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May 29, 2008

United States Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Attn: Nancy M. Morris, Secretary

Re: Exchange-Traded Funds: Proposed Rule: File No. S7-07-08.

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law of the American Bar Association ("ABA"), in response to a request for comment by the Securities and Exchange Commission (the "Commission") in proposing several new rules[1] under the Investment Company Act of 1940 ("Act"), as well as amendments to existing rules of the Commission, that would relate to certain exchange-traded funds ("ETFs").[2]

The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

We commend the Commission for proposing the New Rules and agree that their adoption should help "eliminate unnecessary regulatory burdens, and to facilitate greater competition and innovation among ETFs".[3] We appreciate the opportunity to comment on the New Rules as per the Proposing Release. All terms used in this letter which are not specifically defined herein are as defined in the Proposing Release, including the terms "exchange- traded fund" and "ETF".[4]

The Proposing Release poses many questions of a technical, economic or highly specific nature that are better addressed by those with more business, economic, operational or marketing expertise. Accordingly, we have limited our comments to those legal issues that relate to the New Rules and their implementation.

A. Brief History of ETFs and Background of the New Rules

Commencing in 1993 with the launch of SPDRs[5]on the American Stock Exchange , ETFs have become "an increasingly popular investment vehicle"[6], and today there are in excess of 600 ETFs listed and trading in the U.S.[7] During this fifteen-year period, the Commission has had ample opportunity to review the actual operations of these ETFs as well as to observe the trading history of their shares bought and sold in the secondary markets on national stock exchanges. The nature and scope of ETFs has expanded considerably from the SPDR Trust and other UITs whose portfolios replicated domestic third party equity indices.[8] Today there are ETFs structured as open-end investment companies whose portfolios replicate, "sample" or "optimize" indices of debt securities,[9] as well as domestic and international equity indices, which may be "cap" [10] weighted, "equally" weighted or "fundamentally"[11] weighted and designed to provide exposure to a particular market style, sector, segment or region.[12] During the past several years, the Commission has approved leveraged and "inverse" ETFs that are not based on underlying indices but which use a "rules- based" methodology[13] for their portfolio selection, as well as ETFs which use affiliated index providers.[14] Most recently, the Commission has approved the first transparent actively managed ETFs,[15] five of which have commenced trading in the secondary market as of the date hereof.[16]

All of this activity hinged upon the processing of more than 60 individual applications for exemptive relief to establish and operate ETFs, whether granted directly by the Commission or via its delegated authority through its Division of Investment Management ("Division).

B. New Rule 6c-*11*

We commend the Commission for proposing New Rule 6c-11 which is "designed to permit certain ETFs to commence operation without incurring the costs and delay of obtaining an exemptive order from the Commission".[17] Clearly, the Commission has grown comfortable with the structure of Index-based ETFs and their regulatory issues, and has decided that that exemptive relief for such ETFs should be codified. We agree with the Commission that the adoption of New Rule 6c-11 would be more efficient for ETF sponsors as well as the staff members of the Division and would aid in the establishment of new Index-based ETFs by minimizing the time to market as well as reducing the costs associated with obtaining individual exemptive relief on a case-by-case basis.

1. *The exclusion of ETFs structured as unit investment trusts under the Act ("UITs") from the Proposed Rule 6c-11(e)(4)*

As drafted, Proposed Rule 6c-11(e)(4) is applicable only to open-end investment management companies ("open-end funds"). We believe that ETFs organized as UITs also should be able to rely upon the Proposed Rule. Despite the fact that the vast majority of ETFs are organized as open-end funds and that the Commission has not received an

exemptive application from a UIT applicant since 2002,[18] we believe that no useful purpose is served by prohibiting UITs from relying upon the Proposed Rule. As discussed above, innovations in ETF structure occur frequently and the end-use application of these securities is hard to predict; in the future an ETF organized as a UIT may be the perfect structure for a particular set of needs.

Given that the Commission is very familiar with ETFs organized as UITs and has granted a number of orders, we recommend that the Proposed Rule be drafted to permit such ETFs to rely upon its provisions. We recognize that certain provisions of the New Rules may need to be revised or "tweaked" to the extent that conditions for ETFs organized as UITs differ from those of ETFs organized as open-end funds[19], but the exemptive applications and the resulting orders granting relief to UITs should provide the necessary language.[20]

2. *Proposed Relief from Section 17 of the Act for In-Kind Transactions Between ETFs and Certain Affiliates*

We believe the proposed relief from Sections 17(a)(1) and (2) to permit first- and second-tier affiliates of ETFs by reason of share ownership ("Ownership Affiliates") to transact with the ETFs is appropriate and necessary. The primary rationale for the adoption of Section 17(a) was to prevent affiliates of a fund from engaging in transactions with the fund that would benefit the affiliate and harm the fund's shareholders. Because many ETFs utilize in-kind transactions in connection with the creation or redemption of their shares, these sections of the Act have the effect of prohibiting an Ownership Affiliate of an ETF from becoming an Authorized Participant of the ETF, absent exemptive relief.

As explained in the Proposing Release, relief for Ownership Affiliates has been granted in previous exemptive orders because ETFs do not treat such affiliates differently from non-affiliates when engaging in purchases and redemptions of creation units, and there is no opportunity for them "to effect a transaction detrimental to other ETF shareholders."[21] Therefore, we agree with the Commission that codification of these exemptions for Ownership Affiliates in the Proposed Rule is appropriate.

The Proposing Release also requests comment on whether this relief should be extended to other affiliates. We recommend that that the Commission extend the proposed exemption to other affiliates of an ETF using the same analysis in the Proposing Release; that is, the Commission should similarly grant exemptions to other affiliates of an ETF if there is no opportunity for such affiliates to benefit in the creation and redemption process to the detriment of other fund shareholders, unless there is some countervailing policy concern that would dictate a contrary result.[22] Thus, for the same reasons relief from Sections 17(a)(1) and (2) was granted to Ownership Affiliates, we recommend that such relief be expanded to encompass other affiliates, including broker-dealers that are affiliated with an ETF's adviser, so long as such affiliate is not a "specialist" or a "lead market-maker"[23] on the primary market for that security (collectively, "Other Affiliates"). Given that specialists or lead market makers for an ETF have significant control over the market price of an ETF's shares,

and the potential for other conflicts of interest that the Commission has not yet been asked to consider, we believe that it may not be in the best interest of ETF investors for the Commission to include this category of affiliated broker-dealers as Other Affiliates permitted to rely upon the Proposed Rule. This, of course, would not preclude affiliated specialists or lead market makers from submitting individual applications for relief from Sections 17(a)(1) and (2).[24]

We believe that no useful purpose would be served by prohibiting Other Affiliates, including affiliated broker-dealers, from making in-kind purchases or in-kind redemptions. Like Ownership Affiliates, Other Affiliates would purchase and redeem creation units in exactly the same manner, on the same terms, and at the same value as other Authorized Participants. As noted in the discussion in the Proposing Release regarding affiliated index providers, registered investment advisers, broker-dealers, and ETFs "well understand the potential circumstances and relationships that could give rise to misuse of non-public information, and can develop appropriate measures to address them."[25]

As a practical matter, we understand that the method of valuing portfolio securities held by each ETF is the same as that used for calculating in-kind purchase or redemption values and therefore creates no opportunity for an affiliate to effect a transaction detrimental to the other shareholders of that ETF. Similarly, because each ETF uses the same standards for valuing its portfolio securities that is used to calculate in-kind redemptions or purchases, each ETF will ensure that its NAV will not be adversely affected by such securities transactions.

Moreover, ETFs stand to benefit from increasing the number of Authorized Participants that may transact in their shares. By increasing the number of Authorized Participants that may transact directly with the ETF, even by only one additional Authorized Participant, the arbitrage mechanism can only be improved. All ETF shareholders would benefit equally from any incremental strengthening of the arbitrage mechanism.

3. *The definition of "Principal Underwriter "under the 1940 Act*

We ask that the Commission confirm that Authorized Participants who buy and sell ETF shares in "creation units" from ETFs, for that reason alone, are not considered "principal underwriters" for purposes of the 1940 Act.

Under a typical structure of an ETF, the principal underwriter of the ETF enters into an agreement with one or more Authorized Participants who are broker-dealers authorized to purchase and redeem "creation units." Typically, these agreements provide that the Authorized Participant acknowledge that some activities on its part, depending on the circumstances, may result in its being deemed a participant in a distribution in a manner which could render it a statutory underwriter and subject it to the prospectus delivery and liability provisions of the 1933 Act.

We believe that while these Authorized Participants may be considered to be statutory underwriters for purposes of the 1933 Act, they should not be considered principal

underwriters for purposes of the 1940 Act. If they were considered to be principal underwriters for this purpose, then other unintended consequences would follow. For example, a trustee of an ETF who owns shares of the Authorized Participant that is considered to be principal underwriter of the ETF would become an "interested person" of the principal underwriter under the Section 2(a)(19)(B) of the 1940 Act and thus would be an interested person of the ETF.

We believe that the status of an Authorized Participant by itself does not give rise to status as a principal underwriter for purposes of the 1940 Act. Section 2(a)(29) of the 1940 Act provides that a "principal underwriter" of or for any investment company (other than a closed-end company), or of any security issued by such company, means any underwriter who as principal purchases from such company, or pursuant to contract has the right (whether absolute or conditional) from time to time to purchase from such company, any such security for distribution, or who as agent for such company sells or has the right to sell any such security to a dealer or to the public or both, but does not include a dealer who purchases from such company through a principal underwriter acting as agent for such company.

We believe that Authorized Participants who contract to purchase or sell creation units from the ETF's principal distributor are not principal underwriters of the ETF. The principal underwriter, not the Authorized Participant, is the one who acts as agent for the EFT and has the right to sell the creation units. Moreover, the four corners of Section 2(a)(29) exclude from the definition of principal underwriter "a dealer who purchases from such company through a principal underwriter acting as agent" for the ETF.

While on its face this definition seems clear, we are not aware of any regulation or regulatory guidance that confirms this interpretation. We are aware of one U.S. District Court case that peripherally addressed this issue. In *Gartenberg v. Merrill Lynch*, 528 F.Supp. 1038 (S.D.N.Y. 1981), money market fund shareholders sued the fund and its adviser and the adviser's broker-dealer affiliate, alleging that the adviser breached its fiduciary duty when it received excessive compensation from the fund. The court held that though the compensation was high, it was lawful and that the shareholders failed to sustain their burden of proving that the fees constituted a breach of fiduciary duties.

The court addressed the plaintiffs' allegation that the contract requirements of Section 15(b) of the 1940 Act should apply to Merrill Lynch Pierce Fenner & Smith ("MLPF&S"), the entity that functioned as a dealer of the Fund. The court explained:

> The complaints in these suits allege but one cause of action - a claim for breach of fiduciary duty under Section 36(b) of the Act, 15 U.S.C. § 80a-35(b) (1976). In a diversionary belated attempt, Andre had sought to suggest additional claims herein after the plaintiffs had rested. We shall deal with them only for the sake of completeness, albeit they were dismissed at the close of the case as lacking merit, not asserted and not proved.

> MLPF&S does not furnish any advisory services to the Fund regarding the investment of its portfolio. Section 15(a) of the Act, 15 U.S.C. § 80a-15(a) (1976), calling for a written contract between an adviser and a fund is therefore inapplicable to MLPF&S. See Teachers Association Mutual Fund of California, Inc., (1971-1972)Fed.Sec.L.Rep. P 78,582 (S.E.C. 1971) (no action letter). MLPF&S is not a "principal underwriter" as defined by Section 2(a)(29) of the Act, 15 U.S.C. § 80a-2 (a)(29) (1976), and is not obligated to act in its processing function pursuant to a written contract with the Fund. ***A dealer who makes purchases from an open-end fund through a principal underwriter acting as agent for the fund is not included in the statutory definition of a principal underwriter. Consequently, the contract requirement of Section 15(b) of the Act, 15 U.S.C. § 80a-15 (b) (1976), does not apply to MLPF&S.*** **[emphasis supplied]**
>
> It is clear on the face of the definitional statute that MLPF&S cannot qualify as a principal underwriter and thus is not subject to Section 15(b). There is no privity of contract between the Fund and MLPF&S which would make MLPF&S a principal underwriter of the shares of the Fund. The only entity in direct privity of contract with the Fund for the purpose of selling its shares is MLFD, which is the Fund's principal underwriter.
>
> The Distribution Agreement with the Fund, an agreement which complies with Section 15(b), describes and appoints MLFD specifically as "the exclusive representative of the Trust to act as principal underwriter," with exceptions not relevant here. The Distribution Agreement gives MLFD the right to have shares of the Fund "re-sold" by its securities dealers, of whom MLPF&S is one, as noted previously. Although MLPF&S sells shares to the public it does not purchase or have the right to purchase them directly from the Fund. It purchases shares through MLFD as agent for the Fund. The system used by the Fund was clearly and correctly explained at trial by Mr. Edgar M. Masinter, counsel for the independent Trustees, and has long been typical in the mutual fund industry. See United States v. National Association of Securities Dealers Inc., 422 U.S. 694, 698-99, 706, 95 S. Ct. 2427, 2432-33, 2436, 45 L. Ed. 2d 486 (1975); Report (by the S.E.C.) on the Public Policy Implications of Investment Company Growth, H.R.Rep. No.2337, 89th Cong., 2d Sess. 9, 54-56 (1966).

For the same reasons expressed by the *Gartenberg* court, an Authorized Participant should not be considered a principal underwriter of the ETF. Although Authorized Participants sell shares to the public, they do not purchase or have the right to purchase them directly from the ETFs. Rather, they purchase through the ETF's principal distributor, which serves as agent for the ETFs. Accordingly, we believe that Authorized Participants fall squarely outside the definition of "principal underwriter" for purposes of the 1940 Act.

We are not aware of any other Commission guidance on this point. We ask that the Commission confirm this interpretation in the release which will accompany the final rule 6c-11 ("Adopting Release") because, absent the Commission's guidance, a court could reach a contrary conclusion, which could have significant adverse unintended consequences.

4. *Section 18 of the Act*

We observe that the Proposing Release does not treat Creation Units issued by an ETF as a separate class of securities, nor does the text of New Rule 6c-11 address this issue. We assume that the lack of discussion about this topic reflects the Commission's view that the ETF structure does not implicate Section 18(f) of the 1940 Act,[26] presumably because Creation Units are simply aggregations of an ETF's individual shares which can be unbundled and re-aggregated, analogous to a "round lot" of shares. Equally important is that the structure of ETFs implicates neither Section 18(f) nor its underlying policy purposes.[27] We concur with this analysis and we encourage the Commission to specifically address this issue in the Adopting Release so that there will be no confusion as to the Commission's view as to this topic.

C. New Rule 12d1-4

As stated in the Proposing Release, both registered and unregistered investment companies are subject to Section 12(d)(1)(A)'s limitations with respect to investments in ETFs.[28] We commend the Commission for proposing to codify relief from the limitations on investments in ETFs imposed by Sections 12(d)(1)(A) and 12(d)(1)(B), which we believe is appropriate and necessary. Thus far, the Commission has granted fifteen exemptive orders to ETF applicants providing relief from certain provisions of Section 12(d)(1) of the Act similar to those that the Commission has issued to traditional mutual funds investing in other unaffiliated traditional mutual funds.[29] These orders permitted open-end funds and UITs to invest in ETFs in excess of the limits imposed by Section 12(d)(1). The adoption of Proposed Rule 12d1-4 would codify the existing exemptive orders,[30] and in some instances would simplify certain conditions contained in such orders.

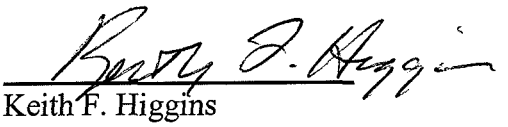
The Proposing Release also requests comment on whether the scope of this relief should be expanded to permit business development companies ("BDCs") to acquire ETFs beyond the limits of Section 12(d)(1).[31] Although we do not have an opinion as to this question, we observe that the text of Proposed Rule 12d1-4 would expand the scope of the exemption to cover far more than BDCs [32]; as written, it would extend to all "investment companies" be they registered or unregistered.[33] It appears that many investment companies, including mutual funds, although familiar with the limitations of Section 12(d)(1), are unaware that ETFs are securities subject to such restrictions. [34] That being the case, it is equally likely that unregistered investment companies do not consider the limitations of Section 12(d)(1) when investing in ETFs. We strongly encourage the Commission to specifically address and clarify the apparent inconsistency between the language in the

Adopting Release and the text of Proposed Rule 12d1-4 to prevent possible confusion or misinterpretation as to the Commission's view.

D. Conclusion

The Committee respectfully requests that the Commission consider the recommendations set forth above. We are prepared to meet and discuss these matters with the Commission and the Staff and to respond to any questions.

Respectfully submitted,



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Endnotes

[1] Proposing Release Nos. 33-8901; IC-28193 (March 11, 2008) (" Proposing Release").
[2] The Commission is proposing for public comment new rules 6c-11 and 12d1-4, as well as amendments to rule 12d1-2, under the Act (collectively, "New Rules"), and amendments to Form N-1A under the Act and the Securities Act of 1933 (the "Securities Act").
[3] Proposing Release at 1.
[4] See, footnote 4 of the Proposing Release
[5] See, *In the Matter of SPDR Trust, Series 1*, Investment Company Act Release No. 19055 (Oct. 26, 1992).
[6] Proposing Release at 5.
[7] *Ibid*
[8] *In the Matter of MidCap SPDR Trust, Series 1*, Investment Company Act Release No. 20844 (January 18, 1995); *In the Matter of Diamonds Trust, et al.*, Investment Company Act Release No. 22979 (December 30, 1997); *In the Matter of the Nasdaq-100 Trust, et al.*, Investment Company Act Release No. 23702 (February

[9] See, for example, *In the Matter of Barclays Global Fund Advisors, et al.,* Investment Company Act Release No. 256622 (June 25, 2002).

[10] See, for example, *In the Matter of Vanguard Index Funds,* Investment Company Act Release No. 24789 (December 12, 2000).

[11] *In the Matter of Wisdom Tree Investments, Inc et al.* (File No. 812-13280) Investment Company Act Release No. 27391 (June 12, 2006) ("WisdomTree Order").

[12] See, for example, *In the Matter of the Select Sector SPDR Trust,* Investment Company Act Release No. 23534 (November 13, 1998).

[13] See, for example, *In the Matter of ProShares Trust et al.,* Investment Company Act Release No. 27394) (June 13, 2006).

[14] See, Wisdom Tree Order.

[15] See, footnote 20 of the Proposing Release for a list of the Actively-Managed Fund Orders.

[16] Currently, there is one (1) Bear Sterns Actively- Managed ETF: Bear Stearns Current Yield Fund, which is listed and trading on the American Stock Exchange ("AMEX") pursuant to the following order: *Bear Sterns Asset Management, Inc., et al.,* Investment Company Act Release Nos. 28143 (Feb. 5, 2008) (notice) and 28172 (Feb. 27, 2008) (order). Also, there are four (4) PowerShares Actively-Managed ETFs listed and trading on NYSE Arca: PowerShares Active Alpha Multi-Cap Fund; PowerShares Active AlphaQ Fund; PowerShares Active Low Duration Portfolio; and PowerShares Active Mega-Cap Portfolio, pursuant to the following order: *PowerShares Capital Management LLC, et al.*, Investment Company Act Release Nos. 28140 (Feb. 1, 2008) (notice) and 28171 (Feb. 27, 2008) (order).

[17] See note 3, *supra.*

[18] Proposing Release at 23.

[19] This can be seen in a comparison of 12(d)(1) relief granted to ETFs structured as UITs and Fund ETFs. Taking into account that UITs have no directors or trustees, the Commission modified the conditions imposed on Fund ETFs receiving 12(d)(1) orders in granting the same relief to UITs.

[22] The conditions contained in the 12(d)(1) orders for both types of ETFs are very similar and accomplish the same goals, but the language is tailored to reflect the differences between the UIT and Fund structures. Compare, for example, conditions 2-3, 4 and 5 in *The Matter of SPDR Trust et al.,* Investment Company Act Release No. 26419 (April 19, 2004) (order) with conditions 2-3, 6 and 9 in *iShares Trust, et al.*, Investment Company Act Release No. 25969 (Mar. 21, 2003).

[21] Proposing Release at 42.

[22] For example, the Commission has determined not to extend this exemption to other investment companies that become affiliates of the fund due to the exemptions from Section 12(d)(1) contemplated by the proposed rule. In that instance the Commission has determined the threat of large scale redemptions and the harm that would possibly result to other shareholders does not warrant an exemption from Section 17(a).

[23] The term "specialist" in this letter refers to the official market maker designated as such for a specific ETF primarily listed on the AMEX (or other securities exchange using a specialist system), and the term "lead market maker" refers to those market makers designated as such for a particular ETF primarily listed on NYSE Arca (or other securities exchange using a lead market maker or similar system).

[24] Proposing Release at 21.

[25] Proposing Release at 33.

[26] Some commenters in the past have argued that the differences between creation units and individual shares create a senior security under Section 18(g), because a class of shareholders will have priority as to distribution of the assets of the fund. Section 18(f) would prohibit the fund from issuing such a senior security. See Comments of the American Bar Association on S7-20-01 dated February 1, 2002 (File name: keller1.htm) at http://www.sec.gov/rules/concept/s72001.shtml ("Comments").

[27] Section 18 was adopted to prevent investment companies from creating unfair and/or opaque capital structures. See, Comments. It has been argued that Creation Units in fact are fair to all investors because the structure is designed to minimize deviations from NAV, as well as to prevent possible dilution resulting from

the transaction costs incurred when Creation Unit purchasers enter, or redeemers exit, an ETF. See, Comments.

[28] Proposing Release at footnote 194.

[29] Proposing Release at 78.

[30] For example, it would preserve the requirement found in most ETF exemptive orders that prohibits the ETF receiving 12(d)(1) relief from "investing in shares of other funds (including companies relying on sections 3(c)(1) and 3(c)(7) of the Act) in excess of the limits in section 12(d)(1)(A) of the Act". See Proposing Release at 67 and footnote 207, as well as the text of Proposed Rule 12d1-4(a)(4) at 141 of the Proposing Release.

[31] Proposing Release at 79.

[32] See text of Proposed Rule 12d1-4 at 139 of the Proposing Release which provides, in part,

> "(a) Notwithstanding sections 12(d)(1)(A), 17(a)(1), and 57(a)(1) of the Act..., an *investment company* ("acquiring fund") may acquire exchange-traded fund shares if..." (*emphasis added*)

[33] Compare the text of Proposed Rule 12d14(a) set forth in footnote 34 *supra* with the text of Proposed Rule 12d1-4(a)(4)(ii).

[34] Proposing Release at footnote 212.