 31, 2005.

3 Certain ETF securities may be issued in the form of units; for simplicity, this letter refers to all such securities as "shares." The relief requested by this letter would not apply to transactions in

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securities exchanges and in the over-the-counter markets at negotiated prices. ETFs are designed to replicate the holdings or correspond to the performance and yield of a reference securities index by purchasing either the component securities underlying the index or a highly correlated subset of the securities underlying the index.

Over the past several years, ETFs have grown dramatically, both in number and volume, as investors have recognized the benefits of investing in ETF shares. These benefits to ETF investors include the following:[4]

- *Diversification.* ETFs are typically comprised of a basket of securities based on a broad index that offers investors significant diversification.
- *Reduced Costs and Execution Risks.* ETFs permit investors to gain exposure to the reference index at a cost that is generally lower than the all-in price of purchasing the component securities. In addition, ETFs generally offer no-load shares, with lower management fees than are usually charged by index-based mutual funds. As exchange-traded instruments, moreover, ETF shares can be traded among investors without imposing on the ETF the transaction costs associated with direct shareholder investments in and redemptions from an investment fund.
- *Liquidity and Transparency.* ETF shares are traded continuously and their prices are disseminated throughout the trading day. Estimated values for ETF shares are usually published in 15-second intervals and net asset value ("NAV") is calculated and disseminated once per day. In addition, the reference index or portfolio typically consists of publicly-traded securities with liquid markets and transparent prices. A number of ETFs are consistently among the most actively-traded securities on the American Stock Exchange and several ETFs (*e.g.*, Nasdaq 100 Index Tracking Stock and SPDRs) are among the most actively-traded securities in the U.S. equity markets.
- *Tax Efficiency.* In general, ETFs generate fewer capital gains than actively-managed mutual funds due to low turnover of the securities that constitute their portfolios. Furthermore, the unique in-kind issuance/redemption process for ETF shares, described more fully below, results in lower tax liabilities for the ETF (and indirectly, its investors) than an index-based mutual fund handling large inflows and outflows of cash.

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securities issued by closed-end investment companies or trust-issued receipts issued by entities not registered as investment companies under the 1940 Act.

4 *See generally* SEC Release 40-25,258 (Nov. 8, 2001), 66 Fed. Reg. 57,613 (Nov. 15, 2001) (concept release regarding actively-managed ETFs); Paul F. Roye, *Regulatory Issues Involving Exchange Traded Funds*, Speech at the American Stock Exchange Symposium on Exchange Traded Funds (Jan. 14, 2002).

The Commission and its staff have provided exemptive, no-action and interpretive relief to ETFs, and to broker-dealers effecting transactions in ETF shares, with respect to various provisions of the securities laws.[5]

B. Issuance and Redemption of ETF Shares.

ETFs have unique issuance and redemption features that distinguish them from other investment companies. In particular, ETF shares are issued and redeemed only in large amounts ("Creation Units") at prices based on the NAV of the ETF's shares. Generally, these Creation Units are issued by the ETF in exchange for an in-kind deposit of securities that generally mirrors the composition of the ETF portfolio and are redeemed in exchange for an in-kind delivery of securities.[6]

ETF shares are issued or redeemed through a distributor that is designated as the ETF's "principal underwriter" for purposes of the 1940 Act (the "Distributor"). Organizations that have entered into an agreement with the Distributor to become Authorized Participants ("APs") of the ETF may place orders with the Distributor to purchase or redeem Creation Units. These APs, which generally are broker-dealers acting in a principal capacity,[7] are not compensated by the ETF in connection with the issuance or redemption of ETF shares;[8] in fact, APs may be required to pay fees to the ETF to cover the transaction costs of issuing and redeeming the shares. A number of broker-dealer APs typically are actively involved in trading the ETF shares.

Broker-dealers, acting as APs, may place orders to purchase Creation Units of ETF shares to facilitate one or more customers that wish to exchange securities that mirror the composition of the ETF portfolio for ETF shares.[9] Broker-dealers acting as APs may also purchase Creation Units of ETF shares for their own inventory – *e.g.*, for proprietary trading, customer facilitation trades or risk management and hedging purposes. In addition, broker-dealers acting as APs may purchase or redeem Creation

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5 *See, e.g.*, iShares Trust (*avail*. Jul. 25, 2002); Vanguard VIPERS Small-Cap Index Fund, Total Stock Market Index Fund, Extended Stock Market Index Fund (*avail*. May 21, 2001); CountryBaskets Index Fund, Inc. (*avail*. Mar. 22, 1996); American Stock Exchange (*avail.* Jan. 28, 1993).

6 The investment adviser or sponsor of the ETF announces the contents of the in-kind deposit/delivery at the beginning of each business day. Certain ETFs reserve the right to issue and redeem shares for cash. In addition, a small number of ETFs based on foreign securities indices issue and redeem shares only on a cash basis.

7 APs generally are participants in the relevant clearing system (typically, DTC) for the shares.

8 However, some broker-dealers may be compensated by an ETF other than in connection with an issuance of ETF shares. *See, e.g.*, note 15 below.

9 Because of the size of Creation Units – typically in the range of 50,000 shares, with a market value frequently in excess of $1,000,000 – generally only large institutions are involved in the issuance or redemption of ETF shares. In secondary market transactions, however, ETF shares may be traded in any quantity by institutional and retail investors.

Units of ETF shares to arbitrage any differences between the market price of an ETF share and the NAV of the ETF share.

The participation by broker-dealers in the issuance and redemption of ETF shares offers a number of important benefits to investors and the marketplace. For example, through their arbitrage activities, these broker-dealers help ensure that ETF shares trade at or near their NAV.[10] Moreover, by making ETF shares available to customers through the issuance process or in secondary market trading, these broker-dealers support the liquidity of the ETF shares, thereby promoting market efficiency and reduced spreads. Because broker-dealers that are APs are also among the most active traders of ETF shares, these broker-dealers are able to offer significant market and product expertise and efficient execution to investors.

C. Prior Commission Guidance Regarding Section 11(d)(1).

Section 11(d)(1) generally prohibits a person who is both a broker and a dealer from extending or maintaining or arranging for the extension or maintenance of credit to or for a customer on any non-exempted security that is a part of a new issue in the distribution of which the broker-dealer participated as a member of a selling syndicate or group within the previous thirty days. The Commission has taken the position that shares of open-end investment companies and unit investment trusts registered under the 1940 Act, such as ETF shares, are distributed in a continuous manner, and that broker-dealers selling such securities are therefore participating in the "distribution" of a new issue for purposes of Section 11(d)(1).[11]

The Commission has provided limited relief from the requirements of Section 11(d)(1) for broker-dealers trading ETF shares. In particular, Commission staff has confirmed that it would not recommend enforcement action against broker-dealers who engage in or effect transactions in ETF shares in the secondary market, but who do not act as APs.[12] In addition, the staff has confirmed that broker-dealers that participate in the issuance of ETF shares may extend, maintain, or arrange for the extension or

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[10] Arbitrageurs play a crucial role in connection with the trading and pricing of ETF shares, which results in benefits for investors. *See generally* SEC Release No. 40-25,258 (Nov. 8, 2001), 66 Fed. Reg. 57,613 (Nov. 15, 2001). As described by the Commission, when an ETF trades at a price less than its NAV, broker-dealers may purchase individual ETF shares in the secondary market and, after accumulating enough shares to equal a Creation Unit, redeem them from the ETF at NAV, thereby acquiring the more valuable underlying securities. These redemptions reduce the supply of ETF shares and may raise the market price of such shares to a level closer to NAV. Conversely, if ETF shares trade at prices greater than NAV, arbitrageurs may purchase the underlying securities, use them to obtain the more valuable Creation Units from the ETF and then sell the individual ETF shares in the secondary market to realize a profit. As the supply of individual ETF shares increases, the price of the ETF shares may fall to levels closer to their NAV. *Id.* at 57,616.

[11] *See, e.g.,* SEC Release No. 34-6726 (Feb. 8, 1962), 27 Fed. Reg. 1415 (Feb. 15, 1962); SEC Release No. 34-21,577 (Dec. 18, 1984), 49 Fed. Reg. 50,174 (Dec. 27, 1984).

[12] *See e.g.,* letters cited in note 5 above.

maintenance of credit on such shares pursuant to Rule 11d1-2 if the shares have been owned by the customer for more than thirty days.[13] To date, however, the Commission and its staff have not provided any additional relief from the restrictions of Section 11(d)(1) specifically addressing broker-dealer APs that trade ETF shares.

II. Rationale for Relief from Section 11(d)(1) for Broker-Dealer APs.

The Commission is authorized under Exchange Act Section 36(a) to issue orders exempting persons, securities or transactions from the requirements of the Exchange Act if such exemption "is necessary or appropriate in the public interest, and is consistent with the protection of investors." In our view, it would be in the public interest and consistent with the investor protection objectives of the Exchange Act for the Commission to extend the relief from Section 11(d)(1) currently available for broker-dealers that trade ETF shares solely in the secondary market to include those broker-dealers that, as APs, also participate in the issuance of ETF shares.

As discussed more fully below, broker-dealers involved in the issuance of ETF shares do not have incentives to use credit to "push" such shares. In addition, many unique features of ETF shares – including their liquidity and the transparency of their pricing – provide additional protections to investors beyond those available for most new issues.

A. Broker-Dealer APs Do Not Have Incentives to Engage in "Share Pushing" of the Type that Section 11(d)(1) Was Intended to Address.

Section 11(d)(1) was intended to address conflicts of interest arising in circumstances in which a person acts as both a broker and a dealer. The restrictions it imposes on the extension, maintenance, and arranging of credit in connection with a new issue of securities are designed to protect investors from "one of the greatest potential evils inherent in the combination of the broker and dealer function in the same person, by assuring that [a broker-dealer] will not induce his customers to buy on credit securities which he has undertaken to distribute to the public."[14] Section 11(d)(1) thus seeks to prevent broker-dealers from "share-pushing" by offering credit for the purchase of newly-issued securities.

Broker-dealer APs do not have incentives to use credit to engage in the share pushing that Section 11(d)(1) was designed to address. First, broker-dealers participating in the issuance of Creation Units do not have the risk exposures that underwriters face in firm-commitment underwritings of new issues. For example, broker-dealer APs do not have capital at risk or market exposure of the type that an underwriter has with respect to its allotment of a new offering. APs are under no

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[13] Exchange Act Rule 11d1-2 provides an exemption from Section 11(d)(1) for broker-dealers who extend credit on securities issued by open-end investment companies or unit investment trusts registered under the 1940 Act to customers who have owned such securities for more than thirty days.

[14] H.R. Rep. No. 1383, 73rd Cong., 22d Sess. at 22 (1934).

obligation to place orders for any amount of Creation Units, and therefore they act only on a demand-driven basis – APs purchase Creation Units of ETF shares only as and when they or their customers need the ETF shares for trading or investment purposes. As a result, broker-dealer APs do not have an incentive to extend, maintain, or arrange credit to induce purchases of securities in order to reduce funding and market risk exposures.

Second, broker-dealer APs do not receive the types of special sales compensation typically paid to underwriters or placement agents. They are not paid an underwriting commission, concession or sales charge from the ETF or the Distributor in connection with the purchase of Creation Units of ETF shares from the ETF. As noted above, broker-dealers acting as APs generally are required to pay a transaction fee for the purchase of a Creation Unit. In addition, upon sale of the ETF shares comprising a Creation Unit to customers or other broker-dealers, a broker-dealer AP receives only a customary commission (if acting as agent) or mark-up/spread (if acting as principal), determined in the same manner as in any sale of stock by the broker-dealer in a secondary market transaction. These forms of compensation do not create any special incentives for a broker-dealer AP to extend, maintain, or arrange for the extension or maintenance of credit to investors in order to induce a purchase of the ETF shares.[15]

We note that upon the initial formation of an ETF, broker-dealer APs may invest in a substantial amount of ETF shares (in the form of Creation Units), among other reasons, to facilitate the launch of the new fund. In our view, there are important distinctions between the activities of such broker-dealers and those of firm-commitment underwriters – including that the broker-dealer APs are not compensated by the ETF for selling the new ETF shares to the public. In order to address any concerns that might arise regarding the incentives created by any such initial investment in the ETF, however, we believe it would not be inappropriate for the Commission to continue to apply Section 11(d)(1) to broker-dealer APs for a period of thirty days after the ETF shares initially commence trading.

B. Certain Features of ETFs Offer Additional Protections to Investors Who Obtain Credit on ETF Shares from Broker-Dealer APs.

Several features of ETF shares that distinguish them from other types of securities, including mutual fund shares, offer significant protections from inappropriate sales practices or other risks that Section 11(d)(1) would otherwise address. Section 11(d)(1) prevents broker-dealers from using financing to encourage a customer to purchase newly-issued securities for which there is no ready market.[16] In the case of ETF

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15 Some broker-dealers may be eligible to receive certain compensation for investor services pursuant to a plan adopted by an ETF under Rule 12b-1 of the 1940 Act ("12b-1 fees"). As discussed in more detail below, the proposed relief would be conditioned on APs not receiving certain compensation from an ETF, including 12b-1 fees.

16 *See*, *e.g.*, H.R. Rep. No. 1383, 73d Cong., 2d Sess. at 15 (1934) (referring to the difficulties for an underwriter in giving impartial advice, particularly with respect to "new securities for which there is no ready market").

shares, however, there is significant price transparency and liquidity. There is little risk that customers would purchase ETF shares on excessive credit due to an inability to accurately value the shares. As noted above, prices for ETF shares are readily available from secondary market transactions on the relevant exchange or in the OTC markets, and the NAV of the ETF shares is published regularly. Moreover, the ETF itself generally consists of liquid securities trading in transparent markets.

In addition, extensions of credit on ETF shares would not raise the types of concerns that the Commission staff has identified in the past when considering extensions of credit on mutual fund shares. In particular, Commission staff has expressed concern that if credit is extended on mutual fund shares, upon a decline in value of those shares investors faced with "margin calls" would seek to redeem the shares, forcing the mutual fund to liquidate its assets and potentially creating additional "downward" price pressure and related operational problems for the fund.[17] We believe that this is less likely to occur in the context of ETFs because investors in ETF shares can sell those shares in a liquid secondary market rather than redeeming them. Moreover, even when redemptions are made by an ETF, the fact that they are made in kind prevents any disruption to the ETF's investment strategy (since, unlike a mutual fund, the ETF would not need to liquidate some of its investments to fund a redemption payment made in cash).

There is also little risk that any credit extended on ETF shares by broker-dealer APs would affect the prices of those shares. As noted above, the in-kind issuance and redemption features of ETFs offer arbitrage opportunities that significantly limit the extent to which ETF shares trade at a premium or discount to the NAV of the ETF shares. Consequently, credit on ETF shares is unlikely to affect the volatility of those shares or otherwise provide a mechanism through which broker-dealer APs or other market participants could affect the price of ETF shares by influencing their supply or demand.

III. Conditions to Relief.

In order to address any concerns the Commission may have regarding broker-dealer APs extending, maintaining or arranging for the extension or maintenance of credit on the shares of an ETF for improper reasons, the exemptive relief could be made subject to the following conditions:

1. Neither the broker-dealer AP nor any natural person associated with such broker-dealer AP, directly or indirectly (including through any affiliate of such broker-dealer AP), receives from the fund complex[18] any payment,

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[17] Investment Company Institute (*avail*. Jan. 19, 1989) ("numerous and sudden redemptions of fund shares . . . [resulting] from forced close-outs of margin accounts if margin calls were not answered with respect to fund shares that were purchased on credit . . . could have a substantial and deleterious effect on the fund's operations").

[18] For purposes of this letter, the term "fund complex" means the issuer of the ETF shares, any other issuer of ETF shares that holds itself out to investors as a related company for purposes of

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compensation or other economic incentive to promote or sell shares of the ETF to persons outside the fund complex,[19] other than non-cash compensation permitted under NASD Rule 2830(l)(5)(A), (B), or (C).[20]

2. The broker-dealer AP does not extend, maintain or arrange for the extension or maintenance of credit to or for a customer on shares of the ETF before thirty days have passed from the date that the ETF's shares initially commence trading (except to the extent that such extension, maintenance or arranging of credit is otherwise permitted pursuant to Rule 11d1-1).

3. The ETF shares are issued by an open-end investment company or unit investment trust registered with the Commission under the 1940 Act.

4. The ETF shares are listed and trade on a market that has obtained approval from the Commission pursuant to Section 19(b) of the Exchange Act of a rule change regarding the listing and trading of the ETF shares on the market (or that is relying on Rule 19b-4(e) to list and trade the ETF shares).

5. The ETF (a) consists of a basket of twenty or more component securities,[21] with no one component security constituting more than 25% of the total value of the ETF, and is managed to track a particular index

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investment or investor services, any investment adviser, Distributor, sponsor, depositor or trustee (in the case of a unit investment trust) of any such issuer or any "affiliated person" (as defined in the 1940 Act) of any such issuer or any such investment adviser, Distributor, sponsor, depositor or trustee.

19 Indirect payments would include a "sales load," as that term is defined in Section 2(a)(35) of the 1940 Act, on ETF shares. We understand that the requested relief from Section 11(d)(1) would not be available to a broker-dealer for transactions in shares of an ETF that charges a sales load either during the initial distribution period for the shares or thereafter, although requests for such relief would be considered by the Commission staff on a case-by-case basis.

20 ETFs may be formed as different series of shares issued by a single trust or company that is registered under the 1940 Act. For purposes of this letter, each such separate series would be viewed as a separate ETF. All classes of securities that are part of the same series would be deemed the same "ETF shares" for purposes of determining whether a broker-dealer AP or any associated person receives from the fund complex any payment, compensation or other economic incentive to promote or sell the ETF shares, even if the other classes of securities are not exchange-traded. Consequently, a broker-dealer's receipt of compensation from the fund complex to promote one class of shares would disqualify the broker-dealer from extending credit in reliance on this letter on any ETF shares that are part of the same series, but would not affect the ability of the broker-dealer to extend credit in reliance on this letter on other ETF shares that are part of a different series issued by the same entity.

21 For purposes of this letter, the term "component securities" means the individual securities that comprise the ETF basket (*e.g.*, securities that are assembled to replicate the particular index that the ETF tracks).

whose components are publicly available,[22] or (b) is an existing ETF with respect to which non-AP broker-dealers are eligible for relief from the requirements of Section 11(d)(1) pursuant to a letter dated prior to the date of any exemptive relief granted in response to this letter.

IV. Conclusion.

For the reasons stated above, we respectfully request that the Commission, pursuant to its authority under Section 36(a) of the Exchange Act, exempt from Section 11(d)(1) broker-dealers involved in the issuance and redemption of ETF shares that extend or maintain or arrange for the extension or maintenance of credit on such shares subject to the conditions described in Part III above.

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If you have any questions, please do not hesitate to contact Jerry Quinn, Associate General Counsel of SIA, at 212-618-0507 or Robert W. Cook of Cleary Gottlieb Steen & Hamilton LLP, counsel to the SIA Derivative Products Committee in this matter, at 202-974-1538.

Sincerely yours,

/s/ Georgia Bullitt
Georgia Bullitt
Executive Director
Morgan Stanley & Co. Incorporated
on behalf of the
SIA Derivative Products Committee

/s/ John R. Vitha
John R. Vitha
Vice President and
Associate General Counsel
Goldman, Sachs & Co.
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/s/ Joanne T. Medero
Joanne T. Medero
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cc: Robert L.D. Colby, Deputy Director
Michael A. Macchiaroli, Associate Director
Brian A. Bussey, Assistant Chief Counsel
Norman M. Reed, Special Counsel
Division of Market Regulation

22 In our view, it would be appropriate to determine whether any one component security constitutes more than 25% of the total value of the ETF as of the most recent rebalancing of the ETF's reference securities index.