

# BLACKROCK®

September 26, 2018

Submitted via electronic filing: <https://www.sec.gov/rules/proposed.shtml>

Mr. Brent J. Fields Secretary  
U.S. Securities and Exchange Commission 100 F Street, NE  
Washington, DC 20549-1090

**Re: Exchange-Traded Funds, Release Nos. 33-10515; IC-33140; File No. S7-15-18**

Dear Mr. Fields:

This letter responds to the request of the Securities and Exchange Commission (the “Commission” or “SEC”) for comment on Proposed Rule 6c-11 (the “Proposed Rule”) under the Investment Company Act of 1940, as amended (the “Act”), related disclosure amendments and other matters discussed by the Commission in the above-referenced release (the “Release”). Exchange-traded funds (“ETFs”) have become an increasingly popular investment product,<sup>1</sup> helping tens of millions of individuals efficiently invest in the markets and meet their retirement goals. BlackRock, Inc. (together with its affiliates, “BlackRock”)<sup>2</sup> has long supported regulation of the ETF market that enhances transparency, market quality and investor choice.<sup>3</sup> BlackRock supports the Commission’s efforts to adopt a consistent, rule-based regulatory framework for ETFs under the Act.

Although the Commission’s current approach to regulating ETFs through exemptions from the Act<sup>4</sup> has generally worked well, and many aspects of those exemptions have now become established market practice, BlackRock strongly supports the Commission’s goal of promulgating a more consistent regulatory framework for ETFs. BlackRock strongly supports the Proposed Rule and believes that it will effectively accomplish the Commission’s goal of

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<sup>1</sup> As of year-end 2008, 2013 and 2017, total US ETF assets equaled approximately \$531 billion, \$1.7 trillion and \$3.4 trillion, respectively, according to the Investment Company Institute. 2018 Investment Company Fact Book (58<sup>th</sup> ed., 2018), available at [https://www.ici.org/pdf/2018\\_factbook.pdf](https://www.ici.org/pdf/2018_factbook.pdf). The US ETF market—with 1,832 funds and \$3.4 trillion in total net assets at year-end 2017—remained the largest in the world, accounting for 72% of the \$4.7 trillion in ETF total net assets worldwide. *Id.* at page 86.

<sup>2</sup> BlackRock is one of the world’s leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed-income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers, and other financial institutions, as well as individuals around the world. We are the investment adviser to the iShares family of ETFs, which invest in US equity, international equity, commodities and a variety of fixed-income segments. BlackRock also advises non-US ETFs. BlackRock and its predecessor companies have provided investment advice to ETFs since 1996.

<sup>3</sup> See e.g., BlackRock, *Viewpoint, Bond ETFs: Benefits, Challenges and Opportunities* (July 2015), available at <http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-bond-etfs-benefits-challenges-opportunities-july-2015.pdf> (“BlackRock July 2015 ViewPoint”); Comment Letter of BlackRock on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (January 13, 2016); available at <https://www.blackrock.com/corporate/literature/publication/sec-liquidity-risk-management-proposal-011316.pdf>; BlackRock, *Viewpoint, A Primer on ETF Primary Trading and the Role of Authorized Participants* (March 2017), available at <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-etf-primary-trading-role-of-authorized-participants-march-2017.pdf> (“BlackRock March 2017 ViewPoint”); Rachel Evans and Annie Massa, “BlackRock’s Weird Wish: ETF Rules That Help the Competition” (October 24, 2017), available at <https://www.bloomberg.com/news/articles/2017-10-24/blackrock-s-unusual-wish-an-etf-rule-that-helps-the-competition>; and BlackRock, *Viewpoint, February 2018 Case Study: ETF Trading in a High-Velocity Market* (March 2018), available at <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-case-study-etf-trading-high-velocity-market-february-2018.pdf> (“BlackRock March 2018 ViewPoint”).

<sup>4</sup> Release at page 6 (“We have granted over 300 of these orders over the last quarter century...”).

permitting ETFs to operate without the expense and delay of seeking individualized exemptive relief, while simultaneously preserving important investor protections.

This letter highlights several technical comments and suggestions relating to certain aspects of the Commission's proposals. Our comments first seek to address aspects of the Proposed Rule related to the construction and publication of baskets. We agree with the Commission in allowing flexibility for custom basket usage across all ETF sponsors. We explain how custom baskets are employed based on our experience, and offer detailed comments on certain modifications and clarifications necessary to avoid unintended consequences that may detract from the intended benefits of custom baskets. In addition, we offer a number of comments on particular aspects of the Proposed Rule, including portfolio transparency, ETF disclosure and related amendments, the time period for delivery of redemption proceeds, trading relief under the Securities Exchange Act of 1934 (the "Exchange Act"), and certain other questions and issues raised in the Release. We conclude by addressing the scope of the Proposed Rule and by expressing our continued support for an exchange-traded product ("ETP") classification scheme.

## **I. Executive Summary**

Key elements of our comments are as follows:

### *Support for Proposed Rule 6c-11*

- We are very supportive of the Proposed Rule. We believe the proposal is thoughtful and will benefit ETF investors and the ETF ecosystem. Our comments are of a technical nature, intended to improve the proposal and ensure it aligns with current best practices in the ETF industry.
- We support the inclusion of creation and redemption basket flexibility ("custom baskets") in the Proposed Rule, as custom baskets ultimately benefit investors.
- We support the requirement that ETF sponsors adopt robust policies and procedures in order to avail themselves of basket flexibility, and we note that BlackRock already has policies and procedures in place that address governance, surveillance and evaluation of custom baskets.
- We are very supportive of the daily portfolio holdings transparency requirement.

### *Suggested Amendments to Disclosure Requirements*

- We recommend the Commission clarify the custom basket publication requirements, including clarification that (i) any custom basket published represents a reasonable indication of a custom basket that an ETF would accept on a trading day and (ii) the ETF has discretion to use other baskets regardless of the basket that is published.
- We recommend that the Commission clarify that an ETF's custom basket policies and procedures can be tailored as it deems appropriate to address different risks, consideration and requirements for different types of custom baskets used, particularly those involving cash substitutions, since cash substitutions do not raise the same concerns and risks as substitutions of alternate securities.

- We do not believe the Commission should require publication of basket or portfolio holdings information prior to an ETF taking orders, as this would be disruptive to current practices and is not necessary for the ETF arbitrage mechanism to function efficiently. Instead, this information should be required to be disclosed prior to the opening of trading of the ETF shares in the US market.
- We recommend that the Commission adopt portfolio holdings disclosure requirements consistent with the generic listing standards for actively managed ETFs adopted by the listing exchanges, which we believe is a more appropriate framework for promoting consistency around portfolio holdings information rather than using Article 12 of Regulation S-X.
- We are supportive of the Commission's efforts to provide investors with information about the impact that trading costs may have on their ETF investments; however we suggest alternative approaches to the current proposal that we believe will be more useful to investors.

*Suggestions Regarding Other Provisions of Proposed Rule 6c-11 and Additional Considerations*

- We support the Commission's proposal to provide an ETF with additional time for the delivery of foreign investments; however, we believe that the definition of "foreign investment" should be clarified as any securities, assets or other positions issued by foreign issuers, as defined in Rule 3b-4 under the Exchange Act, for which there is an established trading market for such security, asset or other position outside of the US.
- We recommend that the Commission harmonize the additional requirements applicable to ETFs under the Exchange Act (such as Section 11(d)(1), Rules 10b-10, 15c1-5, 15c1-6 and 14e-5) either under the Proposed Rule, under separate rulemaking, or under industry-wide no-action relief in order to create a consolidated and efficient regulatory framework for ETFs.
- We reiterate our recommendation that the Commission consider a more comprehensive approach to ETP classification to improve investors' abilities to understand and analyze the risks of individual ETPs. We provide an updated example of a potential classification scheme that would categorize the risks associated with different types of ETPs, and suggest that Rule 35d-1 under the Act could be amended to preclude the use of the term "Exchange-Traded Fund" or "ETF" in the name of exchange-traded products that do not meet the definition of ETF outlined in our suggested classification scheme.

## **II. Creation and Redemption Baskets**

BlackRock is supportive of the Commission permitting custom basket flexibility for all sponsors under the Proposed Rule, and also supports the Commission's efforts to create a level playing field among ETFs, which we believe is beneficial to the ETF ecosystem. We strongly agree with the Commission that increased basket flexibility benefits the effective functioning of the arbitrage mechanism.<sup>5</sup> Set forth below are a number of technical comments and

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<sup>5</sup> Release at page 236.

recommendations related to baskets that BlackRock believes will help to better achieve the Commission's stated goal of promoting a custom basket framework that is in the best interests of ETFs and investors.

### A. Basket Flexibility

BlackRock agrees with the Commission that basket composition is an important aspect of the efficient functioning of the arbitrage mechanism, that it is important to ETF portfolio management, and that additional basket flexibility could potentially benefit ETF investors.<sup>6</sup>

Most bond index ETF portfolio managers employ a set of techniques to effectively sample bonds from the broader underlying index. These techniques, the most common of which are optimization and stratified sampling, involve creating a portfolio that contains a subset of the securities from an index that match the major risk and other characteristics of that index with a goal of tracking it. Many bonds have discontinuous liquidity, making it virtually impossible for most bond index-based ETFs to fully replicate a broad market index. BlackRock's bond ETFs have demonstrated robust tracking to underlying indexes despite the fragmentation and discontinuous liquidity of the bond market.<sup>7</sup> Thoughtful, risk-aware portfolio management through sampling and optimization techniques enables our portfolio managers to replicate index exposure with fewer bonds than the index.<sup>8</sup>

BlackRock utilizes custom creation and redemption baskets, which are actionable, representative samples of the underlying index, particularly with respect to the operation and management of its fixed-income ETFs, because delivering *pro rata* all of the holdings in an ETF or underlying index may not be feasible.<sup>9</sup> Custom baskets are designed to satisfy the ETF's investment objective of tracking the index, while facilitating creation and redemption activity when market conditions warrant, which also benefits investors by helping to reduce premium/discount volatility. Even though not all securities in the index (or portfolio) are able to be included, custom baskets seek to match the major risk characteristics of the index, such as duration, yield, sector allocation and credit quality. The use of custom baskets is beneficial since not all of the bonds that comprise an index (or portfolio) may be trading at the time of a creation or redemption. Importantly, the ETF portfolio manager determines basket composition, subject to policies and procedures, not the Authorized Participant ("AP").

The AP's ability to source the securities required to effectuate the in-kind creation is made easier and more efficient through the use of the custom basket. This, in part, has contributed to lower transaction costs and narrower bid-ask spreads for the benefit of investors.<sup>10</sup> Moreover, custom baskets are also utilized to satisfy redemption requests

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<sup>6</sup> Release at pages 89-94.

<sup>7</sup> See BlackRock, *Index your bonds: A guide to dispelling the myths*, available at <https://www.ishares.com/us/literature/whitepaper/index-your-bonds-en-us.pdf>.

<sup>8</sup> As an example, the iShares Core Total USD Bond Market ETF (ticker: IUSB), which was launched in June 2014, held 2% of its index initially. Over time, the assets grew and the ETF increased holdings, leading to a reduction in tracking error. Even with an allocation of only 30% of the bonds in the index, IUSB exhibited a tracking error of less than 0.1% annualized, as of December 31, 2017.

<sup>9</sup> For example, the Bloomberg Barclays US Aggregate Bond Index contains 10,113 securities, as of September 7, 2018. There are currently 48 index-based iShares ETFs that have a *pro rata* basket that includes 500 or more securities.

<sup>10</sup> For example, iShares broad bond market and broad investment grade corporate bond ETFs have narrower bid-ask spread percentages relative to other leading ETFs with similar exposures that do not currently use custom baskets, where bid-ask spread is measured against the market price of the ETF. From a period of August 23, 2013 to August 22, 2018, iShares Core U.S. Aggregate Bond ETF (ticker: AGG) had a bid-ask spread of 0.01%, where a competitor broad bond market ETF had a bid-ask spread of 0.06%; iShares Broad USD Investment Grade Corporate Bond ETF (ticker: USIG) had a bid-ask spread of

predominantly in-kind, as opposed to using substantial amounts of cash (e.g., cash-in-lieu for odd lots and minimum trade sizes), which would be the case if required to deliver *pro rata* baskets. Decreased reliance on cash transactions reduces the amount of cash required to be held by the ETF, and is more cost- and tax-efficient. BlackRock believes these benefits of custom baskets far outweigh the potential risks<sup>11</sup> and, as our practices have shown, these risks can be mitigated through effective policies and procedures.

## **B. Custom Basket Policies and Procedures**

BlackRock strongly supports the Commission's proposal to require ETFs to adopt written policies and procedures governing the construction of all baskets and the process for acceptance of all baskets, including the heightened requirements for custom baskets. BlackRock has already adopted robust basket operating policies and procedures, described in more detail below, that focus on governance related to the construction and evaluation of custom baskets.<sup>12</sup>

BlackRock supports the proposed heightened requirements for custom basket usage through the mandated adoption of policies and procedures that: (i) set forth a methodology and process for construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, (ii) specify the titles or roles of employees responsible for review and approval,<sup>13</sup> and (iii) are covered by the ETF's compliance program and other requirements of Rule 38a-1.<sup>14</sup> We believe that such policies and procedures help mitigate the potential risks associated with custom baskets.

We note that BlackRock's existing policies and procedures address governance around evaluation of custom baskets and include an oversight framework managed by BlackRock's internal risk and compliance teams, which are separate from our portfolio management team. These policies and procedures are primarily implemented on a day-to-day basis by the ETF's portfolio manager(s), who must approve each custom basket after a determination that the custom basket is in the best interests of the ETF. While portfolio managers are responsible for approving custom baskets, reviews of such baskets may utilize analytics designed by employees outside of portfolio management, including risk or compliance functions, which set parameters to help ensure that custom baskets facilitate an ETF's investment objective (e.g., tracking an index).

Consistent with the requirements in the Release, our policies and procedures specifically set forth various requirements and considerations for custom baskets, in addition to process oversight. For example, they enumerate reasons for accepting security substitutions in the context of creations and redemptions (e.g., index rebalancing, or inaccessibility of certain basket

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0.11%, where a competitor investment grade corporate bond ETF had a bid-ask spread of 0.26%; and iShares Floating Rate Bond ETF (ticker: FLOT) had a bid-ask spread of 0.03%, where a competitor investment grade floating rate bond ETF had a bid-ask spread of 0.20%.

<sup>11</sup> See, e.g., Release at pages 92, 94 and 96.

<sup>12</sup> Release at page 94, footnote 250 ("We note that ETFs already may have policies and procedures governing the construction of baskets in order to comply with the representations and conditions of their exemptive orders."). See also Release at page 90, footnote 236, citing to WEBs Index Funds, Inc., et al., Investment Company Act Release Nos. 23860 (June 7, 1999) [64 FR 31658 (June 11, 1999)] (notice) and 23890 (July 6, 1999) (order) and related application.

<sup>13</sup> As discussed below, we recommend that this requirement for the delineation of titles or roles of employees responsible for review and approval of custom baskets be revised so that it is clear that it applies to those with discretionary or direct supervisory authority as it relates to the construction and acceptance of custom baskets (*i.e.* portfolio management).

<sup>14</sup> Release at page 96-99.

securities).<sup>15</sup> Under our policies and procedures, custom redemption baskets are generally non-negotiable (*i.e.*, there is not an iterative discussion between the AP and the portfolio manager(s) as to which securities the ETF may be able to redeem);<sup>16</sup> we believe that iterative discussions with APs are generally not necessary for redemption baskets, as APs are not sourcing securities.

In addition, BlackRock's policies and procedures are supplemented with a comprehensive oversight framework designed to help maintain the quality of securities accepted by the ETF and prevent any overreaching by APs. Where appropriate, BlackRock's risk and compliance teams provide surveillance, including back testing and periodic reviews, which analyze custom creation baskets, utilizing analytics to assess each basket's impact on tracking, and other components of the ETF's risk profile (*e.g.*, liquidity). This oversight framework includes a governance committee that oversees the custom basket process.

While we commend the Commission's proposed approach to custom basket policies and procedures, we request clarification regarding the requirement that the titles and roles of employees responsible for review and approval of custom baskets be included in the policies and procedures. We believe that the Commission intended the requirement to approve custom baskets apply only to those with discretionary or direct supervisory authority as it relates to the construction and acceptance of custom baskets (*i.e.*, portfolio management) and not to those responsible for governance and back-testing and periodic reviews (*e.g.*, risk and compliance teams). We would appreciate the Commission's clarification on this proposed requirement.

BlackRock encourages the Commission to explicitly delineate appropriate considerations for ETF sponsors' basket policies and procedures in the final rule or in the adopting release. For instance, sponsors should consider developing periodic monitoring and testing to analyze the impact of custom baskets on tracking error and other metrics where appropriate, such as liquidity. Sponsors should consider establishing a governance process to oversee custom baskets with a focus on ensuring the existence of a robust basket approval process in which custom baskets are beneficial to the ETF's ability to meet its investment objective and do not inappropriately advantage an AP. BlackRock's basket policies and procedures and the associated oversight framework were developed with the aim of protecting investors and mitigating against AP overreaching. We believe that these should be the governing principles of any effective policies and procedures implemented by an ETF sponsor.

## **C. Technical Comments for Rule Improvements and Practical Considerations**

### *1. Basket Publication*

As currently proposed, the Proposed Rule requires publication of one basket that an ETF would accept in exchange for orders to purchase or redeem creation units and further provides that where an ETF plans to use custom baskets on a particular business day, a custom basket should be the "published" basket on such day.<sup>17</sup> BlackRock generally publishes only a *pro rata* basket and customizes baskets separately which is our preferred practice since a single published custom basket is unlikely to reflect all possible custom baskets that could be accepted

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<sup>15</sup> BlackRock has also established additional parameters for certain custom baskets, such as requiring a minimum number of securities for each basket and a maximum percentage of any one security allowed in a basket.

<sup>16</sup> As discussed below, certain exceptions are made where the AP must accept cash-in-lieu for certain securities where they are prohibited from receiving securities (*e.g.*, regulatory restrictions).

<sup>17</sup> See Release at page 104.

under different circumstances in a given trading day. As discussed further below, custom baskets, by their nature, are dynamic and need to be appropriately adjusted throughout the business day to facilitate creation and redemption activity with the aim of achieving the ETF's investment objective. As a result, if a custom basket is required to be published, BlackRock recommends the rule clarify that: (i) publication of a custom basket represents a reasonable indication of a basket that an ETF would accept on such trading day, (ii) the ETF may adjust the published custom basket in response to changing market conditions without re-publishing the custom basket<sup>18</sup> and (iii) the ETF has discretion to use other baskets regardless of the basket that is published.<sup>19</sup> In addition, because publication of a single custom basket is unlikely to be fully representative of an order that may be utilized for both creation and redemption orders, BlackRock recommends that an ETF should be permitted to qualify and disclose that a published custom basket represents an order in a single direction and for a specified number of units<sup>20</sup> to prevent the published custom basket from being misleading. Furthermore, because an ETF may seek to accept both a published *pro rata* basket as well as a custom basket on the same day, BlackRock believes publishing a *pro rata* basket is appropriate in such circumstances.<sup>21</sup> This approach would similarly extend to any potential customization with respect to a cash substitution rather than a security substitution.<sup>22</sup> Accordingly, BlackRock recommends clarifying that publication of a *pro rata* basket does not preclude the use of custom baskets in addition to the *pro rata* basket.

Our recommendations above stem from our experience with custom baskets. In practice, there are many factors that impact the use and composition of custom baskets in practice, such as the direction of a trade, the size of an order, and market conditions (including the composition of other custom baskets accepted by the ETF that day). We discuss each of these in more detail below.

The direction of a trade affects the composition of a custom basket, as a custom basket that may be appropriate for a creation may not be appropriate for a redemption, and vice versa. While the mechanics underpinning creation and redemption are similar, the composition of creation and redemption baskets can be fundamentally different, as they serve different purposes in managing to the ETF's investment objective. For certain ETFs, the bonds in a custom redemption basket could be positions that the ETF is slightly overweight versus its underlying index. In such instance, by delivering out an in-kind redemption basket that includes

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<sup>18</sup> See Release at page 104, footnote 269 ("Our proposal does not prevent an ETF from changing the assets in a published basket to respond to market conditions after the basket is published"). We recommend the Commission include this statement in the rule text.

<sup>19</sup> See Release at page 104, noting "[b]ecause an ETF would be required to post only one published basket to comply with this condition, there may be occasions where an ETF would not post the contents of every custom basket." We recommend that the Commission include similar language in the text of the Proposed Rule to clarify that this applies regardless of whether the published basket is *pro rata* or a custom basket.

<sup>20</sup> Depending on the ETF, this may represent a transaction for one unit or multiple units of the ETF.

<sup>21</sup> For example, when a particular stock is being deleted from an index due to a rebalance or an acquisition, that stock would no longer be included in the published *pro rata* basket. While the published *pro rata* basket would be used for most transactions, the flexibility to utilize and deliver a custom basket in connection with redemption requests would allow the ETF to include that stock in the custom basket and deliver it to the redeeming AP, without realizing the tax impact of any appreciation. If the ETF is only able to utilize the published *pro rata* basket for the redemption request, the ETF would sell shares of that stock into the market and the ETF would realize the tax impact of any of the stock's appreciation in value.

<sup>22</sup> For example, an ETF that generally does not utilize custom baskets may need to on occasion because an AP, for instance, cannot contribute a particular security due to regulatory or operational constraints. In such situations, a sponsor can generally not anticipate the need to make a cash substitution in advance of basket publication. Further, we do not believe that publication of a basket with a security or securities substituted with cash would provide useful information to shareholders, nor would it necessarily be indicative of other permissible cash substitutions.

bonds in which the ETF is slightly overweight relative to its underlying index, the portfolio manager is able to reduce the amount that the ETF is overweight for those specific bonds, which helps to maintain or improve forward-looking tracking error of the ETF. Conversely, some bonds in a fixed-income ETF's portfolio or underlying index may not be available to be delivered by the AP to the ETF as part of the creation process. Actual availability of securities depends on AP inventory or ability to access those securities in the market.<sup>23</sup> In addition, the bonds in a custom creation basket could be positions that a fixed-income ETF is slightly underweight versus the underlying index. In such instance, the creation basket is often composed of issues that may be underweight in the ETF. The AP's delivery of the in-kind creation basket may help to bring the ETF closer to the index weights and helps to maintain the ETF's tracking of its underlying index.

Similarly, we have observed that the size of an order can affect the composition of a custom basket, and a custom basket that may be appropriate for an order of one size may not be appropriate for a larger or smaller size order. In order to maintain desired index tracking, a large creation or redemption order may require more names to be included in the custom basket constructed for such order than would be included in the single published custom basket.<sup>24</sup> As such, when faced with a large creation or redemption order, the published basket would need to be adjusted; otherwise the ETF would likely be either overweight or underweight the names in the published basket.

As is the case for both custom and *pro rata* baskets, BlackRock makes adjustments to baskets based on the size of the order to account for rounding, odd lots, minimum trade sizes and securities that are subject to trading restrictions. Rather than account for these adjustments by accepting or paying cash, the aggregate value of the amount resulting from these adjustments may be redistributed across the ETF's in-kind basket to facilitate tracking and the ETF's investment objective. This redistribution will vary for each transaction since the aggregate adjustment amount will differ based on the size of the transaction, resulting in custom baskets that differ for the same ETF. This redistribution process benefits ETFs by maximizing the benefits of the in-kind creation and redemption process.

Market conditions must be factored in, necessitating flexibility through custom baskets. We aim to include securities in each ETF's creation basket that are believed to be accessible by APs. However, actual availability of securities depends on an AP's ability to access those securities in the market during the trading day. Market activity in a particular name on any given trading day may make a security more or less liquid and affect the ability of an AP to deliver that name. As a result, substitutions of alternate securities available from the AP or in the market are made intraday. A single published basket cannot take into account how intraday market activity may have impacted the accessibility of securities, and would prevent an ETF from being able to take advantage of additional liquidity for a particular security and from reacting to market movements. Moreover, if there has been significant creation activity in a given day, an ETF may determine that accepting the published custom basket may negatively impact tracking by overweighting certain names. Conversely, during a day of significant redemption activity, it may not be in the best interests of the ETF or its shareholders to deliver a given security to all APs if that security is not available in sufficient quantity in the ETF's portfolio or if delivery could cause the ETF to become underweight that name.<sup>25</sup>

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<sup>23</sup> BlackRock estimates that only 29% and 25% of US investment grade and high yield bonds, respectively, trade on a daily basis.

<sup>24</sup> BlackRock generally expects the published custom basket to be based on one unit of activity in a single direction.

<sup>25</sup> On any given day, an ETF such as iShares iBoxx \$ Investment Grade Corporate Bond ETF (ticker: LQD) may consider multiple custom creation basket requests from APs in sequential order. Each custom creation basket is reviewed and approved by the



To maintain the overall risk profile and investment exposure of an ETF, BlackRock assesses all custom baskets prior to their acceptance by an ETF, consistent with our current policies and procedures. In practice, different custom baskets may be used across APs on the same business day for a single ETF for a variety of reasons, as noted above. However, these custom baskets are collectively aimed at facilitating the investment strategy of the ETF in a cost-effective and efficient manner.

## 2. Timing of Publication

The requirement that basket information (and portfolio holdings information) be published before an ETF's acceptance of orders is inconsistent with current market practice and poses a number of operational challenges, particularly for ETFs investing in international markets that do not overlap (or have limited overlap) with US market hours.

ETFs that invest in foreign markets that prohibit the free transfer of securities from one beneficial owner to another<sup>26</sup> may be required to meet creations and redemptions fully or partially in cash as opposed to in-kind.<sup>27</sup> Other ETFs investing in foreign markets may transact in cash because APs may be unable to transact in specific securities for regulatory or operational reasons.<sup>28</sup> Executing purchase and sale transactions in cash, rather than in-kind, can cause such foreign ETFs to incur costs associated with the purchase or sale of the relevant securities, including transaction-related costs (e.g., brokerage) and market impact costs. As a result, ETFs have developed procedures and mechanisms whereby APs bear the economic risk of a price differential of any assets bought with the cash, or sold to raise the cash, from the valuation of those assets used to determine the net asset value ("NAV") for the

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ETF's portfolio manager before other subsequent basket proposals are considered since each custom basket is evaluated for the ETF's positioning against its underlying index. For example, on August 1, 2018, LQD accepted three distinct custom creation baskets ("Creation Baskets 1, 2 and 3") from APs that totaled \$321 million. Each of the three custom creation baskets differed in terms of their size, positions, issuers, and risk exposures. Once Creation Basket 1 was accepted, Creation Baskets 2 and 3 were reviewed by the portfolio manager(s), taking into consideration the composition of the ETF's portfolio after it had evolved as a result of Creation Basket 1. If Creation Baskets 1, 2 and 3 were all identical in terms of size, composition, and position weights, accepting each basket may have caused the ETF to be overweight certain bonds. Creation Basket 3 only had a 10% and 9% overlap, respectively, with Creation Baskets 1 and 2 from a CUSIP perspective. However, in the aggregate, all 3 custom baskets facilitated the ETF's tracking of its underlying index. While BlackRock may consider multiple custom creation baskets from APs in a single trading day, as discussed earlier in Section II.A and B, BlackRock generally does not engage in iterative discussions with APs for custom redemption baskets.

Conversely, during a day of significant redemption activity, a fixed-income ETF portfolio manager may not want to deliver the same securities to all APs if they are not available in sufficient quantity or if their delivery could cause the ETF to become underweight certain positions. For example, if we assume LQD received a \$500 million redemption order ("Redemption Order 1"), which the ETF facilitated by delivering a custom basket of 500 securities, and assume that after Redemption Order 1, 50% of those positions went from an overweight versus the underlying index to a neutral weight, if LQD received a second \$500 million redemption order ("Redemption Order 2"), using the same custom redemption basket may result in those positions moving from neutral weight to underweight versus the underlying index. Also, after Redemption Order 1, the ETF may not have possessed all 500 positions in sufficient quantity to satisfy Redemption Order 2 using the same basket. As a result, it may be optimal from a tracking error perspective to evolve the redemption basket as primary flows occur to balance existing positions versus the underlying index and market impact, and to more efficiently facilitate redemption orders.

<sup>26</sup> Securities are prohibited from being freely transferred from one beneficial owner to another in the following jurisdictions: Brazil, Chile, China A shares, China B shares, Colombia, Egypt, India, Jordan, Korea, Kuwait, Malaysia, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Taiwan and the United Arab Emirates.

<sup>27</sup> For example, iShares Emerging Markets Dividend ETF (ticker: DVYE) transacts in cash in markets where securities are prohibited from being freely transferred in-kind (i.e., markets listed *supra* footnote 26). In all other markets, the ETF generally transacts in-kind.

<sup>28</sup> Reasons may include an AP being restricted in a name, lacking a custodial account in the relevant market or lesser trading sophistication in a particular market. The AP may otherwise have the capabilities to transact in the other basket names and markets invested in by the ETF.

creation or redemption. Alternatively, APs agree to accept certain slippage costs, up to a specified maximum additional charge. This process is intended to eliminate both transaction-related costs and the potential for dilution in connection with such cash transactions, so that the transactions are economically equivalent to in-kind transactions.

Because APs bear the costs for such cash transactions, execution of these foreign basket securities are targeted to occur during market hours in the relevant foreign jurisdiction(s), following the close of the US market. For this reason, ETF order-taking for any business day (*i.e.*, for T) begins after the close of the current US business day (after 4:15 pm Eastern Time on T-1), but prior to the opening of the US market the next business day (on T) so that executions can occur during foreign market hours. This allows for greater opportunities to align securities transactions closer to expected NAV prices, and minimizes slippage costs to APs and potential shareholder dilution.<sup>29</sup> It also facilitates the arbitrage function and more efficient secondary market prices for the ETF shares since APs are better able to estimate the pricing for the underlying securities and overall costs more accurately if their orders can be placed on the prior business day or overnight.

Due to the time required for standard daily ETF processing and reconciliation for NAV calculations, and other end of (US) day practices, it is operationally difficult for sponsors to post basket or portfolio holdings information prior to an ETF taking orders. Such end of day processes result in BlackRock's basket and portfolio holdings information generally being made available by 7 pm Eastern Time, while many of our ETFs begin accepting orders at 4:15 pm Eastern Time.<sup>30</sup>

Based on our experience, APs have sufficient information to start placing orders on T-1 (after the US market closes), before current portfolio holdings or basket content information is released. APs have available the prior business day's holdings and basket information which, as a general matter, do not vary materially day over day, outside of major rebalances.<sup>31</sup> Furthermore, APs are sophisticated investors with their own comprehensive tools and data to predict with reasonable accuracy any information required for their orders. We note that APs are under no obligation to place ETF orders early; they do so entirely at their own convenience and can always choose to wait until the basket or portfolio holdings information is available, should they prefer. As a practical matter, we understand that many APs prefer placing their orders on T-1 for operational reasons and as part of their end of day processes, so that they can utilize the ETF's affirmation of an order while they have US personnel available during US business hours (until approximately 6 pm Eastern Time) to perform internal checks, controls and processing of such orders. APs may then subsequently utilize their foreign affiliates for trading or hedging activities in connection with their order(s), at which time current basket information is generally available (6-7 pm Eastern Time).<sup>32</sup> If APs were required to await

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<sup>29</sup> We note that clients of APs may agree to certain pricing terms related to the creation/redemption order, which may be dependent on market executions occurring at specified times in the underlying foreign market, so APs seek to place the creation/redemption order, as applicable, to help coincide with those pricing terms.

<sup>30</sup> Basket information is may be made available before portfolio holdings information. As discussed below, basket information is more concise and provides information required solely for creation and redemption activity. Portfolio holdings information provides additional transparency related to portfolio holdings and other information that is available to all investors. Producing portfolio holdings information requires additional time and processing relative to the time required to prepare basket content information. In both cases, the information is currently available prior to the US market open of the following business day.

<sup>31</sup> T-1 orders are predominantly used for equity ETFs investing in international markets. Major rebalances of an index, which typically occur quarterly, are publicized events and APs are able to adjust its order based on the prior day's basket and the public information provided by index providers related to the index rebalance.

<sup>32</sup> For iShares ETFs that invest in international equity markets (all of which are available for order taking from APs on T-1), the timing of creation/redemption orders submitted by APs between March 2014 and August 2018 was as follows: approximately

publication of basket and portfolio holdings information prior to placing their order(s), they will either have to expend considerable resources to enhance their foreign trading desks, or may will face significant delays in execution in the local markets, which will likely result in widened spreads for international equity ETFs. For market making and other trading activities in ETF shares during US market hours, APs will have available both the current business day's basket and portfolio holdings information prior to US market open, which is the current and preferred practice.

Many ETFs in the marketplace currently take orders prior to publication of basket or portfolio holdings information and operate efficiently and with tight spreads.<sup>33</sup> Accordingly, we believe the requirement to publish basket or portfolio holdings information prior to ETF order taking is not necessary. We recommend that both basket and portfolio holdings information be required to be made available prior to US market open, consistent with current practice. At a minimum, we would request that only basket information be required to be made available to APs prior to taking orders since basket information may be able to be generated in a more timely manner than portfolio holdings information.<sup>34</sup> As discussed in Section III below, basket information is more streamlined content required solely for creation and redemption activity, while portfolio holdings information provides additional transparency and details regarding an ETF's portfolio holdings to all investors, which requires additional time and processing over basket content information. In all cases, both are available prior to the opening of trading for the ETF shares in the US market.

### 3. *Cash In Lieu*

While BlackRock supports the Commission's position that heightened policies and procedures should be required for custom baskets, we note that the Proposed Rule defines custom baskets to include those resulting from cash substitutions of basket securities for a single AP and, thereby, subjects such baskets to the heightened custom basket policies and procedures requirements. For many ETFs that operate predominantly in-kind, particularly domestic and international equity ETFs, the same basket is generally used for all APs on the same business day, except for substitution of one or more names for cash. These cash substitutions occur because an AP may be unable to deliver or receive the security due to regulatory or operational constraints.<sup>35</sup> Because we do not believe such cash substitutions raise the same concerns and risks for potential overreaching as substitutions of alternate securities outlined by the Commission,<sup>36</sup> BlackRock recommends that the Commission clarify that an ETF has discretion to tailor its custom basket policies and procedures as it deems appropriate to

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58.5% of orders were placed on T and approximately 41.5% of orders were placed on T-1. Of the orders placed on T-1, approximately 91% were placed between 4:15-6:00 pm Eastern Time and approximately 97% were placed between 4:15-7:00pm Eastern Time.

<sup>33</sup> APs have been able to effectively use the tools available to them to place orders on a T-1 basis without current portfolio holdings or basket content information in such a manner as to maintain small bid-ask spreads in ETFs accepting such orders. Shares MSCI Emerging Markets ETF, (ticker: EEM) for example, has since its inception accepted orders a T-1 basis and as of August 15, 2018 EEM maintained an average 30-day bid-ask spread of \$0.01. Over the past 10 years EEM's bid-ask spread has been less than 0.10% of the price of a share of EEM.

<sup>34</sup> We note that the rule indicates that the proposed requirements under Article 12 of Regulation S-X would be applicable to baskets as well, but as discussed in Section III below, we request the Commission clarify that such requirements only apply to portfolio holdings information and not baskets and that a more simplified information be presented for baskets.

<sup>35</sup> For example, an AP may be restricted from purchasing or accepting delivery of a particular name otherwise acceptable to other APs.

<sup>36</sup> Release at page 96.

address different risks, considerations and requirements that may be associated with different types of custom baskets used, especially custom baskets involving cash substitutions.

BlackRock's existing basket policies and procedures currently address both cash substitutions and security substitutions, however, the requirements for each differ. For example, our custom basket policies that address substitution of securities include additional procedural requirements that aim to ensure that such accepted baskets facilitate an ETF's ability to meet its investment objective. By contrast, policies on cash substitutions<sup>37</sup> seek to ensure that appropriate transaction cost charges are passed to the AP such that the ETF is in the same or similar place had the transaction been in-kind while at the same time enforcing consistency in their application among APs. Such policies also enumerate limited circumstances under which waivers of such charges could be appropriate. It is simpler for an ETF to evaluate the appropriate transaction costs to pass to an AP than it is to evaluate the appropriateness of an offered substitute security. Accordingly, any custom basket policies and procedures on baskets involving cash substitutions for a single AP may be subject to more streamlined requirements than the custom basket policies and procedures relating to baskets involving securities substitutions. We believe that the ability to differentiate within the custom basket policies and procedures and to provide a more streamlined approach for cash substitutions would minimize the time and amount of sponsor resources spent on routine and simple "custom" cash substitutions and, conversely, allow for more resources and greater focus to be spent on the assessment of security substitutions being evaluated in connection with other custom baskets.

#### 4. Custom Basket Definition

BlackRock supports the Commission's proposed definition of custom basket with certain minor modifications. To clarify the definition of custom basket, we ask the Commission to embed a definition for "representative selection" in the Proposed Rule rather than in the Release and request that the Proposed Rule modify the definition of "*pro rata*."

We propose a definition of "custom baskets" as follows: "(i) baskets that are not composed of a representative selection of the ETF's portfolio holdings; or (ii) different baskets used in transactions on the same business day."

Additionally, we believe that "representative selection" should be defined in the Proposed Rule using language from the Release. Specifically, "a representative selection of the ETF's portfolio holdings would include, but not be limited to, baskets that reflect: (i) a *pro rata* representation of the ETF's portfolio holdings; (ii) a representative sampling of the ETF's index or portfolio holdings; or (iii) changes due to a rebalancing or reconstitution of the ETF's securities market, if applicable."<sup>38</sup>

Lastly, we recommend that a published *pro rata* basket should still be deemed to be "*pro-rata*" if it is or includes (i) cash substitutions for odd lot positions or as a result of minimum trade sizes, (ii) cash substitutions due to security specific restrictions such as corporate actions or regulatory reasons, (iii) positions or other instruments that cannot be delivered in-kind (e.g., derivatives, to-be-announced (or "TBA") transactions) or (iv) a basket that is otherwise a representative selection of the ETF.

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<sup>37</sup> Cash substitutions are utilized more frequently for creations than redemptions, primarily due to accessibility considerations associated with creations.

<sup>38</sup> Release at page 95.

### III. Portfolio Transparency and Disclosure Matters

BlackRock commends the Commission for seeking to address the distinct portfolio transparency and disclosure issues presented by ETFs. We support the Commission's proposal to require full portfolio transparency and agree with the Commission that Form N-1A should be modified to address ETF-specific disclosure issues. Although BlackRock agrees with many of the Commission's proposals with respect to portfolio transparency and disclosure matters, we believe certain aspects of the Proposed Rule should be modified to more effectively accomplish the Commission's goals. We have focused our comments and recommendations below on specific issues raised by the Release.

#### A. Portfolio Transparency/Daily Holdings Disclosure

We strongly support the Commission's proposed condition to require an ETF to provide full portfolio holdings transparency on a daily basis on its website and agree that full transparency is an important tool in facilitating an ETF's arbitrage mechanism. BlackRock has previously commented extensively on the requirements for an effective arbitrage function and the role of portfolio transparency in supporting such function.<sup>39</sup> Transparency allows market participants to easily detect the existence, and estimate the extent of, any discrepancy between the value of an ETF's portfolio and the current exchange price of the ETF's shares, which leads to a more efficient arbitrage mechanism and secondary market trading. When deviations occur, market participants are readily able to take advantage of trading opportunities offered by these short-term imbalances of supply and demand which, in turn, provides liquidity on the exchange. With complete portfolio transparency, an efficient arbitrage mechanism exists, since it enables APs and market participants to provide ETF share prices on the exchange that are highly aligned with the value of the ETF's underlying holdings.<sup>40</sup>

We note that BlackRock currently provides full disclosure of portfolio holdings on a daily basis for all of our existing index-based and actively managed ETFs in the US.

While we are very supportive of the Proposed Rule's requirement to provide daily publication of portfolio holdings and to disseminate such holdings before the opening of regular trading, we disagree with the proposal's additional timing requirement to require dissemination of the holdings *before* the ETF begins accepting orders for the purchase or redemption of creation units.<sup>41</sup> This condition poses similar challenges as those discussed above in Section II.C relating to publication of the basket prior to the ETF accepting orders and is unnecessary for the reasons discussed above.<sup>42</sup>

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<sup>39</sup> See Comment Letter of BlackRock on 2015 ETP Request for Comment (Aug. 11, 2015) ("2015 ETP Comment Letter"), available at <https://www.blackrock.com/corporate/literature/publication/sec-request-for-comment-exchange-traded-products-081115.pdf>; Comment Letter of Barclays Global Fund Advisors (May 16, 2008), available at <https://www.sec.gov/comments/s7-07-08/s70708-14.pdf>.

<sup>40</sup> While portfolio transparency is the simplest means of permitting professional trading firms to compare the value of an ETF's portfolio relative to the ETF's current share price, BlackRock believes that for more novel ETF structures such as non-transparent actively managed ETFs, there are alternative mechanisms for facilitating the arbitrage mechanism without daily portfolio holdings transparency. In such cases, the ETF arbitrage mechanism can be achieved by other arrangements that permit market participants to assess an ETF's underlying value reasonably accurately, and to hedge trading exposures to the ETF's shares, throughout the trading day.

<sup>41</sup> Release at page 79.

<sup>42</sup> As discussed in Section II.C(2), because portfolio holdings information requires additional information than what is included in current basket information, the timing constraints for publishing ETF holdings prior to an ETF taking orders are more pronounced for dissemination of portfolio holdings information than basket information.

We support the Commission's efforts to standardize the manner in which portfolio holdings information is presented on an ETF's website. While we recognize that ETFs already comply with Article 12 of Regulation S-X for financial reporting purposes, we believe that the information required by Article 12 of Regulation S-X is overly broad, less useful to investors, costly and operationally challenging to provide on a daily basis. Instead, we recommend that the Commission adopt portfolio holdings disclosure requirements consistent with the generic listing standards for actively managed ETFs adopted by the listing exchanges (the "Portfolio Holdings Listing Standards"), which we believe is a more appropriate framework for promoting consistency around portfolio holdings information. The Portfolio Holdings Listing Standards include the following portfolio holdings information (as applicable): (1) ticker symbol; (2) CUSIP or other identifier; (3) a description of the holding; (4) with respect to holdings in derivatives, the identity of the security, commodity, index, or other asset upon which the derivative is based; (5) the strike price for any options; (6) the quantity of each security or other asset held as measured by select metrics (par value, notional value, number of shares, number of contracts, and number of units); (7) maturity date; (8) coupon rate; (9) effective date; (10) market value; and (11) percentage weighting of the holding in the portfolio.<sup>43</sup>

First, we believe the information required by the Portfolio Holdings Listing Standards more effectively allows market participants to identify and fairly value an ETF's portfolio holdings. For example, ticker symbol and other identifier (such as CUSIP), which are relevant for identifying a particular holding, are required by the Portfolio Holdings Listing Standards but not by Article 12 of Regulation S-X. With respect to information provided in connection with derivatives holdings of an ETF, we believe the information required in the Portfolio Holdings Listing Standards is more useful and relevant for an investor than the information required under Article 12 of Regulation S-X, which is much more detailed and potentially confusing to investors in this context.<sup>44</sup>

Second, we think it is helpful to note that various items required by the Portfolio Holdings Listing Standards, including a description of the holding, the strike price for any options, the quantity of each security or other asset held, maturity date, coupon rate, and market value, are also required by Article 12 of Regulation S-X. As such, adopting the Portfolio Holdings Listing Standards does not mean a complete departure from Article 12; rather, it would result in a more streamlined portfolio holdings disclosure that includes a subset of the items required by Article 12 that is most relevant and useful for investors. This would also make it more operationally feasible to publish portfolio holdings information on a daily basis, while still providing sufficient information to facilitate the arbitrage mechanism.

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<sup>43</sup> See NYSE Arca Rule 8.600-E(c)(2); Nasdaq Rule 5735(c)(2); Cboe BZX Rule 14.11(i)(3)(B).

<sup>44</sup> For example, Article 12 of Regulation S-X requires the disclosure of, among other things:

- (i) For futures, foreign currency contracts and swaps: unrealized appreciation/depreciation.
- (ii) For options and swaps where (a) the underlying investment or reference instrument is an index or basket of investments, (b) the components are not publicly available on a Web site, and (c) the notional amount of the option or swap contract exceeds 1% of the net asset value of the ETF: a description of the index or custom basket, listing separately the 50 largest components in the index or custom basket and any other component where the notional value for that component exceeds 1% of the notional value of the index or custom basket.
- (iii) For futures, options, foreign currency contracts and swaps: the identification of each investment that cannot be sold because of restrictions or conditions applicable to the investment and the identification of each investment whose value was determined using significant unobservable inputs.

We note that with respect to (i) above, that the Portfolio Holdings Listing Standards require the disclosure of market value of all derivative instruments. With respect to (ii) and (iii) above, providing this level of detail on a daily basis would likely require complex system development that we believe would outweigh any potential value to investors, especially for item (iii) since we believe the likelihood of such restrictions described in item (iii) are remote.

Third, the Portfolio Holdings Listing Standards are already applicable to actively managed ETFs relying on the generic listing standards,<sup>45</sup> and the adoption of such existing framework for all ETFs would avoid having the consequence of subjecting certain ETFs to two different (albeit overlapping) sets of portfolio holdings disclosure requirements. BlackRock currently provides daily disclosure portfolio holdings information consistent with the Portfolio Holdings Listing Standards for all of its ETFs, including index based ETFs, in a downloadable format on its website.<sup>46</sup>

If, however, the Commission disagrees with our recommendation to adopt the Portfolio Holdings Listing Standards and chooses to use the framework provided by Article 12 of Regulation S-X, we recommend that the Commission consider excluding certain requirements in Article 12 that we believe are overly broad and not useful or additive to investors.<sup>47</sup> Requiring disclosure of such detailed information on a daily basis is also operationally impractical and may increase the risk of inaccurate information being presented to investors. Accordingly, if the Commission were to adopt Article 12 of Regulation S-X as an approach, at a minimum we request the Commission to (i) exclude the items that are not necessary for market participants to identify and value an ETF's portfolio holdings<sup>48</sup> and (ii) confirm that all requirements under Article 12 of Regulation S-X that are not specifically noted in Footnote 220 of the Release are not required and embed that in the text of the Proposed Rule<sup>49</sup>.

Finally, we note that certain language in the Release suggests that basket information must also be published on an ETF's website in a manner prescribed within Article 12 of Regulation S-X; however, there is no substantive discussion, and no comment was solicited, on this aspect of the Proposed Rule in the Release. As such, we request that the Commission confirm the requirements prescribed within Article 12 do not apply to basket information. Because the main purpose of basket information is to inform APs of the identity and quantity of the assets to be delivered or received in connection with a creation or redemption transaction, we believe that the Commission should only require basket information to include what is necessary for APs to create or redeem in an ETF, which represents a subset of the information required under the Portfolio Holdings Listing Standards, including the description, identifier (*i.e.*, ticker symbol and CUSIP or other identifier), and quantity or amount (*i.e.*, number of shares for equity securities and principal amount for debt securities) of each basket asset.<sup>50</sup> Limiting basket information to only those items required for purposes of

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<sup>45</sup> While only actively managed ETFs relying on the generic listing standards are currently subject to the Portfolio Holdings Listing Standards, we note that the 19b-4 applications approved for various BlackRock actively managed and index ETFs also require portfolio holdings information that are the same as, or similar to, the Portfolio Holdings Listing Standards, as set forth in their respective 19b-4 applications.

<sup>46</sup> We note that portfolio holdings information for BlackRock ETFs is supplemented by various additional information that investors may find useful, and we would expect to continue to provide such additional information along with the required portfolio holdings information in one file on our website.

<sup>47</sup> Information required by Article 12 of Regulation S-X that we believe is overly broad and not useful for investors as part of a daily publication includes: (i) disclosure related to repurchase agreements as required by footnote 2 to Rule 12-12; (ii) disclosure related to variable rate securities and disclosure related to payment in-kind income, each as required by footnote 4 to Rule 12-12; (iii) the identification of each issue of restricted securities and related disclosure and the identification of each issue of securities whose value was determined using significant unobservable inputs as required by footnotes 8 and 9 to Rule 12-12; and (iv) those items related to derivatives holdings noted in footnote 44 of this comment letter.

<sup>48</sup> See *supra* footnote 47.

<sup>49</sup> This means with respect to footnotes prescribed within Article 12 of Regulation S-X, those footnotes that are not related to the description columns would be excluded.

<sup>50</sup> The required basket information we propose reflects the information we currently provide to APs, which has been sufficient to allow for orderly creation and redemption activities.

creation and redemption activities is also important to allow for more timely dissemination of such basket information to APs, particularly in light of the Commission's proposed requirement that basket information be available prior to ETF order taking. While both basket information and portfolio holdings information will be made available prior to US market open, basket information is generally able to be generated more readily and can be made available prior to portfolio holdings information.<sup>51</sup> Please refer to the discussion above in Sections II.C and III.A for our related comments on the timing of website publication of basket and portfolio holdings information.

## **B. Definition of "Market Price"**

BlackRock agrees with the Commission that daily website disclosure of an ETF's current NAV per share and market price promotes transparency and helps investors to understand the potential risk that an ETF's market price may deviate from the ETF's NAV per share. We believe that the proposed two-prong approach to defining "market price" detailed in the Release provides ETFs with the necessary flexibility to determine a market price that more accurately reflects the shares' market value, and agree with the Commission that the midpoint of the national best bid and national best offer ("NBBO") is an appropriate alternative to official closing price.<sup>52</sup> By establishing the midpoint of the NBBO as an alternative price, we believe that ETF sponsors will be able to provide investors with a more accurate market price in situations where the official closing price information is stale.

Furthermore, while each of the major ETF listing exchanges prescribes a methodology for improving the accuracy of the "official closing price", only NYSE Arca, Inc. ("NYSE Arca") has developed an alternative closing price methodology that factors in the time-weighted NBBO midpoint price.<sup>53</sup> We believe the Proposed Rule's allowance to use the midpoint of the NBBO when it more accurately reflects the market value of an ETF share at the time when the ETF calculates current NAV per share will improve the accuracy of market price information, particularly for ETFs listed on other major ETF listing exchanges.

BlackRock would propose to comply with the Proposed Rule by generally using the official closing price of an ETF share to calculate market price so long as there are shares exchanged in a closing auction or when an exchange has established an alternative closing price methodology (i.e., NYSE Arca); however, when no such closing auction or alternative closing price methodology is present, BlackRock proposes to use the midpoint of the NBBO to determine market price. BlackRock encourages the Commission and the other listing exchanges to collaborate on additional guidance or rulemaking to incorporate an alternative closing price methodology into the listing rules for all major ETF listing exchanges to further the goal of consistency within the ETF regulatory framework.

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<sup>51</sup> Based on our recommendations, basket information would include a subset of items required under the Portfolio Holdings Listing Standards for portfolio holdings information, making it easier for basket information to be generated than is the case for portfolio holdings information.

<sup>52</sup> Release at pages 109-110, noting that "[p]roposed rule 6c-11 would define the term 'market price' to mean: (i) the official closing price of an ETF share; or (ii) if it more accurately reflects the market value of an ETF share at the time as of which the ETF calculates current NAV per share, the price that is the midpoint of the [NBBO], calculated as of the time NAV per share is calculated."

<sup>53</sup> See NYSE Arca Rule 1.1(II) (definition of "Official Closing Price"). See also Securities Exchange Act Release No. 82907 (March 20, 2018) [83 FR 12980 (March 26, 2018)].



### C. Disclosure of Certain ETF Trading Information and Costs, and Interactive Calculator Requirement

BlackRock believes that ETF investors should have access to information regarding the potential trading costs associated with their investments in ETFs and agrees with the Commission that additional disclosure regarding trading costs, such as bid-ask spreads, would help investors better understand the total costs of investing in an ETF.<sup>54</sup> However, we believe that certain of the proposed amendments to Item 3 of Form N-1A may not be helpful to investors, and therefore provide below recommendations with respect to the proposed amendments.

The principal transaction costs involved in purchasing (or selling) ETF shares are (a) any brokerage charges imposed by the investor's broker for effecting a transaction (which are established by the broker, not the ETF or its sponsor), (b) the spread (which is established by market makers, not the ETF or its sponsor), and (c) on larger transactions, the market impact of the transaction (which is established by the market, not the ETF or its sponsor).<sup>55</sup> BlackRock believes that spread costs are not well understood by most ETF investors despite the fact that, for retail-sized transactions, spread costs may be an important transactional expense associated with buying or selling an ETF.<sup>56</sup> Spread costs may vary significantly from one ETF to another,<sup>57</sup> and may even be notably different for index-based ETFs that track similar indexes.<sup>58</sup>

BlackRock is supportive of the Commission's efforts to bring awareness to investors of the impact that trading costs may have on their investments in ETFs, and agrees with the Commission that ETFs should be required to disclose bid-ask spread information pursuant to a prescribed methodology so that investors can compare this information across ETFs pursuing similar investment strategies.<sup>59</sup> However, the median bid-ask spread for the most recent fiscal year is not a particularly useful data point for investors, as it may not be representative of the trading experience of investors due to the staleness of the data. We recommend that the Commission consider adopting an alternate metric, such as time-weighted average, over a more recent time period (e.g., trailing 30 days), to be disclosed on the ETF's website. We believe that a more recent data point would provide a more representative spread level that an

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<sup>54</sup> Release at page 154.

<sup>55</sup> The expenses of selling ETF shares are borne by the selling ETF shareholder.

<sup>56</sup> For institutional-sized transactions, market impact costs typically may be a more significant expense consideration for institutional investors rather than spread costs.

<sup>57</sup> The average spread applicable to an ETF's shares may vary over time as a result of the number of, and competition among, firms making a market in the ETF's shares. The spread charged is a function of a number of factors, which include both the costs of purchasing the ETF's in-kind basket and the liquidity of the ETF's shares (more liquid ETF shares attract greater price competition among market makers). Spreads on ETFs can be as low as a penny per share on very liquid ETFs, and substantially greater for less liquid ETFs. As an example, an investor seeking to purchase 10,000 shares of the iShares Russell 2000 ETF (ticker: IWM), which typically trades at a bid-ask spread of 0.01% or 1bp, would bear implicit spread costs of \$100 to invest \$1.7mm (at a recent price of \$171.79 per share), while an investor seeking to purchase 16,000 shares of the iShares Micro-cap ETF (ticker: IWC), which typically trades at a bid-ask spread of approximately 0.21% or 20bps, would bear implicit spread costs of \$3,360 to invest a similar amount.

<sup>58</sup> For example, the iShares S&P 500 Value ETF (ticker: IVE) and the Vanguard S&P 500 Value ETF (ticker: VOOV) both seek to track the S&P 500 Value Index, comprised of large-capitalization value stocks. For the month ended August 2018, based on average quote size of at least 100 shares for the iShares ETF and 100 shares for the Vanguard ETF, the average spread of the iShares ETF was 1bps, while the average spread of the Vanguard ETF was 8bps. The difference in the spread may be a reflection of the greater average daily trading volume in the secondary market for shares of the iShares ETF versus the Vanguard ETF.

<sup>59</sup> Release at page 115.

investor could expect to encounter when executing a trade in that ETF, and that the more recent data point would also be useful for investors in new ETFs with limited trading history.<sup>60</sup> Likewise, BlackRock does not believe that the proposed amendment to Item 3 of Form N-1A to disclose the costs associated with 25 hypothetical \$10,000 round-trip trades (50 total trades) would be useful to investors, as this example is not reflective of how most retail shareholders trade ETFs.

With the modifications suggested herein, BlackRock supports the required inclusion of the proposed question and answer section regarding ETF trading information and related costs in Form N-1A, but believes that the disclosures would be more appropriate in the statutory prospectus rather than in the summary prospectus.

As stated above, BlackRock believes that enhanced disclosure regarding potential trading costs for ETFs may be useful and informative for investors, and we are supportive of the Commission's efforts to provide investors with the ability to customize hypothetical trading cost information to their specific investing situation. The Proposed Rule would require each ETF sponsor to provide an interactive calculator in a clear and prominent format on the ETF's website.<sup>61</sup> BlackRock is concerned that, as currently proposed, the web-based interactive calculator requirement would not result in a consistent investor experience across ETF sponsors as a result of differing data sources and calculation methodologies, and could therefore result in investor confusion.<sup>62</sup> In addition, requiring each individual ETF sponsor to build and host an interactive calculator may be a costly exercise, particularly for smaller ETF sponsors. We recommend that the Commission consider tasking a third party (for example, a listing exchange, a market research or data provider, or the Commission's Division of Trading and Markets<sup>63</sup>) with the construction and maintenance of a single interactive calculator tool that would allow investors to truly compare trading cost information across different ETFs, using uniform data. Further, a single tool would provide the additional utility of advancing the technology utilized by other industry participants, such as brokerage platforms, by promoting a standardized calculation methodology. A single third party tool would allow all ETF sponsors to provide the same information while alleviating the expense of building their own interactive calculator. The Commission could further require that the third party's interactive calculator tool be made available via a link on each ETF sponsor's website. We believe that the existence of a single tool, using the same underlying data source for all ETFs, would significantly enhance the value of the tool and would provide a greater benefit to ETF shareholders, as compared to the current proposal.

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<sup>60</sup> As an ETF matures, it is expected that both assets under management and average daily trading volume will increase over time, which typically lead to an improvement in market quality (spread). The median bid-ask spread as of the most recent fiscal year end could overestimate the trading costs an investor could incur. As an example, the iShares Edge MSCI Multi Factor USA ETF (ticker: LRGF) has seen its median spread improve since inception from 35bps in January 2016 to 4.03bps in July 2018. The ETF's median bid-ask spread as of the most recent fiscal year ending July 31, 2018 was 6.34bps, and the median bid-ask spread for the month of July 2018 was 4.03bps. Disclosure based on the SEC's currently proposed methodology results in a significant overstatement of expected trading costs as compared to the more recent 30 day median. We also note that spreads tend to widen during periods of market volatility, which could lead to an investor experiencing higher trading costs than would be expected based on the use of the median bid-ask spread as of the most recent fiscal year end.

<sup>61</sup> Release at page 164.

<sup>62</sup> As is the case with most intraday calculations, the trading data that would form the basis for the interactive calculations are not standardized data points, and therefore may be different across different third-party data vendors used by ETF sponsors.

<sup>63</sup> BlackRock believes that greater collaboration between the Division of Trading and Markets and the Division of Investment Management would benefit the ETF ecosystem and ETF shareholders generally. The Division of Trading and Markets has demonstrated its extensive knowledge of ETF trading dynamics, and its ability to access the relevant trading data. See *Corporate Stock Trading Volume, Spreads and Depth Before, During and After the NYSE Trading Suspension on July 8, 2015* (February 3, 2016), available at [https://www.sec.gov/marketstructure/research/highlight-2016-01.html#\\_ftn4](https://www.sec.gov/marketstructure/research/highlight-2016-01.html#_ftn4).

## **D. General Disclosure and Website Requirement Feedback**

BlackRock is supportive of the Commission's efforts to enhance website disclosure for ETFs, in light of the significant increase in the use of the internet as a tool for disseminating information,<sup>64</sup> and agrees that ETF sponsors should make required disclosures easily accessible and readily available to the public, without encumbrance or restrictions on access or retrieval, subject to standard website terms and conditions and intellectual property protections. We would also support a requirement to include a website disclaimer indicating the potential limitations of historical disclosures similar to the current performance-related disclosure legend in Form N-1A.<sup>65</sup>

BlackRock notes the elimination of the current exemptive relief requirement to transmit a portfolio composition file or "PCF" for each ETF each business day to the National Securities Clearing Corporation ("NSCC") under the Proposed Rule. As noted above, we are generally supportive of the Commission's efforts to enhance website disclosure for ETFs, and support the proposed requirement for ETFs to post PCFs (and portfolio holdings information as discussed above) on their website. As a practical matter, ETF sponsors are likely to continue to transmit PCFs to the NSCC for the foreseeable future in order for APs to properly consume the information. We note that BlackRock has been a strong advocate of establishing more consistent and transparent primary market trading processes for market participants, including APs, which would standardize and simplify ETF creations and redemptions.<sup>66</sup> BlackRock strongly supports a regulatory framework that encourages enhanced data uniformity across the ETF industry for the benefit of all investors.

## **IV. Comments on Details of the Proposed Rule and other Questions and Issues Raised in the Release**

BlackRock believes the Proposed Rule generally captures the essential features of existing Commission exemptive relief under the Act applicable to ETFs. BlackRock, however, recommends that the Commission consider certain technical enhancements to the proposal, as discussed below. BlackRock also recommends that the Commission modify the proposals to resolve several issues on which the Commission requested comments in the Release, but which the Proposed Rule currently does not address.

### **A. Additional Time for Delivering Redemption Proceeds/Definition of Foreign Investment**

BlackRock supports the Commission's proposal to provide an ETF with additional time for the delivery of foreign investments. However, with respect to the definition of "foreign investment," we request clarification on the provision that the security have "no established [US] public trading market." Many foreign issuers (as defined by Rule 3b-4 under the Exchange Act) issue common stock in an established US public trading market (the "US Traded Security"),<sup>67</sup> which would mean that an investment in such issuers' foreign

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<sup>64</sup> Release at page 107.

<sup>65</sup> Release at page 129; see Item 4(b)(2)(i) of Form N-1A.

<sup>66</sup> See BlackRock March 2017 ViewPoint, *supra* footnote 3.

<sup>67</sup> As of July 31, 2018, there were 502 foreign issuers that listed on NYSE and NYSE American. Of those 502 foreign issuers 269 issued common stock, available at: <https://www.nyse.com/publicdocs/nyse/data/CurlListofallStocks.pdf>. A majority of the remainder accessed the US market through the use of depositary receipts. The 269 foreign issuers of common stock represent about 10% of the all issuers listed on NYSE and NYSE American.

security would not be considered a foreign investment under the proposed definition. Such an interpretation would be extremely disruptive to current practices. Currently, most index ETFs invest in the security issued by the foreign issuer that trades in that issuer's local public trading market (the "Foreign Traded Security") and *not* the US Traded Security. This is because index providers typically include in international indexes used by ETFs the Foreign Traded Security as opposed to the US Security.<sup>68</sup> In addition, the trading volume and liquidity of the Foreign Traded Securities are generally much greater in comparison to those of the US Traded Security, which are often more limited. As a result, even where it is possible for an ETF to invest in a US Traded Security, there is a very strong preference to invest in the Foreign Traded Security as there may not be sufficient liquidity in the US Traded Security to meet the ETF's investment needs.<sup>69</sup>

Accordingly, the mere existence of an established US public trading market does not alleviate the need for an ETF to have relief from Section 22(e) of the Act when the ETF invests in the Foreign Traded Security.<sup>70</sup> The definition of "foreign investment," if adopted as proposed, would eliminate the ETF's ability to rely on existing Section 22(e) relief, which is essential for continued investment in Foreign Traded Securities consistent with its underlying indexes,<sup>71</sup> potentially resulting in increased tracking error and reducing the volume of securities available to many ETFs.<sup>72</sup> Further, we note that ETFs currently do not

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<sup>68</sup> For example, according to the index methodology for MSCI Global Investable Market Indexes, securities are generally represented by local listings (*i.e.*, a listing in the country where a security is classified), and securities may be represented by non-local listings only if the securities are from countries that met certain country requirements and certain other conditions are met, available at [https://www.msci.com/eqb/methodology/meth\\_docs/MSCI\\_GIMIMethodology\\_May2018.pdf](https://www.msci.com/eqb/methodology/meth_docs/MSCI_GIMIMethodology_May2018.pdf). As of May 2018, only the following 13 countries met the country requirements to allow securities from these countries to be represented by non-local listings: Argentina, Bahrain, Botswana, China, Hong Kong, Israel, Kazakhstan, Mauritius, Netherlands, Panama, Peru, Russia and Ukraine. Accordingly, a US-traded security of a foreign issuer or a US-traded depositary receipt representing a foreign investment may be included in a MSCI Investable Market Index only if such securities are from one of these 13 countries. In addition, according to the index methodology for Morningstar Global Markets ex-US Index, where there are multiple listings for a security, and each of them is liquid enough to warrant index selection, the listing selected would be the equivalent to the country classification, which generally is the country a company is incorporated and has the primary listing for its security, available at <http://corporate.morningstar.com/US/documents/Indexes/ConstructionRulesforexUSGlobalIndexFamily.pdf>.

<sup>69</sup> As an example, we analyzed the iShares MSCI ACWI ex U.S. ETF (ticker: ACWX), which seeks to track the investment results of the MSCI ACWI ex USA Index, a market capitalization weighted index composed of large- and mid-capitalization companies in developed and emerging markets countries excluding the US. Specifically, we reviewed the 50 largest non-US listed positions held by this ETF as of September 19, 2018, based on portfolio weights. 48 of these issuers have a US-traded line either in the form of common stock or registered shares on a US exchange. Of those US-traded securities, none had higher liquidity, as measured by 30-day average daily trading volume, when compared to the security listed on the foreign public market. Moreover, the US-traded line had 5% or less of the liquidity of the foreign public market for 40 of the 48 issuers, as measured by 30-day average daily trading volume.

<sup>70</sup> For the calendar year 2018, there are 28 countries where, as a result of a country's holiday schedule, a transaction may take longer than 7 calendar days to settle a redemption in kind as further described herein. The following 6 countries may take up to 8 days to settle a transaction: Argentina, Brazil, Mexico, Norway, Serbia and Tanzania. The following 8 countries may take up to 10 days to settle a transaction: Bangladesh, Bosnia and Herzegovina, Japan, Kuwait, Morocco, Oman, Qatar and Thailand. The following 2 countries may take up to 11 days to settle a transaction: Saudi Arabia and Turkey. The following 11 countries may take up to 12 days to settle a transaction: Australia, China, Indonesia, Malawi, Namibia, South Africa, Swaziland, Taiwan, Uganda, Vietnam and Zimbabwe. Lastly, it may take up to 15 days to settle a transaction in Israel.

<sup>71</sup> In certain circumstances, an ETF may invest in a foreign investment that also has a US Traded Security, an American Depositary Receipt (ADR), or a Global Depositary Receipt (GDR). We note that ADRs and GDRs that provides exposure to a certain foreign issuer would not be a US Traded Security of that foreign issuer since both ADRs and GDRs are not issued by the foreign issuer but rather a bank counterparty. As a result, a foreign issuer with an ADR or GDR would not be captured by the definition of "foreign investment" and we agree with the Commission that extended delivery and relief under Section 22(e) is not required for an ETF's investment in such US Traded Security, ADR or GDR. In such cases, the ETF would satisfy redemptions of such securities in-kind within the normal settlement cycle and in any case, within seven days.

<sup>72</sup> An ETF may experience higher tracking error if the proposed definition of "foreign investment" is adopted because (i) an ETF holding a foreign investment that is also traded in the US (and therefore would not have additional time to deliver proceeds under the Proposed Rule) may have to sell other portfolio securities in order to comply with Section 22(e); or (ii) all or a portion of an ETF's holdings in a foreign investment may have to be in the US-traded line of the foreign investment, even when its

monitor whether a foreign issuer has equivalent securities that both trade on a US market and the foreign issuer's local market since our primary investment practices are to invest in the securities of the underlying index. As a result, the adoption of the proposed definition of "foreign investment" would likely require substantial technology builds to monitor the availability of a US Traded Security even if the ETF does not invest in such security in order to comply with Section 22(e).<sup>73</sup> We therefore recommend that the definition of "foreign investment" be clarified to mean any securities, assets or other positions issued by foreign issuers, as defined in Rule 3b-4 the Exchange Act, for which there is an established trading market for such security, asset or other position outside of the US.<sup>74</sup>

## B. Exchange Act Trading Relief

BlackRock appreciates the Commission's efforts under the Proposed Rule to streamline certain areas of relief relied upon by ETFs under the Exchange Act and strongly encourages additional rulemaking by the Commission to promote a regulatory framework for ETFs that is harmonized under both the Act and Exchange Act. BlackRock is supportive of the fact that the Proposed Rule allows ETFs to be eligible for the "redeemable securities" exceptions in Rules 101(c)(4) and 102(d)(4) of Regulation M and Rule 10b-17(c) under the Exchange Act.<sup>75</sup> BlackRock also agrees with the Commission that ETFs relying on the Proposed Rule would be considered within the "registered open-end investment company" exemption in rule 11d1-2 under the Exchange Act.<sup>76</sup>

However, the Proposed Rule does not address relief from Exchange Act Section 11(d)(1) and Rules 10b-10, 15c1-5, 15c1-6 and 14e-5 (the "Other Exchange Act Rules"). ETFs currently rely on a web of exemptions and no-action relief as a class or individually from the Other Exchange Act Rules ("Trading Relief"). In addition, ETFs are subject to the applicable listing exchange's initial and continuous listing standards ("Exchange Listing Requirements"). As noted in the Release, such relief is subject to a variety of conditions, including minimum creation unit sizes, frequent dissemination of Intraday Indicative Value ("IIV"), restrictions on the payment of certain cash compensation or economic incentives to broker-dealers, and minimum levels of diversification in the ETF's portfolio, which are duplicative or, in some cases, inconsistent with other requirements to which the ETF may be subject. For example, although the Proposed Rule does not mandate a particular maximum or minimum creation unit size for ETFs,<sup>77</sup> ETFs relying on the Equity Class Letter<sup>78</sup> are required to maintain a minimum creation unit size of 50,000 shares or such other amount

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underlying index includes the locally-listed foreign investment.

<sup>73</sup> BlackRock's compliance systems are generally designed to review investments held by the ETF as opposed to investments that are not held by the ETF.

<sup>74</sup> The Staff may consider a definition of "foreign security" from rule 15a-6 of the Exchange Act and applicable no-action letters, which provide that a foreign security is defined as: (i) a security issued by an issuer not organized or incorporated under the laws of the US when the transaction in such security is not effected on a US exchange or through the Nasdaq system, or (ii) a debt security (including a convertible debt security) issued by an issuer organized or incorporated in the United States in connection with a distribution conducted outside the United States. See Cleary, Gottlieb, Steen & Hamilton, SEC No-Action Letter (Jan. 30, 1996), available at <https://www.sec.gov/divisions/marketreg/mr-noaction/cleary040997.pdf>.

<sup>75</sup> Release at page 39.

<sup>76</sup> *Id.* at page 39.

<sup>77</sup> *Id.* at Pages 64-66 ("Accordingly, we do not believe it is necessary to mandate a particular maximum or minimum creation unit size for all types of ETFs...Moreover, we believe that the conditions in the Proposed Rule designed to promote effective arbitrage are better suited for that purpose than conditions related to creation unit size.")

<sup>78</sup> See Class Relief for Exchange-Traded Index Funds (pub. avail. Oct. 24, 2006), which provides class relief for equity index-based ETFs.

where the value of a creation unit is at least \$1 million at the time of issuance, and ETFs relying on the Fixed-Income Class Letter<sup>79</sup> are required to maintain a minimum creation unit size of 50,000 shares. In addition, the Proposed Rule does not require dissemination of IIV, as the Release notes that market makers generally use their own proprietary algorithms, rather than publicly-disseminated IIVs, to value shares throughout the trading day.<sup>80</sup> Further, the process for obtaining relief from the Other Exchange Rules can be time-consuming and cumbersome, and has historically lacked coordination among SEC divisions (sometimes within the same division based on allocation of responsibilities for different rules).<sup>81</sup>

BlackRock recommends that ETFs relying on the Proposed Rule and satisfying the Listing Exchange Requirements be exempt from the Other Exchange Act Rules. BlackRock recommends that the Commission harmonize the additional requirements applicable to ETFs under the Exchange Act either under the Proposed Rule, under separate rulemaking, or under industry-wide no-action relief in order to create a consolidated and efficient regulatory framework for ETFs. This will allow new and existing sponsors to bring traditional ETFs to market more rapidly and at a reduced cost to facilitate greater competition and innovation.

### C. Investment Strategy Flexibility

BlackRock supports the Commission's efforts to create a level playing field among market participants by permitting both index-based and actively-managed ETFs to operate under the Proposed Rule, subject to the same conditions. We agree with the Commission that eliminating the regulatory distinction between index-based and actively-managed ETFs will provide a more consistent and transparent regulatory framework and promote consistency with the Commission's regulation of other types of open-end funds.

Further, because index-based ETFs would continue to be subject to the "Names Rule" requirements pursuant to Section 35(d) of the Act and Rule 35d-1 thereunder with respect to the percentage of the ETF's assets invested in the type of investment suggested by the ETF's name, we do not believe that investors would benefit from including a separate condition in the Proposed Rule that an index-based ETF is required to invest at least 80% of its assets in the component securities of its underlying index in the Proposed Rule.<sup>82</sup>

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<sup>79</sup> See Class Relief for Fixed-Income Exchange-Traded Funds (pub. avail. Apr. 9, 2007), which provides class relief for fixed-income index-based ETFs.

<sup>80</sup> *Id.* at page 72 ("We understand that market makers today typically calculate their own intraday value of an ETF's daily portfolio disclosure and available pricing information about the assets held in the ETF's portfolio. We further understand that they generally use the IIV, if at all, as a secondary or tertiary check on the value that their proprietary algorithms generate.") BlackRock notes that listing exchange rules and the Rule 19b-4 process impose requirements with respect to dissemination of IIV. See, e.g., NYSE Arca Rule 5.2-E(j)(3), Commentary .01(c), noting that the ETF will disseminate an estimated IIV, updated at least every 15. See also, e.g., Securities Exchange Release No. 34-75468 (July 16, 2015) [80 FR 435000 (July 22, 2015)] (SR-NYSEArca 2015-25), at page 10, noting that "[s]hares will comply with all other requirements...[including] requirements relating to the dissemination of...the IIV."

<sup>81</sup> For example, in order to obtain relief from the Other Exchange Act Rules, ETF applicants are currently required to submit no-action requests to the Commission's Division of Trading and Markets with respect to Exchange Act Section 11(d)(1), Rules 10b-10, 15c1-5, 15c1-6 and the Commission's Division of Corporate Finance with respect to Exchange Act Rule 14e-5.

<sup>82</sup> See *Investment Company Names*, Investment Company Act Release No. 24,828 (Jan. 17, 2001) ("Index funds, for example, generally would be expected to invest more than 80% of their assets in investments connoted by the applicable index.") We note that, depending on the investment strategy of the ETF, an issuer subject to the rule may determine to self-impose similar limits with respect to the percentage of the ETF's assets that will be invested in the component securities of its underlying index.



#### **D. Affiliated Index ETFs**

We are supportive of the proposal to eliminate distinct rules and requirements applicable to index-based ETFs with an affiliated index provider. We agree with the Commission that index-based ETFs with an affiliated index provider should be subject to the same regulatory framework as index-based ETFs with a third-party index provider. We believe that current securities laws and compliance requirements adequately address and mitigate potential conflicts of interest that could exist, such as with respect to information sharing between portfolio management staff and index management staff. We note that BlackRock currently maintains information barriers to prevent misuse of material non-public information across our investment management business, including in the context of ETFs using an affiliated index provider.

#### **E. Suspension of Creations**

We agree with the Commission that the circumstances where an ETF may need to suspend creations are limited. However, in addition to the example cited in the Release of a closure of the market(s) on which an ETF's portfolio holdings are traded, there are additional circumstances where an ETF may be effectively restricted from access to portfolio holdings. We believe it would be helpful for the Commission to clarify in the Proposed Rule or in commentary that it is permissible in such additional circumstances for an ETF to suspend creations. First, capacity constraints may effectively restrict an ETF's ability to access sufficient quantities of securities to meet its investment objective. This may be due to regulatory or threshold restrictions applicable to the ETF or to specific issuers in the portfolio that may be exacerbated depending on the size of the ETF. This is common practice in the context of other open-end registered investment companies, which are known to close to new subscriptions for temporary and sometimes extended periods in order to support efficient management of the fund's portfolio.<sup>83</sup> To that end, we see no reason to restrict ETFs, which are also open-end investment companies, from a similar ability to do so. Second, imposition of regulatory sanctions applicable to significant components of underlying indexes could result in certain securities or issuers in certain markets becoming uninvestable. We also request that the Commission clarify in the adopting release any maximum period that can be considered "temporary" for ETF suspensions, or provide guidelines on making such determination.

We note that, in the ETF context, a suspension may cause the ETF to trade at a premium until new issuances or creations resume. We believe appropriate risk disclosures, in conjunction with the proposed disclosure requirements regarding persistent premiums (or discounts) detailed in the Release, would adequately inform shareholders of the impact of any suspension of creations while giving discretion to the sponsor to more efficiently manage the ETF in the best interests of existing shareholders.

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<sup>83</sup> See, e.g., Vanguard PRIMECAP Fund, Supplement to the Prospectus, filed May 1, 2006, available at <https://www.sec.gov/Archives/edgar/data/752177/000093247106000860/primecap497.txt>; Fidelity Growth Company Fund, Supplement to the Prospectus, filed April 18, 2006, available at <https://www.sec.gov/Archives/edgar/data/707823/000070782306000003/main.htm>; Oakmark International Fund, Prospectus, filed January 26, 2018, available at [https://www.sec.gov/Archives/edgar/data/872323/000110465918004124/a18-3299\\_4485bpos.htm](https://www.sec.gov/Archives/edgar/data/872323/000110465918004124/a18-3299_4485bpos.htm).

## F. Liquidations

We appreciate the Commission's recognition of the need to create an exception to the definition of "exchange-traded fund" to allow ETFs to sell or redeem individual shares on the day of consummation of a liquidation.<sup>84</sup> However, we request that the Commission also confirm that a liquidating ETF whose trading is halted on a national securities exchange in connection with the liquidation process (and therefore no longer meets the definition of "exchange-traded fund") may nonetheless continue to rely on the Proposed Rule to accept redemption requests from APs only, and not from all shareholders, during the period after the trading halt of such ETF but before the final distribution of liquidation proceeds, provided that (i) the ETF notifies shareholders of the liquidation at least 60 days before the trading halt of the ETF; and (ii) the final liquidation proceeds are distributed to the remaining shareholders no more than seven days after the trading halt of the ETF. The regulatory framework for ETFs, both under existing exemptive relief as well as under the Proposed Rule, contemplate transactions only with APs, and therefore ETFs do not generally have the operational capabilities to transact directly with shareholders who are not APs. We believe that this requested clarification is consistent with the spirit and intent of Section 22(e) of the Act and eliminates unnecessary operational burdens for ETFs that are already in the process of being liquidated.

## V. Scope of Proposed Rule

As noted above, BlackRock is very supportive of the Commission's efforts to create a consistent regulatory framework for ETFs and is generally in agreement with the Proposed Rule. We note below several recommendations for addressing leveraged and inverse ETPs (as defined below) and Section 12(d)(1) relief, each of which are currently outside the scope of the Proposed Rule.

### 1. Leveraged and Inverse ETPs

While the Proposed Rule does not address leveraged exchange-traded products ("ETPs"), we appreciate several of the Commissioners' remarks acknowledging that these products have different risks than traditional ETFs and warrant additional consideration by the Commission and its staff.<sup>85</sup> As discussed below in Section VI of this letter, we believe that leveraged and inverse ETPs are not ETFs, and should not be permitted to refer to

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<sup>84</sup> Release at page 66 and Proposed Rule 6c-11(c)(5) ("Notwithstanding the definition of exchange-traded fund in paragraph (a) of this section, an exchange-traded fund is not prohibited from selling (or redeeming) individual shares on the day of consummation of a reorganization, merger, conversion or liquidation").

<sup>85</sup> Statement of Commissioner Robert J. Jackson, Jr. on Proposed Rules Regarding Exchange-Traded Funds (ETFs), available at <https://www.sec.gov/news/public-statement/statement-jackson-exchange-traded-funds-062818> ("[t]hat's why I'm delighted to report that I have expressed these views to Chairman Clayton, and he shares my concern that these products can pose a real danger to American investors. We hope to work together to study this question—starting with hard empirical data that can tell us whether there are a significant number of retail investors who are exposed to the risks I've described."); Statement at Open Meeting on the Proposed Rule under the Investment Company Act of 1940 Governing Exchange-Traded Funds (statements of Commissioner Kara M. Stein), available at <https://www.sec.gov/news/public-statement/statement-stein-exchange-traded-funds-062818> ("[u]ltimately, I agree with the outcome that leveraged and inverse ETFs should not be permitted to rely on this proposed 'plain vanilla' ETF rule, but we still need to address these questions."); Statement at Open Meeting on Exchange-Traded Funds (statements of Commissioner Hester M. Peirce), available at <https://www.sec.gov/news/public-statement/statement-peirce-ef-062818>, ("I would have preferred to write a more comprehensive rule, but the release does a nice job asking questions about the potential for including such funds, and I hope that commenters will weigh in on whether and how the rule could accommodate such funds. These funds are here to stay, and a rule that accommodated them would benefit investors, fund sponsors, and the Commission.")



themselves as ETFs.<sup>86</sup> A more clear-cut and consistent naming convention for ETPs would better serve retail investors by ensuring there is clarity around the structure and risks of different types of ETPs.

While the comprehensive classification scheme outlined below is not entirely within the scope of the Proposed Rule, we believe that a naming convention for leveraged and inverse ETPs could be achieved through an amendment to Rule 35d-1 of the Act that precludes leveraged and inverse ETPs from using “ETF” or “Exchange Traded Fund” in their names.<sup>87</sup>

## 2. Section 12(d)(1) Exemptive Relief

We note that the Proposed Rule would not rescind existing exemptive relief with respect to Section 12(d)(1) of the Act, which limits the ability of a fund to invest substantially in shares of another fund.<sup>88</sup> BlackRock currently utilizes its exemptive relief in this area extensively, which permits registered investment companies (including ETFs) to invest in ETFs beyond the limits otherwise permitted by Section 12(d)(1) of the Act, and is supportive of additional rulemaking to streamline the legal requirements associated with this relief.

As the Commission has previously noted, its own views (as well as those of Congress) have evolved since the enactment of Section 12(d)(1), and the experience under exemptive orders issued by the Commission to permit investment by registered investment companies in ETFs in excess of the limits of Section 12(d)(1) has been positive.<sup>89</sup> Indeed, not only have the abuses Congress envisioned when enacting Section 12(d)(1) not occurred, but such exemptions have facilitated the growth of cost-effective asset allocation and target maturity mutual funds that invest principally through ETFs as well as other, innovative new mutual funds. We urge the Commission to propose a rule to codify existing exemptive relief permitting investments in ETFs beyond the limits in Section 12(d)(1).

## VI. The Need for Improvements in ETP Classification

While all ETPs share certain characteristics, including exchange-tradability, “ETF” has become a blanket term describing many products that have a wide range of different structures. We have long highlighted our concerns regarding the use of the term “ETF” by products that have materially different risks embedded in their structures than traditional ETFs. Examples of these products include exchange-traded notes (“ETNs”) and leveraged and inverse ETPs.<sup>90</sup>

The equity market sell-off and heightened volatility during the first week of February 2018 highlights the different risk profiles associated with different types of ETPs. Specifically, a steep drop in equity benchmarks on February 5, 2018 coincided with the largest one-day percentage increase ever recorded in the VIX level. During the week of February 5th, ETFs

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<sup>86</sup> See BlackRock March 2018 Viewpoint, *supra* footnote 3.

<sup>87</sup> 15 U.S.C. 80a-34(d).

<sup>88</sup> Release at pages 36, 143 and 202.

<sup>89</sup> Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008) [73 FR 14618 (Mar. 18, 2008)].

<sup>90</sup> See BlackRock Viewpoint, *ETFs: A Call for Greater Transparency and Consistent Regulation* (October 2011), available at <https://www.blackrock.com/corporate/literature/whitepaper/transparency-and-consistent-regulation-oct-2011.pdf>; 2015 ETP Comment Letter, *supra* footnote 39; BlackRock July 2015 ViewPoint, *supra* footnote 3; and BlackRock March 2017 Viewpoint, *supra* footnote 3.

experienced more than \$1 trillion in US-listed exchange trading volume, roughly double normal trading volumes. This episode demonstrated the resilience of the traditional ETF market in a time of market stress. However, after the closing bell on February 5, 2018, several inverse VIX ETPs suffered declines in excess of 90%. These price declines reflected the embedded economics of these ETPs, as a fall in the VIX increases the value of the inverse ETP while a rise in the VIX decreases the value of the ETP.<sup>91</sup> In our view, this episode highlights the need for clearer labeling of ETPs in order to make sure investors understand that certain ETPs have greater embedded risks and more complexity than others.<sup>92</sup>

We believe it is particularly timely for the Commission to consider more consistent terminology for ETPs as the Commission works to foster more consistent regulatory standards for traditional ETFs. Indeed, the continued use of the term “ETF” or “exchange-traded fund” by products that do not have embedded structural risks that go beyond the scope of traditional ETFs such as those covered under the Proposed Rule could be even more confusing to investors, who may mistakenly believe that all products referred to as ETFs have similar structures, when in fact they may have different structural features that could embed greater risks.

Naturally, investors might mistakenly assume that all products referred to as ETFs are structured and regulated like traditional ETFs such as those covered under the Proposed Rule standard. Based on this potential concern, we recommend that the Commission consider an amendment to Rule 35d-1 under the Act that would preclude leveraged and inverse ETPs from using the terms “ETF” or “Exchange-Traded Fund” in their name.

Of course, this solution would only address the use of the term “ETF” by registered investment companies and would not apply to other types of ETPs that are not registered investment companies. As such, while we believe that a naming convention in the context of the Act would be a helpful step forward, it is not sufficient to address the lack of a common classification scheme for ETPs. As such, we reiterate our suggestion that the Commission consider a more comprehensive approach to ETP classification to improve investors’ abilities to understand and analyze the risks of individual ETPs.<sup>93</sup> Below, we provide an example of a potential classification scheme that would better categorize the risks associated with different types of ETPs. We welcome an open dialogue with the Commission and with other market participants as to the best approach to ETP classification.

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<sup>91</sup> While these products performed as designed, the dramatic jump in the VIX prompted the closure of an inverse VIX ETN by its sponsor under the terms detailed in the ETN’s prospectus (a so-called “event acceleration”). See Credit Suisse AG Press Release (Feb. 6, 2018), *Credit Suisse AG Announces Event Acceleration of its XIV ETNs*, available at <https://www.credit-suisse.com/corporate/en/articles/media-releases/credit-suisse-announces-event-acceleration-xiv-etn-201802.html>.

<sup>92</sup> See BlackRock March 2018 Viewpoint, *supra* footnote 3.

<sup>93</sup> It is frequently difficult for investors to compare even structurally similar ETPs. For example, various market data services, electronic trading systems, broker-dealers and sponsors of fixed-income ETFs have historically each reported basic metrics such as yield, spread and duration using their own proprietary calculations. This has made it difficult to compare fixed-income ETFs to other fixed-income investments, as well as to each other. A number of leading market participants have recently come together to promote a common reporting standard. See Alastair Marsh, *BlackRock, State Street Seeking ETF Standards for Trading Boost*, Bloomberg (Jul. 27, 2015), available at <http://www.bloomberg.com/news/articles/2015-07-27/blackrock-state-street-seeking-etf-standards-for-trading-boost>.

## BlackRock's Recommended Classifications for ETPs

<b>ETP</b>	<b>Exchange-Traded Product</b>	<ul style="list-style-type: none"> <li>• Generic term for any portfolio exposure product that trades on an exchange.</li> <li>• ETFs, ETCs, ETNs and ETIs are all subsets of ETP.</li> </ul>
<b>ETF</b>	<b>Exchange-Traded Fund</b>	<ul style="list-style-type: none"> <li>• ETFs are publicly-offered investment funds that trade on an exchange.</li> <li>• ETFs can be passive or active that meet diversification and liquidity thresholds set by regulators and exchanges.</li> <li>• ETFs' underlying securities can include stocks, bonds or other investment instruments (e.g., bank loans).</li> <li>• This category should exclude ETIs, as defined below.</li> </ul>
<b>ETN</b>	<b>Exchange-Traded Note</b>	<ul style="list-style-type: none"> <li>• Debt instruments that provide an index-based return. ETNs may or may not be collateralized, but depend on the issuer's solvency and willingness to buy and sell securities to deliver fully to expectations.</li> <li>• This category should exclude ETIs, as defined below.</li> </ul>
<b>ETC</b>	<b>Exchange-Traded Commodity</b>	<ul style="list-style-type: none"> <li>• A variety of fully-collateralized legal structures that are not ETNs but seek to deliver the unleveraged performance of a commodity or basket of commodities.</li> <li>• Some ETCs may hold physical commodities, while others invest in commodity futures or commodity-based total return swaps.</li> </ul>
<b>ETI</b>	<b>Exchange-Traded Instrument</b>	<ul style="list-style-type: none"> <li>• An ETI is any ETP that has embedded structural features designed to deliver performance that will not track the full unlevered positive return of the underlying index or exposure (that is, products that seek to provide a leveraged or inverse return, a return with caps on upside or downside performance or "knock-out" features).</li> </ul>

\* \* \* \* \*

We thank the Commission for providing BlackRock with the opportunity to comment on the Release, and we are eager to assist the Commission in any way we can to ensure that the rule proposal will benefit ETF investors. Please contact the undersigned if you have any questions or comments regarding BlackRock's views.

Sincerely,

Samara Cohen  
 Managing Director, Head of ETF Global Markets

Deepa Damre  
 Managing Director, Legal & Compliance

Alexis Rosenblum  
 Director, Global Public Policy Group

cc:

The Honorable Jay Clayton  
 Chairman  
 Securities and Exchange Commission

The Honorable Robert J. Jackson Jr.  
 Commissioner  
 Securities and Exchange Commission

The Honorable Hester M. Peirce  
Commissioner  
Securities and Exchange Commission

The Honorable Elad L. Roisman  
Commissioner  
Securities and Exchange Commission

The Honorable Kara M. Stein  
Commissioner  
Securities and Exchange Commission

Dalia Blass  
Director  
Division of Investment Management  
Securities and Exchange Commission