Law Offices

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May 19, 2008

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549–1090

Re: Exchange-Traded Funds, Release No. 33-8901, IC- 28193, File No. S7–07–08

Dear Ms. Morris,

Stradley Ronon Stevens & Young LLP ("Stradley") appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's (the "Commission") proposed rulemaking (the "Proposal") to exempt exchange traded funds ("ETFs") from certain provisions of the Investment Company Act of 1940, as amended (the "Act").[1] We are pleased to observe that the proposed rules would generally allow future ETF offerings to proceed without undue burdens or restrictions. Our comments on the Proposal are provided below.

## I. 12d1-4(a)

Among the provisions of proposed Rule 12d1-4 is a requirement in subsection (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: (1) [n]o acquiring fund or any of its investment advisers or depositors, and any company controlling, controlled by or under common control with the acquiring fund, or any of its investment advisers or depositors, each individually or together in the aggregate: (i) [c]ontrols the exchange-traded fund; …

The Commission paraphrased this provision in the Release as follows:

> The condition would provide that: (i) an acquiring fund and any of its investment advisers or depositors, and any company in a control relationship with the acquiring fund or any of its investment advisers or depositors, each individually or in the aggregate, do not control an ETF; …[2]

[1] *Exchange-Traded Funds*, Rel. Nos. 33–8901, IC–28193; 53 F.R. 14618; File No. S7–07–08 (Mar. 11, 2008) (the "Release").

[2] Release, at n. 215.

The wording of subsection (a) could be read to provide that a fund could not rely on the rule when 25% or more of an ETF is held, in the aggregate, by a fund, its adviser, its subadviser, and any company in a control relationship with the fund, the adviser, or the subadviser. That calculation could include any fund over which either the investment adviser or subadviser has investment discretion, because, under at least some facts and circumstances, an investment adviser or subadviser may be deemed to control a fund over which it has investment discretion. This may preclude many funds from investing in ETFs in reliance on proposed Rule 12d1-4 because funds managed by their advisers and subadvisers would be aggregated.

As noted in the Release, the Commission intended this provision to echo relief granted in previous ETF exemptive orders.[3] Accordingly, we suggest that the Commission clarify, as it has done in recent ETF exemptive orders, that a fund would not be required to aggregate the assets under management of its adviser and subadviser for purposes of the proposed rule.[4]

To address the concerns underlying Sections 12(d)(1) and 17(a), the focus of analysis should be the adviser and the subadviser, rather than the acquiring fund. A fund's holdings of an ETF's shares should be included in the total for both the investment adviser and the subadviser, but otherwise each of the investment adviser and the subadviser should separately calculate their holdings of the ETF for purposes of Rule 12d1-4.[5] For example, if, aside from the acquiring fund, the adviser's other funds already held 23% of an ETF, and the subadviser's other funds also held 23% of the ETF, the fund could acquire 1% of the ETF in reliance on the proposed rule. This would bring the total for each of the adviser and the subadviser separately to 24%. If the adviser and subadviser were required to aggregate their holdings, the fund could not acquire any shares of the ETF.

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[3] Release, at n. 215.

[4] *See, e.g.*, *ALPS Advisers, Inc., et al.* Rel. No. IC-28235 (Apr. 9, 2008) (Notice) and *ALPS Advisers, Inc., et al.*, Rel. No. IC-28262 (May 1, 2008) (Order). The Notice provides:

> To limit the control that a Purchasing Fund may have over a Fund, applicants propose a condition prohibiting a Purchasing Fund Adviser or a Sponsor, any person controlling, controlled by, or under common control with a Purchasing Fund Adviser or Sponsor, and any investment company and any issuer that would be an investment company but for sections 3(c)(1) or 3(c)(7) of the Act that is advised or sponsored by a Purchasing Fund Adviser or Sponsor, or any person controlling, controlled by, or under common control with a Purchasing Fund Adviser or Sponsor ("Purchasing Fund Advisory Group") from controlling (individually or in the aggregate) a Fund within the meaning of section 2(a)(9) of the Act. <u>The same prohibition would apply</u> to any Purchasing Fund Sub-Adviser, any person controlling, controlled by or under common control with the Purchasing Fund Sub-Adviser, and any investment company or issuer that would be an investment company but for sections 3(c)(1) or 3(c)(7) of the Act (or portion of such investment company or issuer) advised or sponsored by the Purchasing Fund Sub-Adviser or any person controlling, controlled by or under common control with the Purchasing Fund Sub-Adviser ("Purchasing Fund Sub-Advisory Group"). (emphasis added.)

[5] In addition, if a subadviser has under its management only a portion of a fund's assets, only that portion should be included in the subadviser's calculation.

## II. Rule 6c-11(d)

Among the provisions of Rule 6c-11 would be a requirement in subsection (d) that:

> A person who is an affiliated person of an exchange-traded fund 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) of the Act with regard to the deposit and delivery of basket assets. …

We believe that the phrase "or more than 25 percent" is superfluous and should be deleted, or its purpose should be clarified.

## III. Board Findings; Creation Unit Size

The Release asks whether ETF boards of directors should be required to make particular findings with respect to whether the ETF is structured in a manner reasonably intended to facilitate arbitrage, noting that this could require the board to look at, among other things, the number of shares in each creation unit and the liquidity of the portfolio securities and other assets.[6] The Commission should avoid requiring boards of directors to make such specific findings. As the Director of the Division of Investment Management recently noted, "fund directors are dependent on the fund's adviser and other service providers for the information that [they] need."[7] This is likely to be true with respect to highly technical information that would be needed to make the findings. The value of such specific Board findings is not clear.

Along similar lines, the Release asks whether the proposed rules should include numerical thresholds for the number of ETF shares in each creation unit.[8] We believe that they should not. Rather, we believe that the number of shares in an ETF's creation units should be determined by the ETF. Certain ETFs may have reason to require larger or smaller creation units, and the boards of such ETFs should be empowered to use their judgment to settle on an optimum size, in either dollars or shares. Any arbitrarily imposed creation unit size, in shares, would not at any rate be related to any particular dollar amount or proportion of an ETF's total outstanding securities, and thus the effect of such an imposition would apply differently to different ETFs.

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6 Release, at 14628.

7 Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Keynote Address at the Mutual Fund Directors Forum Institute, Coral Gables, Florida (Mar. 1, 2007).

8 Release, at 14628.

## IV. Rule 12d1-4(b)(2)(i)

The Proposal would provide an ETF, a principal underwriter, or a broker or dealer with an exemption from Sections 12(d)(1)(B) and 17(a) with respect to redemptions of ETF shares so long as the ETF does not redeem, or a principal underwriter, broker or dealer does not submit for redemption, any of the ETF's shares that were acquired in excess of the limits of Section 12(d)(1)(A)(i) in reliance on Rule 12d1-4(a).[9] To avail itself of the safe harbor for compliance with this subsection, the ETF, its principal underwriter, or a broker or dealer must fulfill two requirements. The first of those requirements is that the ETF, principal underwriter, or broker or dealer must have:

> Received a representation from the acquiring fund that none of the exchange-traded fund shares it is redeeming was acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act in reliance on paragraph (a) …

An ETF, a principal underwriter, or a broker or dealer should be able to rely on a contractual arrangement with or representation from the redeeming fund to the effect that the redeeming fund will not redeem through such party any ETF shares it acquired in excess of such limits, rather than requiring a representation with respect to every redemption by a mutual fund of ETF shares. An ETF, a principal underwriter, or a broker or dealer might also rely on such a representation in a mutual fund's registration statement.

## V. Other

We applaud the Commission's proposal to revise Rule 12d1-2 to broaden the allowable investments of funds relying on Section 12(d)(1)(G). We also commend the Commission and the staff for the speed with which Commission is providing exemptive relief while this rule proposal is pending.

## VI. Conclusion

We appreciate this opportunity to comment on the Release. We note that this letter does not necessarily represent the views of all of Stradley's individual attorneys, nor does it necessarily represent the views of the firm's clients. Please feel free to contact the undersigned at 215 564-8128 or at sgoldstein@stradley.com if you have any questions regarding our comments.

Very truly yours,

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[9] We note that a comma seems to be missing in this paragraph of the proposed rule. It reads, in relevant part, "… if the exchange-traded fund does not redeem, or the principal underwriter, broker or dealer does not submit for redemption[,] any of the exchange-traded fund's shares …"

Sam Goldstein
Associate
Stradley Ronon Stevens & Young

cc: Alison M. Fuller, Esq.