MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

May 20, 2008

Via Electronic Mail: rule-comments@sec.gov

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Exchange-Traded Funds; S7-07-08

Dear Ms. Morris:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on Release IC-28193 (the "Release") issued by the Securities and Exchange Commission ("SEC" or "Commission") regarding proposed rules under the Investment Company Act of 1940 (the "Act") with respect to exchange-traded funds ("ETFs").

We generally support the Commission's rulemaking initiatives regarding ETFs, which we believe will ultimately result in benefits to investors. The comments we submit for the Commission to consider are limited to proposed rule 12d1-4 (the "Proposed Rule"), Exemption for Investment Companies Investing in ETFs. The Proposed Rule does not provide an exemption to funds that rely on section 3(c)(1) or 3(c)(7) of the Act (together "Private Funds"). As discussed below, we request the Commission extend the exemption contained in the Proposed Rule to Private Funds.

I. Background and Introduction

The Proposed Rule provides an exemption to permit investment companies to invest in ETFs in excess of the limits of section 12(d)(1) of the Act, subject to four conditions that are designed to prevent the types of abuses historically associated with fund of funds arrangements. By statute, Private Funds relying on sections 3(c)(1) and 3(c)(7) are not investment companies, except for purposes of the limitations set forth in subparagraphs (A)(i) and (B)(i) of section 12(d)(1).[2] The Release is silent as to whether Private Funds were intentionally excluded from the

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[1]MFA is the voice of the global alternative investment industry. Our members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2]Section 3(c) of the Act states that "none of the following persons is an investment company within the meaning" of the Act. Each of sections 3(c)(1) and 3(c)(7) contains an exception to this exclusion from the

Proposed Rule and fails to provide a policy rationale for their exclusion.[3] MFA believes that Private Funds should be treated like other investment companies under the Proposed Rule and allowed to invest in ETFs without regard to the 3% limit contained in subparagraphs (A)(i) and (B)(i) of section 12(d)(1) (the "3% limit"), subject to the conditions of the Proposed Rule. We believe extending the application of the Proposed Rule to Private Funds is consistent with the public interest and the protection of investors.

The Role of ETFs

Like other institutional investors, including other types of investment companies, Private Funds may use ETFs as part of their overall investment strategy, as well as to "equitize" cash balances to earn returns in excess of money market rates. In addition, Private Funds use ETFs for hedging and risk management purposes. For example, investment advisers with significant short positions in a specific industry or sector will often seek to hedge their exposure through the acquisition of a long position in an industry or sector-specific ETF (and *vice versa* for advisers with significant long positions in individual names).

In light of recent market events, regulators and market participants have been focusing on risk management generally and the development of enhanced risk management tools in particular. In light of this effort, we believe that effective regulation should strive to remove obstacles to the use of ETFs by Private Funds. In fact, we believe that the tremendous growth in the use of ETFs for hedging purposes enhances market transparency and ultimately benefits the individual investor. Prior to the advent of ETFs, it was more common to hedge industry and sector risk through the placing of single-name long purchases (or short positions) against the dominant issuer in a particular sector. Such a practice could result in a distortion of market prices because issuers were bought and sold as loose hedges for other positions.

We respectfully submit that Private Funds should not be singled out for exclusion from the ability to make expanded use of ETFs for this purpose, particularly in the absence of any stated public policy concern relating to Private Funds' use of ETFs.

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definition of investment company for funds relying on its provisions. Specifically, section 3(c)(1) states "[s]uch issuer shall be deemed to be an investment company for purposes of the limitations set forth in subparagraphs (A)(i) and (B)(i) of Section 12(d)(1) governing the purchase or other acquisition by such issuer of any security issued by any registered investment company and the sale of any security issued by any registered open-end investment company to any such issuer." Section 3(c)(7) includes the same provision.

[3] We note that the Release in footnote 194 inaccurately discusses the application of section 12d(1) to "registered and unregistered" funds and states that a registered fund is subject to limits with respect to investments in an unregistered fund. In 1996, the National Securities Markets Improvement Act ("NSMIA") amended the Act to permit registered investment companies to invest in Private Funds outside the scope of section 12(d)(1). *See* sections 3(c)(1) and 3(c)(7) of the Act. In addition, footnote 194 of the Release states that unregistered funds are subject to all of the limitations contained in section 12(d)(1). As noted above, Private Funds' investments in registered investment companies are subject only to the limits set out in subparagraphs (A)(i) and (B)(i) of section 12(d)(1).

II. The Commission Should Extend the Proposed Rule to 3(c)(1) and 3(c)(7) Funds

We believe the conditions set forth in the Proposed Rule adequately address the abuses and concerns that historically were associated with fund of funds arrangements and that led Congress to enact section 12(d)(1) of the Act. These abuses included undue influence and control by an acquiring fund, excessive fees when one fund invested in another, and the formation of overly complex structures that could be confusing to investors.[4]

The Commission has not publicized, and we are not aware of, any manipulative or abusive practices concerning ETFs that are unique to Private Funds. There is no record to support that a distinction between Private Funds and other investment companies for purposes of the Proposed Rule is warranted; nor has the Commission articulated a policy rationale for the different treatment of Private Funds. In fact, as discussed above, we believe that the enhanced use of ETFs by Private Funds may lead to lower volatility in the stocks of leading industry and sectoral issuers. We believe the conditions set forth in the Proposed Rule will be equally effective when applied to Private Funds as to other investment companies in preventing the abuses underlying section 12(d)(1), and do not believe that there is a policy rationale to distinguish between Private Funds and other investment companies.

Private Funds, for purposes of Rule 12d1-1 under the Act, are treated identically to other investment companies and have been able to invest in shares of registered money market funds in excess of the limits of section 12(d)(1).[5] Such investments by Private Funds and registered investment companies have not implicated the concerns that underlie section 12(d)(1).[6] Similarly, we believe that treating Private Funds comparably to other types of investment companies for purposes of the Proposed Rule is justified, because the conditions of the Proposed Rule address the concerns that underlie section 12(d)(1) and are equally applicable to all types of investment companies that acquire ETF shares.

Analysis

The number of ETFs available on the market has grown 42% since March of 2007, while assets of ETFs have increased by 28.6%.[7] Clearly, there is a great deal of investor demand for ETFs. Providing Private Funds the flexibility of investing in ETFs above the 3% limit under the Proposed Rule would bring many investor and market benefits. It would enhance the ability of Private Funds to meet their investment objectives, enhance market transparency, and increase liquidity and trading of ETFs, among other benefits. Adequate protections are built into the Proposed Rule to prevent fund of funds abuses. The conditions of the Proposed Rule are designed to address concerns with fund of funds relating to undue influence and control, excessive fees, and the formation of overly complex structures.

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[4] *See Hearings Before House Subcomm. of the Comm. on Interstate and Foreign Commerce on H.R. 10065,* 76th Cong., 3d Sess. at 112 (1940).

[5] 71 Fed. Reg. 36640, 36643 (June 27, 2006).

[6] 68 Fed. Reg. 58229 (Oct. 8, 2003); 71 Fed. Reg. 36640, 36641 (June 27, 2006).

[7] Exchange-Traded Fund Assets, March 2008, ICI Statistics and Research, *available at* http://www.ici.org/stats/etf/arc/etfs_03_08.html.

A. Control

The conditions of the Proposed Rule are adequate to prevent a Private Fund from unduly influencing or controlling an ETF in which it invests in reliance on the Proposed Rule. The Proposed Rule exempts an investment company from the investment limits of section 12(d)(1) only if it does not "control" the ETF. The Release provides that "[a] determination of control depends on the facts and circumstances of the particular situation."[8] The Release further states that even if an acquiring fund has beneficial ownership of less than 25% of the ETF's outstanding voting securities, if it exercises a controlling influence over the ETF, it would not be able to rely on the exemption. The Proposed Rule also provides that if, as a result of a decrease in the outstanding voting securities of an ETF, the acquiring fund and any entity in a control relationship with it, either individually or together in the aggregate, become holders of more than 25% of the outstanding voting securities of an ETF, each of those shareholders must vote its shares of the ETF in the same proportion as the vote of all the other ETF shareholders.

These same limitations would prevent a Private Fund and an entity in a control relationship with it from taking advantage of their position to use the assets of the acquired ETF to enrich themselves at the expense of the ETF's other shareholders. By not being able to control the acquired ETF, a Private Fund would not be in a position to exercise a controlling influence over the management or policies of the ETF. A Private Fund, and any entity in a control relationship with it, that overreached or tried to influence the terms of any services or transactions with an acquired ETF would find themselves unable to rely on the Proposed Rule. Additionally, the "echo" voting provision of the Proposed Rule would ensure that a Private Fund does not inadvertently control an ETF, by requiring a Private Fund that becomes a holder of more than 25% of the outstanding voting securities of an acquired ETF by virtue of a reduction in the number of outstanding ETF shares, to vote its shares in the same proportion as the vote of all the other ETF shareholders. Accordingly, we are confident that the "control" limitations contained in the conditions of the Proposed Rule would fully protect ETFs and other shareholders of ETFs from a Private Fund that owns more than 3% of the outstanding voting stock of the ETF, and prevent a Private Fund from controlling or taking advantage of an ETF.

B. Redemptions

The second condition of the Proposed Rule precludes an acquiring fund from redeeming from the ETF shares it acquired above the 3% limit. This condition, when applied to a Private Fund (just like to any other investment company), would prevent it from being able to threaten large-scale redemptions as a means of coercing an ETF or exercising undue influence.[9] We note, however, the Proposed Rule presents certain administrative challenges with respect to the tracking of ETF shares. We are concerned that the difficulty of implementing a tracking method to abide by the Proposed Rule may negate any practical benefits of the Proposed Rule. We suggest that the Commission consider volume and time limitations on redemption (for example, no more than 1% per month during any month in which the fund is over the 3% limit), rather than rendering particular shares ineligible for redemption.

[8] 73 Fed. Reg. 14637 at n. 218 (Mar. 18, 2008).

[9] To our knowledge, most Private Funds purchase and sell ETF shares in secondary market transactions.

C. Layering of Fees

Another Congressional concern regarding fund of funds arrangements was that investors in the fund of funds would be subject to two layers of advisory fees. The Commission's 1966 report to Congress, *Public Policy Implications of Investment Company Growth*, found that the layered costs of a fund of funds were significantly higher than the costs of an ordinary mutual fund.[10] The Commission has determined that this concern should not prevent other investment companies from investing in ETFs in excess of the limitations set out in section 12(d)(1), subject to the conditions of the Proposed Rule. We respectfully submit that the possible layering of fees should not be viewed as a greater concern for investors in Private Funds than for the shareholders of the other types of investment companies covered by the Proposed Rule. In fact, we believe that this is less of a concern with respect to Private Funds than other investment companies.

First, only sophisticated investors are generally able to invest directly in Private Funds.[11] These investors are able to evaluate the merits and appreciate the risks and costs associated with investments in Private Funds. These investors are able to judge for themselves whether the fees of a Private Fund that invests in an ETF are appropriate.

Second, that Private Funds are not subject to investment limitations under section 12(d)(1) with respect to their investments in other Private Funds is a key indication that Congress did not intend to regulate the level of advisory fees the investors in Private Funds pay directly or indirectly. If this were not the case, we would have expected that Congress would have taken the opportunity, when it enacted NSMIA in 1996, to amend the Act to subject Private Funds to the limitations of section 12(d)(1) with respect to investment in other Private Funds.[12]

Finally, advisers to Private Funds are subject to recently adopted rule 206(4)-8 under the Investment Advisers Act of 1940, which subjects disclosures made by the investment adviser to a Private Fund to investors and prospective investors in such fund to an anti-fraud standard. This rule should be adequate to address the disclosure issues surrounding the possible layering of advisory fees caused by a Private Fund's investment in ETFs.

Thus, we believe that allowing Private Funds to invest in ETFs in excess of the 3% limit, subject to the conditions of the Proposed Rule, does not raise policy concerns with respect to excessive advisory fees.

D. Complex Fund Structures

We do not believe that the risk of an overly complex structure is any greater for a Private Fund investing in an ETF under the Proposed Rule than for any other type of investment company that may rely on the Proposed Rule. Indeed, for the reasons discussed above with respect to the layering of advisory fees, we believe that the risk of an investor in a Private Fund

[10] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess., 319-320 (1966).

[11] With respect to Private Funds relying on section 3(c)(1), investors are generally accredited investors within the meaning of the Securities Act of 1933 and Regulation D thereunder. Investors in Private Funds relying on Section 3(c)(7) must generally be qualified purchasers as defined in section 2(a)(51) of the Act.

[12] House Report No. 104-622, 104th Cong., 2d Sess., (1996).

being confused by a fund of funds structure involving an investment in ETFs is likely to be less than for a shareholder of other types of investment companies that will be permitted to rely on the Proposed Rule. In that regard, Private Funds frequently engage in complex, structured transactions, compared to which an investment in an ETF in excess of the 3% limit seems fairly simple. Accordingly, we submit that the risk of an overly complex structure does not seem particularly compelling with respect to Private Funds and the protection of their investors.

III. Conclusion & Recommendation

For the stated reasons, we believe extending the exemption afforded by the Proposed Rule to Private Funds is consistent with the public interest and the protection of investors. The conditions set forth in the Proposed Rule will be equally effective when applied to Private Funds in preventing the abuses at which section 12(d)(1) of the Act is directed. As a result, we do not believe there is a policy rationale for the Proposed Rule's exclusion of Private Funds.

Extending the Proposed Rule to cover Private Funds would facilitate these funds' ability to engage in hedging transactions and to use ETFs as a risk management tool in a manner consistent with the protection of investors. The exemption would also increase the potential pool of investors and assets available for investment in ETFs, thereby, enhancing liquidity and trading of ETFs.

MFA recommends that the Commission extend the exemption of the Proposed Rule to Private Funds by defining Private Funds as an investment company for purposes of proposed rule 12d1-4, just as they are defined as an investment company for purposes of subparagraphs (A)(i) and (B)(i) of section 12(d)(1). Specifically, we recommend the Commission adopt the following language under proposed rule 12d1-4(d), Definitions:

> "(4) Investment company includes a company that would be an investment company under section 3(a) of the Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7))."

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MFA appreciates the opportunity to provide comments to the Release, and respectfully requests for the reasons stated herein that the Commission extend the relief provided by the Proposed Rule to Private Funds. We welcome an opportunity to meet with Commissioners and staff if it would provide assistance to your rulemaking efforts. Please do not hesitate to contact me or Jennifer Han with any questions at (202) 367-1140.

Respectfully submitted,

Richard H. Baker
President and Chief Executive Officer

CC: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Kathleen L. Casey, Commissioner
Mr. Andrew Donohue, Director, Division of Investment Management