SUPPORTING STATEMENT
Proposed Rule 6c-11

A. Justification

1. Necessity of Information Collections

The Securities and Exchange Commission ("Commission") is proposing new rule 6c-11 under the Investment Company Act of 1940 ("Investment Company Act").[1] Proposed rule 6c-11 would codify certain exemptions provided under prior Commission orders that have allowed exchange-traded funds ("ETFs") to form and operate as open-end management investment companies. The proposed rule, by exempting ETFs from certain provisions of the Investment Company Act and rules thereunder, would permit ETFs to begin operating without obtaining an exemptive order from the Commission.

All ETFs trading today operate in a similar way. Unlike traditional mutual funds, ETFs do not sell or redeem their individual shares ("ETF shares") at net asset value ("NAV"). Instead, financial institutions purchase and redeem ETF shares directly from the ETF, but only in large blocks called "creation units."[2] A financial institution that purchases a creation unit of ETF shares first deposits with the ETF a "purchase basket" of certain securities and other assets identified by the ETF that day, and then receives the creation unit in return for those assets. The basket generally reflects the contents of the ETF's portfolio and is equal in value to the aggregate NAV of the ETF shares in the creation unit. After purchasing a creation unit, the financial institution may hold the ETF shares, or sell some or all in secondary market transactions.

Like operating companies and closed-end funds, ETFs register offerings and sales of ETF shares under the Securities Act of 1933[3] and list their shares for trading under the Securities

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[1] 15 U.S.C. 80a.

[2] Creation units typically consist of at least 25,000 ETF shares.

[3] 15 U.S.C. 77a.

Exchange Act of 1934.[4] As with any listed security, investors may trade ETF shares at market prices. ETF shares purchased in secondary market transactions are not redeemable from the ETF except in creation units.

The redemption process is the reverse of the purchase process. The financial institution acquires (through purchases on national securities exchanges, principal transactions, or private transactions) the number of ETF shares that comprise a creation unit, and redeems the creation unit from the ETF in exchange for a "redemption basket" of securities and other assets. An investor holding fewer ETF shares than the amount needed to constitute a creation unit (most retail investors) may dispose of those ETF shares by selling them on the secondary market. The investor receives market price for the ETF shares, which may be higher or lower than the NAV of the shares, and pays customary brokerage commissions on the sale.

The ability of financial institutions to purchase and redeem creation units at each day's NAV creates arbitrage opportunities that may help keep the market price of ETF shares near the NAV per share of the ETF. For example, if ETF shares begin trading on national securities exchanges at a price below the fund's NAV per share, financial institutions can purchase ETF shares in secondary market transactions and, after accumulating enough shares to comprise a creation unit, redeem them from the ETF in exchange for the more valuable securities in the ETF's redemption basket. Those purchases create greater market demand for the ETF shares, and thus tend to drive up the market price of the shares to a level closer to NAV. Conversely, if the market price for ETF shares exceeds the NAV per share of the ETF itself, a financial institution can deposit a basket of securities in exchange for the more valuable creation unit of ETF shares, and then sell the individual shares in the market to realize its profit. These sales would increase the supply of ETF shares in the secondary market, and thus tend to drive down

[4] 15 U.S.C. 78a.

the price of the ETF shares to a level closer to the NAV of the ETF share.

Certain provisions of proposed rule 6c-11 would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[5] The title for the collection of information requirements is "Rule 6c-11 under the Investment Company Act of 1940, 'Exchange-Traded Funds.'" If adopted, this collection would not be mandatory, but would be necessary for ETFs that seek to form and operate as open-end management investment companies without seeking individual exemptive orders. Responses to the collection of information requirements of rule 6c-11 will not be kept confidential.

a. Proposed Rule 6c-11

Proposed rule 6c-11 would expand the relief the Commission has issued in the past under exemptive orders to index-based ETFs, and to transparent, actively managed ETFs. The rule, by exempting ETFs from certain provisions of the Investment Company Act and rules thereunder, would permit ETFs to begin operating without obtaining an exemptive order from the Commission. Each ETF seeking to rely on the proposed rule would have to disclose on a daily basis specific information to market participants: (i) the contents of its basket assets; (ii) the identities and weightings of the component securities and other assets in its portfolio if it does not track an index whose provider discloses its composition daily; (iii) the prior business day's NAV, market closing price for its ETF shares and premium/discount information. In addition, each ETF would have to disclose in its registration statement on Form N-1A: (i) the number of shares that comprise a creation unit; and (ii) the foreign holidays that would prevent timely satisfaction of redemption with respect to foreign securities in its basket assets. An ETF that chooses not to disclose its portfolio would have to track an index whose provider discloses the identities and weightings of the securities and other assets that constitute the index in order to

[5] 44 U.S.C. 3501 to 3520.

rely on the proposed rule. In addition, each ETF seeking to rely on the proposed rule also would have to, in any sales literature (as defined in the rule), identify itself as an ETF, which does not sell or redeem individual shares, and explain that investors may purchase or sell individual shares on national securities exchanges. This condition is necessary to help prevent investors from confusing ETFs with traditional mutual funds. The respondents are investment companies that seek to register with the Commission as ETFs.

2. Purposes of Information Collection

Proposed rule 6c-11 is designed to allow index-based and transparent, actively managed ETFs to form and begin operating as open-end management investment companies without the expense and delay of obtaining an exemptive order from the Commission. The information collection requirements in proposed rule 6c-11 are designed to facilitate the arbitrage mechanism inherent in the ETF structure that generally prevents ETF shares from trading on a national securities exchange at a significant premium or discount to the NAV of the fund.

3. Role of Improved Information Technology and Obstacles to Reducing Burden

Proposed rule 6c-11 would not require the reporting of any information or the filing of any documents with the Commission.

4. Efforts to Identify Duplication; Substitution of Similar Information

The Commission periodically evaluates rule-based reporting and recordkeeping requirements for duplication, and reevaluates them whenever it proposes a rule or a change in a rule. The conditions in proposed rule 6c-11 are not duplicated elsewhere.

5. Effect on Small Entities

Commission staff expects proposed rule 6c-11 to have little impact on small entities. Like other funds, small entities would be affected by proposed rule 6c-11 only if they determine to rely on rule 6c-11 to operate as an ETF. Commission staff estimates that only one of the 61 Commission exemptive orders permitting funds to operate as ETFs was issued to a small entity. The Commission believes that proposed rule 6c-11 would decrease burdens on small entities by making it unnecessary for them to seek an exemptive order from the Commission to operate as ETFs and by eliminating some of the conditions included in the exemptive orders from the proposed rule. The staff therefore anticipates that the number small funds that would operate as an ETF under proposed rule 6c-11 would increase. Nevertheless, the staff believes that the proportion of small entities compared to the total number of funds that operate as ETFs would remain small. As a result, we do not anticipate the potential impact of the proposed rule on small entities would be significant. For these reasons, alternatives to the proposed rule appear unnecessary and in any event are unlikely to minimize any impact that the proposed rule might have on small entities.

We review all rules periodically, as required by the Regulatory Flexibility Act, to identify methods to minimize recordkeeping or reporting requirements affecting small entities.

6. Consequences of Less Frequent Collection

Less frequent information collection would be incompatible with the objectives of proposed rule 6c-11. As discussed above, proposed rule 6c-11 requires daily disclosure of the ETF's basket assets and its portfolio assets if it does not seek to track the performance of a transparent index. These proposed disclosure requirements are designed to facilitate the arbitrage mechanism inherent in the ETF structure. As discussed above, active arbitrage in ETF shares by large financial institutions generally prevents ETF shares from trading at a significant premium or discount to the NAV of the ETF. Less frequent disclosure of any of the proposed requirements may hinder the arbitrage mechanism in ETFs. In addition, disclosure of the prior business day's NAV, the market closing price and premium/discount information is designed to alert investors to the current relationship between NAV and the market price of the ETF's shares, and that they may purchase or sell ETF shares at prices that do not correspond to the NAV of the fund. Less frequent disclosure may not alert investors of the effect of premiums or discounts on their investments.

7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

Not applicable.

8. Consultations Outside of the Agency

Before adopting proposed rule 6c-11, the Commission will receive and evaluate public comments on the proposals and their collection of information requirements. The Commission and staff of the Division of Investment Management participate in an ongoing dialogue with representatives of the industry through public conferences, meetings, and informal exchanges. These various forums provide the Commission and the staff with a means of ascertaining the magnitude of and acting upon paperwork burdens confronting the industry.

9. Payment or Gift to Respondents

Not applicable.

10. Assurances of Confidentiality

Not applicable.

11. Sensitive Questions

Not applicable.

12. Estimates of Hourly Burdens

The Commission staff estimates that hourly burden estimates would differ for index-based versus actively managed ETFs. Proposed rule 6c-11 defines index-based ETFs as ETFs that have a stated investment objective of maintaining returns that correspond to the returns of a securities index whose provider discloses on its Internet Web site the identities and weightings[6] of the component securities and other assets of the index. The proposed rule defines an actively managed ETF as an ETF that discloses on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the ETF.[7] Unlike index-based ETFs, an actively managed ETF does not seek to track the return of a particular index. Instead, an actively managed ETF's investment adviser, like an adviser to any traditional actively managed mutual fund, generally selects securities consistent with the ETF's investment objectives and policies without regard to a corresponding index.

The staff estimates that each index-based ETF each year would spend approximately 236 hours to comply with the conditions of proposed rule 6c-11. The staff further estimates that each actively managed ETF each year would spend an additional 200 hours (for a total of 436

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[6] Proposed rule 6c-11(e)(9) defines "weighting of the component security" as "the percentage of the index's value represented, or accounted for, by such component security."

[7] Proposed rule 6c-11(e)(4)(v)(A).

hours) to comply with the conditions of proposed rule 6c-11.[8]

As of December 2007, there were 601 ETFs.[9] The Commission staff estimates that each year 149 new ETFs will form and operate.[10] For purposes of this PRA, the staff estimates that one-half of all new ETFs (75 ETFs) would be index-based and the other half (75 ETFs) would be actively managed.

Index-based and actively managed ETFs. First, the proposed rule would require each ETF to disclose its prior business day's NAV, market price for its shares, and premium/discount information, which would provide investors with information on the deviation, if any, between the price of ETF shares and the NAV of the underlying portfolio. Commission staff estimates that an ETF each year spends approximately 206 hours of professional time to update the relevant Internet Web page daily with this information. Based on staff estimates, we estimate the annual cost would be $43,466 for internal ETF staff time to update the Web page.[11] In addition, the staff estimates that each new index-based and actively managed ETF would spend 75 hours to develop the Web sites for daily disclosure of its prior business day's NAV, market closing price for its shares, and premium/discount information. Thus the staff estimates that ETFs would

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8 Estimates on the number of burden hours associated with the collections of information in this PRA are based on informal conversations between Commission staff and representatives of ETFs.

9 Investment Company Institute ("ICI"), Outline of Supplemental Tables for Exchange-Traded Fund Report (http://members.ici.org/stats/etfdata.xls ("ICI ETF Statistics 2007")), *Exchange-Traded Fund Assets December 2007*, Jan. 30, 2008.

10 To estimate the number of new ETFs each year for purposes of this PRA, the staff has used the approximate average of the number of new ETFs for the past three years ((50 + 153 + 244)/3 =149). ICI, *Exchange-Traded Fund Assets December 2006*, Jan. 31, 2007; ICI ETF Statistics 2007, *supra* note Error: Reference source not found.

11 Commission staff estimated the cost would equal 206 hours for internal Web site developers at ($211 per hour) (206 x $211 = $43,466). Hourly wages used for purposes of this PRA analysis are from the Securities Industry Association (now named Securities Industry and Financial Markets Association), SIA Report on Management & Professional Earnings in the Securities Industry 2006, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

spend 11,250 hours initially to develop these Web sites, amortized over three years for an annual burden of 3750 hours.[12]

Second, in any sales literature each ETF must identify itself as an ETF that does not sell or redeem individual shares, and explain that investors may purchase or sell individual shares only on national securities exchanges. This condition is similar to the condition in our exemptive orders, which requires each ETF to agree not to market or advertise the ETF as an open-end company or mutual fund and to explain that the ETF shares are not individually redeemable. Based on conversations with ETF representatives, Commission staff estimates that an ETF each year spends approximately 30 hours at a cost of $1704 to comply with the condition in our exemptive orders.[13] Because the condition in the proposed rule is similar, the staff estimates that each new ETF also would spend 30 hours at a cost of $1704 to comply with the condition in the proposed rule.

Finally, some ETFs that track foreign indices have stated that local market delivery cycles for transferring foreign securities to redeeming investors, together with local market holiday schedules, require a delivery process in excess of the statutory seven days required by section 22(e) of the Act. The proposed rule would codify the disclosure requirement in existing exemptive orders that requires ETFs to disclose in their registration statements the foreign holidays that would prevent timely satisfaction of redemption. The collection of information burden for this disclosure is discussed in the PRA analysis for the proposed amendments to Form N-1A.

Actively managed ETF. In addition to complying with the collection of information

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12 This estimate is based on the following calculation: ((75 hours x 75 (estimated new index-based ETFs) + (75 hours x 75 (estimated new actively managed ETFs) = 11,250).

13 Commission staff estimated the cost would equal 2 hours for the fund’s internal counsel (at $292 per hour) to draft the disclosure and 28 hours for clerical staff (at $40 per hour) to input and copy check the marketing materials ((2 x $292) + (28 x $40) = $1704).

requirements above, the proposed rule would require an ETF that does not track an index whose provider discloses its composition daily (*i.e.* an actively managed ETF) to provide daily disclosure of the identities and weightings of the component securities and other assets in the ETF's portfolio. Currently, two ETF registrants are required to disclose their portfolios daily under the terms of their exemptive orders.[14] The Commission staff estimates that an actively managed ETF each year would spend approximately 200 hours of professional time to update the relevant Internet Web page daily with this information, at a cost of $42,000.[15] In addition, actively managed ETFs would spend an additional 100 hours to develop the Web sites for daily disclosure of their portfolio securities and assets. The staff estimates that all new actively managed ETFs would spend 7500 hours initially to develop these Web sites, amortized over three years for an annual burden of 2500 hours.[16]

Thus, the staff estimates that the total annual burden for complying with the requirements of proposed rule 6c-11 is 211,286 hours (146,307 for index-based ETFs and 64,979 for actively managed ETFs),[17] at an annual internal cost of $40 million.[18]

13. Estimate of Total Annual Cost Burden

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14 ProShares Trust, Investment Company Act Release No. 27323 (May 18, 2006) [71 FR 29991 (May 24, 2006)]; Rydex ETF Trust, Investment Company Act Release No. 27703 (Feb. 20, 2007) [72 FR 8810 (Feb. 27, 2007)]. Together, these registrants offer 64 ETFs that are required to disclose their portfolios daily.

15 The staff estimates the cost would be 200 hours for an internal Web site developer (at $211 per hour) (200 x $211 = $42,200).

16 This estimate is based on the following calculation: (100 hours x 75 (estimated new actively managed ETFs) = 7500).

17 Assuming all existing ETFs would rely on the proposed rule, these estimates are based on the following calculations: (*Index-based ETFs:* ((206 hours + 30) x 612 (existing plus estimated new index-based ETFs))) + (*Actively managed ETFs:* (436 hours x 139 (existing plus estimated new actively managed ETFs))) + 3750 (annual burden for all ETFs for development of Web site for proposed 6c-11 disclosure requirements) + 2500 (annual burden for actively managed ETFs for development of Web site for portfolio disclosure) = 211,286.

18 These estimates are based on the following calculations: (($43,466 + $1704) x 612) + ($43,466 + $1704 + $42,000) x 139) = $39,760,670.

As discussed above, each ETF relying on the proposed rule would be required to disclose, its prior business day's NAV, market price for its shares, and premium/discount information. Based on discussions with ETF representatives, the staff estimates that each ETF would have an annual external cost of $6,000 to acquire the data from external data providers.[19] Therefore, the staff estimates that the total annual cost would be $4.5 million ($3.7 million for index-based ETFs and $0.8 million for actively managed ETFs).[20]

As discussed above, each new index-based and actively managed ETF would need to develop Web sites for daily disclosure of its prior business day's NAV, market closing price for its shares, and premium/discount information. Based on discussions with ETF representatives, the staff estimates the initial cost would be $9540 for an external Web site developer to develop the Web page. In addition, actively managed ETFs also would need to develop the Web sites for daily disclosure of their portfolio securities and assets. Staff estimates the initial cost would be $12,600 for an external Web site developer to develop the Web page. Thus, the staff estimates that the annual external costs to develop the Web sites for index-based ETFs would be $0.7 million, or $0.2 million amortized over three years.[21] The staff further estimates that the annual external cost to develop Web sites for actively managed ETFs would be $1.7 million, or 0.6 million amortized over three years.[22]

Thus the staff estimates that the total annual external cost would be $4.4 million for

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19 Estimates on the external costs associated with the collections of information are based on informal conversations between Commission staff and representatives of ETFs.

20 These estimates are based on the following calculations: ($6000 x 612 (existing plus estimated new index-based ETFs) = $3,672,000) + ($6000 x 139 (existing plus estimated new actively managed ETFs) = $834,000) = $4,506,000.

21 This estimate is based on the following calculation: $9540 x 75 = $715,500.

22 This estimate is based on the following calculation: ($9540 + $12,600) x 75 = $1,660,500.

index-based ETFs[23] and $2.5 million for actively managed ETFs.[24]

14. Estimate of Cost to Federal Government

The proposed rule will not impose a cost on the federal government. The proposed rule does not require funds to file any documents with the Commission. Commission staff may review records produced pursuant to the proposed rule and form amendments in order to assist the Commission in carrying out its examination and oversight program.

15. Explanation of Changes in Burden

Not applicable. This is the first request for approval of the collection of information for this rule.

16. Information Collections Planned for Statistical Purposes

Not applicable.

17. Approval to Not Display Expiration Date

Not applicable.

18. Exceptions to Certification Requirement

Not applicable.

B. Collection of Information Employing Statistical Methods

Not applicable.

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[23] This estimate is based on the following calculation: $3,672,000+ $715,000 = $4,387,000.

[24] This estimate is based on the following calculation: $834,000 + $1,660,500 = $2,494,500.