October 1, 2018

Brent J. Fields  
Secretary, Securities and Exchange Commission  
100 F Street, NE  
Washington DC 20549

Re: S7-15-18

Ladies and Gentlemen:

Morningstar welcomes the opportunity to comment on the SEC's proposal on "Exchange-Traded Funds" (ETF Rule). Morningstar's mission is to help investors reach their financial goals. Because we offer an extensive line of products for individual investors, professional financial advisors, and institutional clients, we have a broad view on the proposed rule and its possible effects for investors.

Morningstar strongly supports the Commission's goal of streamlining the process for the approval of exchange-traded funds (ETFs). Morningstar supports the greater efficiency and transparency that the new ETF Rule provides. The ETF Rule will make the process for launching most new ETFs more efficient and provide more certainty to the marketplace. A uniform, efficient process will allow for more standardization and transparency around these products, which are growing more popular as portfolio components for investors.

The ETF Rule is an opportunity for the Commission to collect and make available data on ETFs in a standardized format that has until now either not been available at all or has been available in an ad-hoc, non-standardized way. The increase in data availability proposed by the Commission will provide opportunities for third-party aggregators to conduct analysis and inform investors. In particular, we strongly support the Commission's proposed transparency around the historical premiums, published baskets, and bid-ask spreads. This information should be provided daily from fund sponsors in order to be meaningful. We believe that this information should be provided in a standardized, structured format, such as XBRL, so that it can be analyzed and compared across providers. While website and prospectus disclosures are helpful, we believe that they are too cumbersome for analysis and easy comparison. Analysis reliant upon website disclosures is also more susceptible to inconsistency and inaccuracy. We strongly encourage the Commission to have the information filed in a standardized format into a public database, such as EDGAR, through which fund sponsors will provide the information about their products. This information will allow third-party aggregators to compare funds on characteristics such as liquidity and assess the effectiveness of the ETF arbitrage process.

As this rule provides an opportunity to collect data from ETF sponsors, we encourage the Commission to ask for additional pieces of data that were typically critical in the exemptive

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relief process. Funds should have to disclose in a standardized format when launched what index methodology, including rules regarding security selection and weighting, are being utilized. As the indexes underpinning ETFs have become ever more nuanced and complicated, we believe it is paramount that ETF sponsors provide clear and concise explanations of the makeup of the intellectual property (that is, the indexes) that dictate the composition of their portfolios. ETFs should also disclose at launch whether they are using over-the-counter derivatives as part of the investment strategy.

We strongly support the Commission's proposal of hypothetical trading costs being disclosed in a tabular and graphical format, as this will be very helpful for investors, and we reiterate that having such information submitted in a standardized, structured format to the Commission and available publicly would aid comparison and analysis. The average daily volume, median bid-ask spreads, the number of days the ETF's shares traded on a national securities exchange, and the ETF's total number of shares outstanding should also be disclosed daily in a structured format, as these data points provide information about liquidity.2

Regarding baskets, we agree with the Commission's definition of a basket as the “securities, assets, or other positions in exchange for which an exchange-traded fund issues (or in return for which it redeems) creation units.”3 We believe that transparency around baskets is critical for investors. We understand that ETF sponsors need the flexibility to deviate from pro rata baskets. As such, all baskets that were utilized in a day should be disclosed, at a minimum, by the end of the day. Such disclosure would allow analysis of whether the baskets are facilitating appropriate market making and liquidity, particularly during times of market stress. We also believe that other information, such as whether the fund faces any impediments to creating new units and whether it is pending closure, should be disclosed on any day that this information is applicable.

We support the requirement that an ETF disclose “information regarding a published basket at the beginning of each business day, as well as the estimated cash balancing amount, if any.”4 We think that this information should not just be on the fund sponsors’ website, however; it should be submitted in a structured format along with other data disclosed on a daily basis in a public database. Without such standardization in the process, the information will not be as useful to the marketplace. Regarding custom baskets, we think that the flexibility to permit them is appropriate, particularly for fixed-income products. We encourage the Commission to make clear that policies and procedures surrounding custom baskets should be sufficiently detailed for investors and third-party aggregators to reasonably anticipate the components of these baskets. Such information is crucial for understanding the true liquidity, or lack thereof, that a fund offers. The policies and procedures governing custom baskets should be subject to board oversight.

We encourage the Commission to make all of this data available publicly in XBRL format. Such availability will allow investors and third-party aggregators seeking to inform investors to analyze and compare data across funds.

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2 Exchange-Traded Funds, P. 37373 and 37375.
3 Exchange-Traded Funds, P. 37404.
4 Exchange-Traded Funds, P. 37358.
Regarding the Commission's questions about affiliated index providers, we would note that affiliated index providers should be permitted on the condition that a firewall between the index provider and the asset manager exists. Just as the Commission has been concerned during the exemptive relief process about manipulation of product pricing and the underlying indexes on which they are based, this concern remains important, and we ask the Commission to maintain safeguards against such manipulation. We believe that a firewall between the index provider and the fund sponsor, even if they are affiliated, should be sufficient to protect against the use of information from the index provider to artificially drive the price of the product, and vice versa. Such price integrity is critical to the integrity of the market making and arbitrage process.

We thank the Commission for the opportunity to comment on its proposal on "Exchange-Traded Funds." Should you wish to discuss any of the comments in this letter, please do not hesitate to contact either of us as indicated below:

Aron Szapiro at [email protected] or (516) 207-7307
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Sincerely,

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