

October 1, 2018



Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549-1090

RE: File Number S7-15-18, Exchange-Traded Funds

Dear Sir:

Charles Schwab Investment Management (“CSIM”)¹ appreciates the opportunity to offer comments on the Securities and Exchange Commission’s (the “Commission”) proposed Rule 6c-11 on exchange-traded funds (“ETFs”) and the accompanying proposed amendments to Form N-1A and Form N-8B-2 (the “Proposed Rule”).²

CSIM is the fifth-largest provider of ETFs with approximately \$115 billion in assets under management as of June 30, 2018.³ The firm launched its first ETFs in November 2009 and today offers 22 index ETFs: 18 equity and 4 fixed income. At CSIM, we believe that ETFs are one of the most significant developments of the last 25 years for retail investors. ETFs generally offer retail investors low fees, potential tax efficiency, intraday trading and access to a wide variety of investment segments. As far back as 2001, the Commission noted that ETF investors “can have the diversification benefits of an investment company with the trading flexibility of a stock.”⁴ The Proposed Rule notes that “investors can buy and hold shares of ETFs (sometimes as a core component of a portfolio) or trade them frequently as part of an active trading or hedging strategy . . . ETFs today provide investors with a diverse set of investment options.”⁵ It is with our individual retail investors in mind that we offer these comments on the Proposed Rule.

Since the advent of the ETF industry, investment advisers have been required to obtain exemptive relief from the Commission to bring an ETF to market. This is a time-consuming and costly process that has, over time, resulted in investment advisers operating ETFs pursuant to and

¹ Founded in 1989, CSIM, a subsidiary of The Charles Schwab Corporation, is one of the nation’s largest asset management companies, with more than \$350B in assets under management as of 06/30/18. It is among the country’s largest money market fund managers (based on assets under management). It is also the third-largest provider of index mutual funds and the fifth-largest provider of ETFs (Source: Strategic Insight as of 6/30/18; based on assets under management). More information about CSIM and the products it manages is available at schwabfunds.com.

² Exchange-Traded Funds, Release No. IC-33140. 83 Fed. Reg. (July 31, 2018), at 37332.

³ Source: Strategic Insight Simfund, as of June 30, 2018.

⁴ SEC Concept Release: Actively Managed Exchange-Traded Funds, Release No. IC-25258, File No. S7-20-01. 66 Fed. Reg. (November 15, 2001), at 57617.

⁵ 83 Fed. Reg., at 37334.

under significantly different standards and conditions. Under the Proposed Rule, the Commission would allow investment advisers to operate ETFs that meet certain conditions without first obtaining exemptive relief. The Proposed Rule's stated goal is to "modernize the regulatory framework . . . create a consistent, transparent, and efficient framework for ETFs and . . . facilitate greater competition and innovation among ETFs."⁶ In addition, it would align disclosure requirements and require new disclosures designed to provide investors additional information.

CSIM strongly supports the overall goals of the Proposed Rule. There is no question that the Proposed Rule would level the playing field for existing and new ETFs, lead to increased innovation, create opportunities for new investment advisers to enter the industry and increase investor choice. The Proposed Rule would also level the playing field for individual investors, who today may bear higher costs (e.g., in the form of wider bid-ask spreads) simply because they choose to invest in an ETF that is subject to different requirements and conditions under its exemptive relief than ETFs that provide similar investment exposure. In addition, we support the goals of the proposed amendments to the current disclosure rules, as we believe they would increase transparency and access to additional information for investors. We do, however, have a number of recommendations for enhancements to the Proposed Rule and have outlined those in detail below.

I. Creation Baskets

CSIM has long expressed concern that the current rules for creation baskets stipulated by the individual exemptive relief orders granted to investment advisers and ETFs create a competitive imbalance in the industry that unfairly impacts the ETFs, investment advisers and individual investors.⁷ The first ETF exemptive relief was granted by the Commission in 1992, and since that time the terms of subsequent exemptive relief orders have gradually changed, such that newer ETFs are subject to meaningfully different conditions and requirements than ETFs that were earlier to market. For example, exemptive relief for newer entrants, including the ETFs managed by CSIM, requires that creation and redemption baskets reflect a pro rata slice of the ETF's portfolio holdings (with some exceptions), while the exemptive relief of other ETFs does not include such a requirement. This allows some ETFs to include in their baskets only a small subset of the securities the ETF holds, while the majority of ETFs must include each portfolio security owned in the basket. The individual and distinct exemptive relief conditions create an imbalance that can lead to potentially significant differences in bid-ask spreads, tax efficiency and trading costs, all of which ultimately affect the experience of each individual investor.

To the Commission's credit, the Proposed Rule recognizes the imbalance that has resulted from the evolving exemptive relief:

⁶ 83 Fed. Reg., at 37333.

⁷ See comments of Charles Schwab & Co., Inc. and Charles Schwab Investment Management, Inc. on SEC Request for Comment on Exchange-Traded Products (Release No. 34-75165), August 17, 2015 (available at <https://www.sec.gov/comments/s7-11-15/s71115-28.pdf>); Letter from Charles Schwab Investment Management, Inc., to Mark N. Zaruba, Division of Investment Management, Securities and Exchange Commission (March 20, 2013); and Letter from Charles Schwab Investment Management, Inc., to Dalia Blass, Division of Investment Management, Securities and Exchange Commission (September 19, 2011).

ETFs without basket flexibility typically are required to include a greater number of individual securities within their baskets when transacting in-kind, making it more difficult and costly for the authorized participant and other market participants to assemble or liquidate baskets. This could result in wider bid-ask spreads and potentially less efficient arbitrage. In such circumstances, these ETFs may be at a competitive disadvantage to ETFs with greater basket flexibility. As a result, these differing conditions and requirements for basket composition in our exemptive orders may have created a disadvantage for newer ETFs that are subject to our more recent, stringent restrictions on baskets.⁸

CSIM believes that the Proposed Rule rectifies these imbalances and creates a significantly more level playing field between the earliest ETFs and more recent entrants to the industry. The result will be a more competitive ETF environment, narrower bid-ask spreads and enhanced flexibility for all ETF investment advisers – all outcomes that will directly benefit individual investors.

A. Definition of Custom Baskets

The Proposed Rule defines a “basket” as “the securities, assets or other positions in exchange for which an ETF issues (or in return for which it redeems) creation units.”⁹ The Proposed Rule further defines two specific types of “custom baskets”: (1) baskets composed of a non-representative selection of the ETF’s portfolio holdings and (2) different baskets used in transactions on the same business day.¹⁰ CSIM strongly supports the definitions for “basket” and “custom basket” outlined in the Proposed Rule and appreciates the flexibility offered, which will allow investment advisers to manage ETF portfolios more efficiently. We do, however, make two recommendations for exceptions to these definitions:

- 1) The Proposed Rule notes that “if an ETF substitutes cash in lieu of a portion of basket assets for a single authorized participant, that basket would be a custom basket.”¹¹ CSIM urges the Commission to reconsider this aspect of the Proposed Rule, as we do not believe that cash-in-lieu transactions based on a published basket should qualify as a “custom basket.” CSIM views cash-in-lieu substitutions for securities in published, standard baskets as a regular and routine occurrence that is necessary for the efficient operation of an ETF.

In its 2008 proposing release for an earlier iteration of Rule 6c-11, the Commission noted several examples where an ETF might substitute cash for some or all of the securities in a basket “to minimize transaction costs or enhance the ETF’s operational efficiency.”¹² The examples discussed included ETFs that track country-specific as well as broader international and emerging market equity security indexes and are restricted by local market regulations on the in-kind transferability of securities, or when ETFs that hold financial instruments operate on a cash basis due to the limited transferability of financial instruments.¹³ The 2008 proposing release also noted circumstances when the in-kind

⁸ 83 Fed. Reg., at 37356.

⁹ *Id.*, at 37354, n. 230.

¹⁰ *Id.*, at 37356.

¹¹ *Id.*, at 37356.

¹² Exchange-Traded Funds, Release Nos. 33-8901; IC-28193. 73 Fed. Reg. (March 18, 2008), at 14628, n. 120.

¹³ *Id.*, at 14628, n. 121.

transfer of securities could trigger unfavorable tax consequences.¹⁴ To those circumstances, we would add situations in which the authorized participant placing the creation or redemption order is restricted from trading one or more securities in the basket, due to situations such as halted securities, vendor relationships, or when an affiliated investment bank to the authorized participant is an underwriter of a secondary offering in a security in the basket.

We appreciate that an ETF's ability to allow authorized participants to make substitutions in a standard basket, particularly security for security substitutions, may lead to concerns regarding preferential treatment of certain authorized participants over others. However, we do not believe the receipt of cash in lieu of a given security disadvantages an ETF or raises concerns of undue influence or preferential treatment. Many ETFs currently have the ability under their existing exemptive relief to use their discretion to accept cash in lieu of all or a portion of the securities in the basket. We are not aware of any negative consequences or conflicts that have resulted from these discretionary substitutions.

We note that all baskets are subject to policies and procedures that govern the construction of the basket and the process used for the acceptance of baskets, and these would apply to baskets that permit cash-in-lieu substitutions. We believe these policies and procedures should detail under what conditions the ETF will permit cash-in-lieu substitutions, which would then serve as a basis for compliance review and testing. But given the lack of apparent conflict or adverse impact in permitting cash-in-lieu substitutions, we do not believe they should be subject to the more detailed policies that CSIM agrees, as proposed, should apply to the use of custom baskets. As such, CSIM recommends that baskets that are different solely due to their cash components be expressly excluded from the definition of "custom basket."

- 2) We recommend that the Commission clarify in the final rule that a published basket that is used for creation or redemption transactions by multiple authorized participants on a given business day and which is constituted as a pro rata slice or representative sampling of portfolio holdings is *not* a custom basket. We believe this to be the Commission's intention because it does not meet either of the two criteria described by the rule proposal for the definition of a custom basket, but we believe the final rule would be strengthened by stating this explicitly.

B. Policy and Procedure Guidelines

The Proposed Rule requires that ETFs adopt and implement written policies and procedures governing the construction and acceptance of both baskets and custom baskets. Further, with regard to the use of custom baskets, the ETF must adopt written policies and procedures that set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders.¹⁵ The custom basket policies and procedures must

¹⁴ *Id.*, n. 120.

¹⁵ CSIM recommends that the Commission clarify in the final rule the definition of "the best interests of the ETF and its shareholders." CSIM interprets this to mean the ETF and its shareholders collectively, but not each individual shareholder. The final rule would benefit from making that interpretation explicit.

also specify the titles or roles of the employees required to review each custom basket for compliance with the policies and procedures, as well as create a record stating that the reviewed custom basket is in compliance with those policies and procedures. The Proposed Rule also notes that “the ETF’s board of directors’ oversight of the ETF’s compliance policies and procedures, as well as their general oversight of the ETF, would provide an additional layer of protection for an ETF’s use of custom baskets.”¹⁶

CSIM strongly supports the requirement for written policies and procedures for ETFs. We appreciate the perceived and actual conflicts associated with the use of custom baskets, and we agree that policies and procedures should be adopted to ensure that use of custom baskets is consistent with the best interests of the ETF and its shareholders. We believe that it is essential that the final rule preserves flexibility to allow ETF investment advisers to adopt policies and procedures that best reflect their particular business models; however, it should not be prescriptive or otherwise dictate specific criteria that must be included in the policies. If the Commission believes that an ETF should consider specific factors or criteria, those views can be outlined in guidance issued within or following the adoption of the final rule.

In addition, in the Proposed Rule, the Commission states that “[a]n ETF may want to consider whether employees outside of portfolio management should review the components of custom baskets before approving a creation or redemption.”¹⁷ The Commission then requests comments on whether this should be a requirement under the final rule. CSIM believes such a requirement would be impractical and would result in unnecessary delays in the creation/redemption process. Moreover, CSIM does not see a meaningful added benefit in a prior review. Under the Proposed Rule, investment advisers must have detailed written policies and procedures governing the creation of custom baskets, and, as the Commission states, those procedures must describe:

... the ETF’s approach for testing compliance with the custom basket’s policies and procedures and assessing (including through back testing or other periodic reviews) whether the parameters continue to result in custom baskets that are in the best interests of the ETF and its shareholders.¹⁸

Therefore the policies and procedures will effectively provide a strong and verifiable framework for compliance review, testing and exception reporting. As such, it is superfluous to require a burdensome pre-approval process for the creation of custom baskets, which can occur multiple times throughout the trading day.¹⁹

C. Affiliated Transactions

The Proposed Rule would permit certain affiliated persons of an ETF to participate in creation and redemption basket transactions (i.e., act as an authorized participant). The Proposed Rule

¹⁶ 83. Fed. Reg., at 37357.

¹⁷ *Id.*, at 37357.

¹⁸ *Id.*, at 37357.

¹⁹ While CSIM believes prior approval of custom baskets by an employee outside of portfolio management should not be a requirement, CSIM acknowledges that certain ETFs may determine that pre-approval may be beneficial to their oversight process, at least in certain circumstances (such as particularly large or customized trades). This underscores the utility of the flexibility in procedures for which we advocate.

essentially codifies prior exemptive relief previously granted by the Commission to ETF applicants. In the proposing release, the Commission states that the Proposed Rule “is necessary to facilitate the efficient functioning of the arbitrage mechanism” and that “an increase in the number of authorized participants could also help to reduce the potential for an ETF to be reliant on one or more particular authorized participants.”²⁰ CSIM heartily agrees.

We would, however, urge the Commission to consider extending the scope of the Proposed Rule to cover additional types of affiliated relationships, such as broker-dealers that are affiliated with the ETF’s investment adviser. In the Proposed Rule, the Commission understandably expresses concern that “the use of custom baskets presents an increased risk that the ETF may be subject to improper pressure by an authorized participant to create specific baskets that favor that authorized participant.”²¹ CSIM believes this concern is effectively mitigated by the detailed written policies and procedures that an ETF would be required to implement and review under the Proposed Rule. These procedures are no less effective in instances where the authorized participant is an affiliate of the ETF’s investment adviser.²² While limiting the types of affiliates that are covered by the exemption to those enumerated under the Proposed Rule may *conceptually* result in additional protections above and beyond those provided by the ETF’s policies and procedures, CSIM believes those added protections, if even measurable, are minimal in comparison to the benefits that may accrue to an ETF and its shareholders through the availability of additional authorized participants. We believe the robust compliance and oversight policies and procedures applicable to the use of custom baskets under the Proposed Rule are more than sufficient to address potential concerns and identify any actual conflicts.

II. Website Disclosure

CSIM has long supported robust disclosure that helps individual investors make informed investment decisions. But disclosure should always be guided by the value it brings to an investor. While CSIM supports many of the enhanced disclosure elements of the Proposed Rule that provide investors increased transparency and consistent information with which to make an investment decision, some of the Commission’s recommendations provide little value to investors and, particularly with regard to individual retail investors, may in fact create confusion.

A. Portfolio Holdings

CSIM strongly supports the Proposed Rule’s requirement that “an ETF disclose prominently on its website . . . the portfolio holdings that will form the basis for each calculation of net asset value (“NAV”) per share.”²³ CSIM believes that this information can be useful to individual investors, as it allows them to better understand what they own and discern differences between ETFs that purport to track similar indexes or have similar investment objectives. Portfolio holdings are also important to market participants who are engaged in arbitrage activity.

²⁰ 83 Fed. Reg., at 37345.

²¹ *Id.*, at 37356.

²² CSIM notes that Rule 38a-1 also effectively limits over-reaching by authorized participants.

²³ *Id.*, at 37352.

B. Published Baskets

The Proposed Rule also requires that “an ETF publish on its website one basket that it would exchange for orders to purchase or redeem creation units” and that the published basket “must be disclosed before the opening of trading of the ETF’s shares and before the ETF begins accepting orders for the purchase or redemption of creation units to be priced based on the ETF’s next calculation of NAV.”²⁴ CSIM does not believe that disclosure of one standard basket for orders to create or redeem creation units on an ETF’s website would be useful disclosure to either individual investors or authorized participants as proposed.

(i) Disclosure of Published Baskets

CSIM believes the Commission should distinguish between information that is meaningful for all investors and information that only has value to authorized participants and other market participants who are engaged in creation and redemption transactions. CSIM believes the standard basket disclosure would be relevant to only authorized participants and other market participants (although, as noted below, these participants already have several means of accessing this information).

With regard to individual investors, however, while we support the public disclosure of portfolio holdings, we believe providing basket-level information to individual investors is likely to cause confusion and potentially mislead investors. As an initial matter, CSIM believes that few individual investors would be familiar with the differences between portfolio holdings and creation and redemption basket securities. As such, it is quite possible that an average individual investor may in fact mistake one for the other. Moreover, even if those differences are understood, CSIM fails to see why such disclosure would be relevant to individual investors who do not typically engage in direct transactions with the ETF but rather purchase ETF shares in the secondary market. It seems any potential benefit of published basket disclosure to individual investors is far outweighed by the risk of confusion.

With regard to authorized participants, we do not believe that authorized participants or other market participants would look to an ETF’s website for information related to the creation basket. Authorized participants and other market participants already have three mediums for accessing basket data for the Schwab ETFs. Specifically, basket files for the Schwab ETFs are currently available to authorized participants and other market participants through: 1) the National Securities Clearing Corporation (NSCC) data file that compiles the baskets of all ETFs; 2) direct e-mail distribution from the Schwab ETFs’ custodian; and 3) a secured File Transfer Protocol (FTP). Notwithstanding the foregoing, CSIM would not object to providing an additional means of making this information available to authorized participants and other market participants, but we would strongly recommend that access to this information be restricted to those persons (e.g., in the form of password-protected web access). By limiting access to the basket data to only those parties that would have a business need for it, the concern relating to investor confusion is eliminated.

²⁴ 83 Fed. Reg., at 37358.

(ii) Timing of Published Basket Disclosures and Order Acceptance

An additional and critical consideration that we would like to highlight to the Commission is the Proposed Rule's requirement that an ETF not accept creation and redemption orders prior to publication of its portfolio holdings. CSIM believes this requirement will cause a set of unintentional adverse consequences that outweigh any benefits, and will be particularly acute in ETFs invested in international securities. The impact will be exacerbated for ETF investment advisers that rely on third-party information processors for order taking and other such functions.

Many ETFs with international securities currently accept creation and redemption orders during a trading window that begins immediately following the close of the U.S. equity markets (4 p.m. EST) on trade date minus one ("T-1") and may extend to the close of regular trading hours on trade date. Accepting orders on a T-1 basis allows the ETF to invest or raise cash in the local markets on the same trade date as the creation or redemption order. Any creation or redemption order received during this window is valued at the next calculated NAV (on trade date). Portfolio holdings in these ETFs are typically disclosed and published several hours after the close of the U.S. equity markets on each business day. Delays in this publication process may include, but are not limited to, processing of daily portfolio trading activity, receipt and update of pricing data from outside vendors, periodic index rebalancing or reconstitution activity, or other corporate actions.

Authorized participants acting in an agency capacity are generally able to accept and affirm creation and redemption orders for their customers prior to publication of ETF portfolio holdings by employing technology to automate and highlight basket changes when the data becomes available, or by requiring qualified personnel to manually update orders when baskets are finalized. Market makers and/or authorized participants acting in a principal capacity and engaging in arbitrage activity could benefit from increased transparency of ETF portfolio holdings prior to placement of creation and redemption orders; however, the benefit would be minimal for two reasons: (1) arbitrage trading is rarely based on perfect hedges; and (2) arbitrage trading is opportunistic and involves contemporaneous hedging activity that may not align with the daily creation and redemption order cycle of an ETF.

To ensure that ETFs with international securities exposure continue to function efficiently, CSIM recommends that the Commission not include a specific requirement that seeks to align the timing of portfolio holdings publication with creation and redemption order acceptance. We support the Proposed Rule's requirement to publish portfolio holdings prior to the open of U.S. markets but do not agree that this should be done prior to accepting creation and redemption orders. We recommend instead allowing market forces to dictate a narrowing or elimination of the time gap between publication of ETF portfolio holdings and order acceptance.

Finally, we note that, as proposed, the Proposed Rule creates a significant operational burden on ETF investment advisers that rely on third parties to process and distribute the necessary information. This is a burden that could include, among other things: additional compensation to the distributor for personnel coverage well beyond normal business hours; costs of developing systematic solutions as a supplement or substitute for after-hours order taking; and extended compliance and technology support. This could result in higher operating expense ratios designed to cover these increased costs to the detriment of ETF shareholders.

C. Portfolio Holdings and Published Basket Disclosure Format

The Proposed Rule requires an ETF to present the description, amount, value and/or unrealized gain/loss, in the manner prescribed within Article 12 of Regulation S-X, for each portfolio holding or basket asset. CSIM believes that providing daily portfolio holdings and basket information under Regulation S-X is too burdensome and costly to operationalize on a daily basis, and that it will be challenging for investment advisers to comply with the requirement to post portfolio holdings daily prior to the ETF opening for trading. Regulation S-X requires more detailed disclosure of fund holdings on a trade date basis, which requires certain adjustments to be made for reporting under U.S. Generally Accepted Accounting Principles (GAAP). In particular, disclosure under Regulation S-X will require adjustments on a daily basis from the portfolio positions used for NAV calculation to record transactions as of trade date rather than trade date plus one (“T+1”). In addition, footnote disclosures and categorization by industry and country are required by Regulation S-X, and those details may reside in systems that are separate from the daily books and records. These details would need to be accessed from third parties that are performing those services or providing disclosure data on a daily basis. The risks and operational burden required to make these adjustments, generally during the period after the NAV is struck and before the ETF opens for market trading the next day, are significant relative to the limited benefits these detailed disclosures will provide to investors.

Specialized technology is used to generate schedules under Regulation S-X, which requires separate schedules and formats for presentation of investments in unaffiliated issuers, affiliated issuers, securities sold short, futures contracts, forward currency contracts, etc. Additional technology will be required to translate each holding schedule to a readable format for viewing and consuming on a website. While these schedules would provide consistency across ETFs from different investment advisers for viewing by an investor, the burden to create them daily would be costly.

We would also call out that unrealized gain/loss information is not meaningful to individual investors on a book basis. The unrealized gain/loss information on a book basis does not reflect the impact of redemptions in-kind and may mislead investors on the current taxable position of the ETF. Instead, the potential impact most applicable to an investor is the tax cost disclosure required by Article 6 of Regulation S-X, which is prepared for the semi-annual and annual reports.

Further, there is no current requirement for disclosure of basket holdings to be made in the same manner as is done in the financial statements (Regulation S-X required schedules). Adding end-of-day pricing to basket files that is in line with the methodology applied to ETF NAV calculations would impose unnecessary and additional cost and provide no tangible value to authorized participants and other market participants who rely on basket information.

As an alternative to following the format prescribed by Regulation S-X, CSIM recommends consideration of a holdings disclosure requirement similar to what money market funds report on fund websites today. Such a format could be composed of readily available data points that will be reported on Form N-PORT and are based on the portfolio holdings process used for NAV calculation. The Commission might also look to the data points required by the generic listing

standards for active ETFs, provided, however, that the actual security positions are those used for the prior end of day NAV calculation.

D. Daily NAV, Market Price and Historical Premium/Discount Disclosure

CSIM generally supports the proposed disclosures around an ETF's daily NAV and market price. These are basic elements that should be easily accessible to any investor, accompanied by educational material that helps investors better understand the differences between an ETF's NAV and market price. We also generally support the disclosure of historical premium/discount information in a tabular chart or line graph format.

The Proposed Rule would also require that any ETF whose premium or discount exceeds 2% for more than seven consecutive trading days disclose that information on its website along with a discussion of the factors it reasonably believes materially contributed to the premium or discount. The ETF would need to maintain this disclosure on its website for a period of at least one year after the disclosure is first posted. CSIM believes the utility of this disclosure to investors will diminish over time and that one year is simply too long a period of time to maintain this disclosure on the ETF's website. As an alternative, CSIM recommends a requirement that the information remain posted for the period during which the premium or discount continues to exceed the 2% threshold and for 45 days after the premium or discount has returned below that threshold.

E. Bid-Ask Spread

CSIM generally agrees with the Commission's goal of enhancing transparency regarding the total costs of investing with ETFs. Providing investors with examples and explanations describing the different fees they may incur during the process of buying and selling an ETF is a critical component in achieving this transparency.

That said, information is not useful to an individual investor if it does not provide value or has the potential to mislead. The Proposed Rule requires an ETF "to disclose the median bid-ask spread for the ETF's most recent fiscal year."²⁵ While on its face, it appears that such disclosure would enable investors to compare the economic impact of bid-ask spreads on their investments across different ETFs, in practice the disclosure does not support true apples-to-apples comparisons and, therefore, is not useful. Simply put, there are too many factors that make such comparisons difficult: ETFs have different fiscal years, draw data from different data providers, and use different data points and different mechanisms for determining the result. Critically, historical quoted bid-ask spreads are not an accurate representation of an investor's experience at the point of execution. Depending on market conditions, size of trade, order type, and other factors, an investor's realized spread (sometimes referred to as "effective spread") can be significantly different from quoted spreads observed just before or after a trade is executed in the market.

Recent market events and current trading conditions will have a profound impact on the bid-ask spread. The publication of historical and stale information lacks relevancy and does not provide

²⁵ 83 Fed. Reg., 37361.

the transparency of the total costs of investing that would be informative at the time of the selling or buying of the security. Further, unlike several of the other components involved with the costs of investing such as performance, taxes, and total operating expenses, ETF investment advisers do not calculate, maintain, nor influence the methodology from which a bid-ask spread is generated. Bid-ask spread calculations are derived through third-party vendors, each utilizing unique and non-standardized data points to derive their spreads. This independence generates bid-ask spread calculations that may be subjective, are proprietary in calculation and lack the applicability to compare similar ETFs from different investment advisers side-by-side.

To provide guidance, and encourage investors to seek more information, we would support written disclosures on an investment adviser's website highlighting the additional cost considerations that an individual investor should consider when investing in a security such as timing of the trade, transaction fees, commissions, and premiums and discounts, and, as discussed in more detail below, the impact of bid-ask spreads.

F. Interactive Calculator

CSIM applauds the Commission for its attempt to enhance disclosure by proposing to require an interactive calculator that would allow investors to customize a hypothetical bid-ask spread to the investor's specific situation. As technology evolves and investors become more comfortable accessing information electronically, rather than through more traditional written documents, the industry should continually seek opportunities to enhance the way in which important information is communicated to investors.

Unfortunately, CSIM does not believe the proposed interactive calculator would provide meaningful disclosure to investors and believes the Commission should reconsider this requirement. As an initial matter, we are not convinced that such a tool is feasible, nor would it provide value to individual investors. An ETF investment adviser would be required to provide investors with data that the adviser itself does not control, calculate, or have influence over. To fulfill this requirement, it would be necessary to (a) build out new website functionality; (b) establish third-party relationships and data feeds; and (c) establish new policy guidelines, controls, procedures, and oversight. Each of these new requirements comes at an additional cost, not only upfront, but ongoing. The cost also would impose a competitive disadvantage for smaller ETF investment advisers. Moreover, unless such a calculator is pulling real-time data from the Securities Information Processor (SIP) or a third-party vendor with access to the SIP,²⁶ the output generated by the interactive calculator will by necessity be backward-looking and of limited use. Historical bid-ask spreads do not account for current market conditions and trading activity. Indeed, a calculator focused solely on the bid-ask spread places undue emphasis on just one aspect of the investing decision, ignoring other equally if not more important factors such as brokerage commission, expense ratio, other transaction costs and, more generally, a fund's investment objective, strategy and risks.

²⁶ CSIM is not suggesting that the Proposed Rule be modified to require ETFs to pull real-time data from SIP or vendors with access to SIP. We believe this would be challenging for ETFs from a technology perspective and ultimately cost-prohibitive.

Additionally, in hosting an interactive calculator, ETF investment advisers would be required to develop their own interpretation and calculation for bid-ask spreads. This is likely to lead to a lack of comparability, transparency, and consistency: the very features the Commission is seeking to provide investors. Investors would not be able to compare bid-ask spreads across several different ETFs side-by-side due to the lack of uniformity in approach and output of the information. As a result, investors who believe they can use the interactive calculator as a comparative tool, when it is not, will receive potentially misleading information.

As an alternative to the proposal by the Commission, we suggest that ETF investment advisers provide a standardized written example on their proprietary websites. The written example should provide investors with an overview of a hypothetical trade, define the different type of costs they may encounter at each step of the hypothetical trade and explain how a difference in costs will yield different results. This example should be accompanied by robust education for investors that provides information on the different aspects to consider when making an investment decision, including investment objective, time horizon, risk tolerance, bid-ask spread, brokerage commissions, expense ratio and other relevant information. The goal should be to provide individual investors with access to as much information as possible to support their investment decision-making process. But that information should not over-emphasize the costs of bid-ask spreads while diminishing the focus on similarly and more important factors.

If the Commission seeks to pursue an interactive calculator as defined within the proposal, we suggest that the tool be made available to investors through the Commission's website as a means to provide a singular view and interpretation of bid-ask spreads across the industry. In its comment letter, the Investment Company Institute recommends the creation of a calculator that makes use of the advanced market metrics available through the Market Information Data Analytics System (MIDAS).²⁷ CSIM supports further exploration of this possible avenue of providing a centralized, standardized, interactive calculator for individual investors.

G. Use of a Structured Format for Additional Disclosure

CSIM supports the provisions of the Proposed Rule that “allow ETFs to select a format for posting information that the individual ETF finds most efficient and appropriate for the content management system of their website.”²⁸ This flexibility will allow ETF investment advisers to display the required information in a way that conforms to other information on its website and is thus familiar to its investors. The alternatives described in the proposal, including the use of structured disclosures, will not be user-friendly for individual investors and will incur unnecessary costs to the ETF.

III. Prospectus Disclosure

The Proposed Rule details several proposed amendments to Form N-1A, including Item 3, which relates to the fees and expenses associated with investing in a mutual fund or an ETF. Included in the proposed amendments is a requirement for new fee and expense disclosure, to be

²⁷ See Comment Letter of Susan Olson, General Counsel, Investment Company Institute (September 21, 2018), available at <https://www.sec.gov/comments/s7-15-18/s71518-4403410-175592.pdf>.

²⁸ 83 Fed. Reg., at 37396.

formatted as a series of questions and answers (“Q&As”), that is designed to provide individual investors with additional information regarding the costs associated with such investments, including information about an ETF’s bid-ask spread and other trading costs.

A. Content of Proposed Investment Disclosure

CSIM is supportive of certain of the Commission’s proposed changes to Item 3 including the proposal to clarify that the fees and expenses reflected in a mutual fund’s or ETF’s fee and expense table may be higher when an investor buys or sells shares. We also support the addition of a statement that investors may be subject to other fees, such as brokerage commissions and fees paid to financial intermediaries, that are not reflected in a mutual fund’s or ETF’s fee and expense table. In addition, CSIM generally agrees that most of the information in the Q&As regarding ETF trading and related costs will be helpful to individual investors (notwithstanding our concerns regarding the inclusion of that information in the summary prospectus, as discussed below). However, CSIM strongly recommends that the Commission reconsider requiring disclosure of historic median bid-ask spreads and use of that information to illustrate the impact of spreads on an investor’s hypothetical \$10,000 investment.

As discussed previously in this comment letter, the bid-ask disclosure may be confusing to investors because, due to differences in sources and calculation methodology, it is unlikely to be comparable in an apples-to-apples manner across ETFs. Moreover, the bid-ask spread information would be based on an ETF’s prior fiscal year making the information stale even before the date the prospectus becomes effective; therefore, it will offer little value to an investor’s personal investing situation. Further, CSIM believes that the disclosure of the historical median bid-ask spread could be potentially misleading to investors because it would not represent the investor’s actual costs. As noted above, historical quoted bid-ask spreads are not an accurate representation of an investor’s experience at the point of execution. Investors are likely to be more concerned about what their costs will be, not what they hypothetically would have been. CSIM believes investors would be better served to understand “how” an ETF’s bid-ask spread can impact the cost of their investment, rather than what the impact “would have been” historically.²⁹

CSIM, like the Commission, believes that investors should have access to adequate information describing the cost of investing in ETFs and all other financial instruments. An understanding of the impact of bid-ask spreads is but one input into the total costs equation. While investors should have access to information that explains that impact, that explanation must be straightforward, helpful, readily understood, and, most critically, not misleading.

Rather than requiring bid-ask spread disclosure that is based on historical bid-ask spreads, CSIM recommends, as described in Section II.F. of this letter, that each ETF disclose a hypothetical

²⁹ In addition to the concerns raised about the general utility of the proposed bid-ask spread disclosures, CSIM also believes that the inclusion of the bid-ask spread information in Item 3 raises prospectus liability concerns under Section 11 of the Securities Act of 1933 (“Securities Act”), which provides for liability for issuers that make material misstatements and omissions in the issuance of securities. As noted above, CSIM believes that the addition of the proposed bid-ask spread disclosures to the prospectus could potentially be considered misleading if the bid-ask spread actually experienced by the investor differs from the spread disclosed in the prospectus, leaving ETF issuers and ETFs susceptible to unnecessary litigation risk.

example using standard inputs prescribed by the Commission, similar to the current fee example required under Item 3 of Form N-1A, so that investors can visualize how costs attributable to bid-ask spreads can impact the total costs of investing in an ETF. This disclosure could be made available on the ETF's website, along with other educational materials, to help investors learn about the cost implications of any ETF investment.

B. Placement of Proposed Prospectus Disclosure

As the Commission is fully aware, Item 3 of Form N-1A is a component of the “summary section” at the front of each ETF’s prospectus. This summary section includes “key information about a fund, including the investment objectives and strategies, risks, costs and performance”³⁰ and can be sent or given to investors in the form of a summary prospectus (“Summary Prospectus”), thereby satisfying the fund’s prospectus delivery obligation under the Securities Act (subject to certain conditions). In its adopting release of its Enhanced Disclosure rule in 2009, the Commission stated that the intent was that the key information in the summary section of a prospectus be “presented succinctly, in three or four pages...”³¹ Further, the Commission also stated that it had rejected making additions, such as comparative performance information, to the summary prospectus because it was “concerned that it would tend to undermine our goal of a concise, user-friendly summary of key information by contributing to the length and complexity of the summary section.”³² That danger persists today.

Given the Commission’s commendable efforts to provide investors with “streamlined and user-friendly information that is key to an investment decision”³³ via the summary section and through the facilitation of the Summary Prospectus, CSIM is concerned that if the proposed language is included in the revised Item 3, an investor would likely not see an ETF’s investment strategy, risks or performance, each of which has been identified by the Commission as “key information” in making an investment decision, until at least page 2 of the Summary Prospectus. Moreover, the inclusion of the proposed Q&A would result in many ETFs having Summary Prospectuses that exceed 4 pages. Given that many, if not most, ETFs deliver a Summary Prospectus rather than the entire statutory prospectus to investors, the addition of the proposed Q&A will require ETFs to rethink the presentation of the summary section, which could lead to less investor-friendly formats, and could result in additional expenses due to increased printing costs that might be passed along to investors in the form of higher expense ratios.

CSIM supports the Commission’s attempts to improve disclosure generally, but we believe that adding the lengthy Q&A disclosure to the Summary Prospectus does not align with the purpose of that important document and, in fact, may detract from its effectiveness. CSIM nonetheless believes that much of the information the Commission proposes be included in the Q&A has value (but for the exceptions we note above), and in lieu of adding this content to the Summary Prospectus, CSIM recommends that the Commission instead require that ETFs make this information available on their websites. Alternatively, if the Commission believes this

³⁰ Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies; Final Rule, Release No. 33-8998. 74 Fed. Reg. (January 26, 2009), at 4546.

³¹ *Id.*, at 4548.

³² *Id.*, at 4556.

³³ *Id.*, at 4546.

information should be included in the ETF's registration statement, CSIM would support, albeit to a lesser degree, including such information in an ETF's statutory prospectus.

IV. Additional Time for Delivering Redemption Proceeds

CSIM supports the relief in the Proposed Rule for delivering redemption proceeds in certain situations, such as when a foreign holiday or other circumstance impedes timely delivery of a foreign security in an ETF's redemption basket. We agree that the Section 22(e) prohibition "can cause operational difficulties for ETFs that hold foreign investments and exchange in-kind baskets for creation units."³⁴ We believe the Commission's proposal of an extended settlement period of 15 days, accompanied by a requirement that delivery be made as soon as practicable, is appropriate and reasonable. However, we suggest the Commission reconsider the sunset provision that accompanies this relief. While the Proposed Rule correctly points out that newer markets continue to evolve toward shorter settlement times, there is no way of knowing with certainty what the next decade will bring or what maturing markets may become investable over the next decade. In addition, there are certain markets that have extended holidays that affect settlement cycles and which are unlikely to change over time. We believe the 15-day requirement, accompanied by the "as soon as practicable" requirement, is sufficient to ensure timely delivery and that a sunset provision is unnecessary.

Conclusion

CSIM applauds the effort the Commission has made in advancing two important goals: leveling the playing field for issuers and investors and improving transparency for individual investors. Thank you very much for the opportunity to share our perspective on these important issues. We would be pleased to answer questions or provide any additional information that would help the Commission come to a final conclusion.

Sincerely,



Marie Chandoha
Chief Executive Officer, Charles Schwab Investment Management

cc: Jay Clayton, Chairman, Securities and Exchange Commission
Kara M. Stein, Commissioner, Securities and Exchange Commission
Robert J. Jackson, Jr., Commissioner, Securities and Exchange Commission
Hester M. Peirce, Commissioner, Securities and Exchange Commission
Elad Roisman, Commissioner, Securities and Exchange Commission
Dalia Blass, Director, Division of Investment Management, Securities and Exchange Commission

³⁴ 83 Fed. Reg., at 37346.