May 19, 2008

Ms. Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-0609  

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

Dear Ms. Morris:

The Independent Directors Council\(^1\) appreciates the opportunity to express its support of the Commission’s proposal relating to exchange-traded funds (“ETFs“). The proposal would introduce two new rules under the Investment Company Act of 1940 that would codify many aspects of the exemptive orders previously issued to index-based ETFs and certain actively managed ETFs and would amend disclosure requirements to provide more useful information to retail investors about ETFs.\(^2\)

IDC commends the Commission for proposing rules that would ease the burdens associated with bringing new ETF products to market and allow funds to invest in ETFs to a greater extent than currently permitted under the 1940 Act. IDC is especially pleased that the Commission’s proposal to codify ETF exemptive relief reflects the appropriate oversight role of fund boards, as discussed below. IDC also strongly supports the proposed amendments to the disclosure requirements for ETFs. Requiring disclosure of information that would be pertinent to retail investors would enhance investor understanding of ETFs, including regarding the attributes of investing in ETFs compared to traditional mutual funds.

\(^1\) IDC serves the fund independent director community by advancing the education, interaction, communication, and policy positions of fund independent directors. IDC’s activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of $12.31 trillion and serve almost 90 million shareholders. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

The appropriate role of fund boards – and the role in which they are most effective – is to provide oversight, and not to engage in day-to-day management. The role of boards of ETFs, as well as of funds that invest in ETFs, should be no different. From a governance perspective, ETFs should function very much like traditional mutual funds and other investment companies. Like directors of traditional mutual funds, directors of ETFs should oversee the ETF’s performance, fees and expenses, the quality and effective delivery of services to the ETF, the ETF’s compliance with applicable rules and regulations, and potential conflicts of interest between the ETF’s sponsor (including its affiliates) and shareholders in the ETF. An ETF board should not be charged with responsibilities pertaining to the day-to-day management of the ETF.

With this view of the role of directors in mind, IDC would like to offer its views on a number of very specific aspects of the Proposing Release that implicate the role of fund boards: (i) facilitating the arbitrage mechanism of ETFs trading in the secondary market; (ii) limiting the ability of a fund investing in ETFs to “control” that ETF; (iii) limiting duplication of fees between ETFs and funds investing in ETFs; and (iv) reviewing quarterly reports relating to transactions between a fund investing in an ETF and a broker-dealer affiliated with the ETF. In all instances, IDC firmly believes the role of boards should be consistent with the role discussed above – that is, one of oversight and not one of management – and strongly supports the proposal’s articulation of this role. Each of these topics is addressed in more detail below.

**Facilitating the Arbitrage Mechanism.** ETFs rely on arbitrage to minimize the potential deviation between the market price and the net asset value (“NAV”) of the ETF shares and, thus, allow investors to buy and sell shares in the secondary market at approximately their NAV. The proposed rule would offer an ETF the flexibility to establish the appropriate size of its creation units, so long as that size is reasonably designed to facilitate arbitrage. ETF boards currently have no specific responsibilities with regard to ensuring that the arbitrage mechanism functions efficiently to minimize deviations between the fund’s market price and NAV. Similarly, in its proposal, the Commission does not assign any specific duty to an ETF board with regard to ensuring that the ETF’s purchase and redemption process facilitates arbitrage. In its Proposing Release, however, the Commission requests comment on whether the rule should require an ETF’s board to make a finding that the ETF is structured in a manner reasonably intended to facilitate arbitrage. The Commission notes that this finding could require the board to review the number of shares in each creation unit and the liquidity of the portfolio securities and other assets.

IDC strongly objects to imposing this type of finding on ETF boards. Directors do not have, nor should they be expected to have, any special knowledge or expertise that would help them to make this type of determination. Instead, it is a decision best left to the ETF sponsor or adviser, who is better able to evaluate factors such as the distributor’s view of demand for the ETF’s shares and the specialist’s view of the liquidity of the underlying securities and the cost to assemble a creation unit. In this case, the interests of the adviser and the ETF are aligned with respect to establishing creation unit sizes that
will facilitate arbitrage. Accordingly, IDC agrees with the Commission’s decision not to rely on the board to make a specific finding with regard to an ETF’s arbitrage mechanism.

**Limiting an Acquiring Fund’s Ability to “Control” an ETF.** A fund investing in an ETF is subject to statutory limits on the amount that can be invested. The Proposing Release would provide an exemption to permit funds to invest in excess of these statutory limits, subject to certain conditions. The limits were imposed, in part, to prevent a fund from acquiring enough assets of another fund to gain control of that fund, and use the assets of the acquired fund to unduly influence the acquired fund or to enrich itself at the expense of other shareholders. The Commission has granted exemptive relief to allow the sale to unaffiliated funds of shares issued by ETFs in excess of the statutory limits, subject to certain conditions. These conditions place responsibilities on both the board of the ETF and the board of the acquiring fund. The proposed rule eliminates these conditions and subjects the funds to fewer conditions that do not call for specific board action. Unlike the conditions contained in the exemptive orders, the proposed conditions include a limit on an acquiring fund’s ability to redeem ETF shares.

IDC strongly supports the elimination of the conditions requiring specific board findings. The proposed conditions, particularly the condition limiting the ability of an acquiring fund to redeem ETF

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5 See Section 12(d)(1)(A) of the 1940 Act, which prohibits an investment company from: (i) acquiring more than 3% of another fund’s outstanding voting securities; (ii) investing more than 5% of its assets in another fund; and (iii) investing more than 10% of its assets in other funds generally. See also Section 12(d)(1)(B), which places similar prohibitions on investment companies selling their shares.

4 The conditions include a requirement that the ETF board, including a majority of its independent directors, determine that any consideration paid by the ETF to an acquiring fund or an acquiring fund affiliate in connection with any services or transactions: (i) is fair and reasonable in relation to the nature and quality of the services and benefits received by the ETF; (ii) is within the range of consideration that the ETF would be required to pay to another unaffiliated entity in connection with the same services or transactions; and (iii) does not involve overreaching on the part of any person concerned. The ETF board, including a majority of the independent directors, also is required to adopt procedures reasonably designed to monitor any purchases of securities by the ETF in an underwriting in which an affiliate of the acquiring fund is a principal underwriter, and to review those purchases at least annually to determine whether the purchases were influenced by the acquiring fund’s investment in the ETF.

The conditions also require the board of directors of the fund acquiring the ETF shares, including a majority of its independent directors, to adopt procedures reasonably designed to assure that the acquiring fund’s investment adviser was conducting the acquiring fund’s investment program without taking into account any consideration received by the acquiring fund or its affiliate from the ETF or certain of its affiliates.

5 The proposed conditions require that: (i) an acquiring fund does not control an ETF, is not presumed to control the ETF by virtue of owning up to 25% of the ETF’s shares, and does not seek to exercise control over the ETF; (ii) an acquiring fund owning more than 3% of an ETF’s shares sell its holdings in the secondary market; (iii) an ETF itself not be a fund of funds; and (iv) an acquiring fund’s sales charges and service fees comply with limits set by the Financial Industry Regulatory Authority.
shares, offer an efficient means to address the same policy concerns relating to undue influence by an acquiring fund of an ETF that the director-related conditions of the exemptive orders were designed to address. Under the proposed conditions, an acquiring fund would not be able to threaten large-scale redemptions as a means of unduly influencing an ETF, nor would it be able to control an ETF. Accordingly, IDC supports the Commission’s decision to eliminate the additional board involvement required by the conditions of the previous exemptive relief.

**Limiting Duplication of Fees Between ETFs and Acquiring Funds.** As noted above, a fund investing in an ETF is subject to statutory limits on the amount that can be invested. In addition to the control issues detailed above, Congress was concerned about duplicative fees in a fund of funds arrangement. The Proposing Release does not include the condition imposed by the exemptive orders that requires the board of the fund investing in ETFs to determine that its advisory fees are based on services that are in addition to, rather than duplicative of, the ETF’s advisory services. As the Commission aptly notes, “an acquiring fund board is already obligated to protect the fund from being overcharged for services provided to the fund” regardless of any additional required findings. Directors take their oversight responsibilities very seriously and, as noted above, one of their fundamental responsibilities is to oversee a fund’s fees and expenses. IDC therefore firmly agrees with the Commission’s conclusion that any additional board findings relating to the appropriateness of fund fees is redundant and unnecessary.

**Reviewing Reports of Transactions Between an Acquiring Fund and a Broker-Dealer Affiliated with the ETF.** The Commission’s proposal would provide an exemption from the quarterly board review requirements of Rule 17e-1 for transactions between an acquiring fund that is affiliated with an ETF by virtue of owning more than 5% of the ETF’s outstanding shares and a broker-dealer affiliated with the ETF also by virtue of owning more than 5% of the ETF’s outstanding shares. We agree with the Commission that any transaction between these second-tier affiliates is “likely to be at arms length.” Under the Commission’s proposal, fund boards would continue to have general oversight over these transactions through, among other things, approval of the procedures reasonably designed to comply with the rule. In light of the fact that these transactions do not raise the conflict of interest issues that Section 17(e) was intended to address, we believe it is appropriate to exempt the transactions from quarterly board reviews.

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6 Proposing Release at note 234. The Proposing Release also notes that no such additional findings are required under Rule 12d1-1.

7 Rule 17e-1(b)(3) requires a fund’s board, including a majority of its independent directors, to determine at least quarterly that all transactions effected in reliance on the rule have complied with procedures reasonably designed to provide that the brokerage compensation is consistent with the rule’s standards.

8 Proposing Release at note 246.
IDC strongly supports the proposal’s reflection of the appropriate role of directors overseeing ETFs and funds investing in ETFs. IDC also commends the Commission for proposing rules that would ease the burdens associated with bringing new products to market while maintaining a high level of investor protection, and enabling retail investors to have access to more useful information about investing in ETFs. If you have any questions about our comments, please contact Amy B.R. Lancellotta, Managing Director, Independent Directors Council, at 202-326-5824.

Sincerely,

/s/ Robert W. Uek

Robert W. Uek
Chair, IDC Governing Council

cc: The Honorable Christopher Cox, Chairman
    The Honorable Paul S. Atkins
    The Honorable Kathleen L. Casey

    Andrew J. Donohue, Director
    Robert E. Plaze, Associate Director
    Division of Investment Management