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January 23, 2013

Re: Rule 16a-1(a)(2) under the Securities Exchange Act of 1934 (the "**Exchange Act**")

Division of Corporation Finance
U.S. Securities and Exchange Commission
Office of Chief Counsel
100 F Street, N.E.
Washington, D.C. 20549-3628

To Whom it May Concern:

We are seeking the interpretive advice of the Staff of the Division of Corporation Finance (the "**Staff**") that a registered broker-dealer (the "**Broker-Dealer**") would not be deemed to have a "pecuniary interest" for purposes of Rule 16a-1(a)(2) of the Exchange Act (a "**Pecuniary Interest**") in the Insider Securities (as defined below) involved in the activities described below. The activities for which we are requesting relief relate to transactions in the component securities of exchange traded funds ("**ETFs**") that seek to replicate the performance of an index or basket of securities (an "**Index**") and are registered with the Securities and Exchange Commission (the "**SEC**") as investment companies under the Investment Company Act of 1940, as amended (the "**Investment Company Act**").

Specifically, we request that the Staff issue an interpretation that the Broker-Dealer does not have a Pecuniary Interest in any of the Insider Securities of the ETF that are the subject of the following activities:

i. The creation of ETF shares (including related hedging activity);

ii. The redemption of ETF shares (included related hedging activity); and

iii. Hedging exposure to Insider Securities due to ETF Rebalancing during the pendency of an ETF Loan Transaction (as each such activity is defined and described below).

We explain each of the activities for which we are seeking relief below.

We emphasize the following:

i. This letter does not seek any interpretations regarding ETF shares themselves, but instead only with respect to the component securities (and specifically, the Insider Securities) of an ETF.

ii. This letter does not seek interpretative relief with respect to activities involving ETFs that are actively managed and do not track an Index, ETFs with component securities that are issued by foreign private issuers or ETFs with debt instruments.[1]

iii. The relief would not apply if the Broker Dealer or any parent, affiliate or any subsidiary thereof were to develop, compile, create, sponsor or maintain an underlying Index for an ETF for which it serves as an Authorized Participant (an "**AP**") or market maker.

iv. The relief sought is with respect to activities in Insider Securities as a result of an ETF Loan Transaction or ETF Cash Transaction (as each such activity is defined and described below) in response to a third-party non-affiliated customer order entered with or by the Broker-Dealer (*i.e.*, either to fulfill such order, or to hedge exposure created by a transaction between the Broker-Dealer or its affiliate and the non-affiliated third-party customer). Relief is not sought with respect to proprietary ETF Loan Transactions or ETF Cash Transactions where one or more of the securities underlying the ETF is an Insider Security.

v. This letter does not seek relief for the disposition of Insider Securities previously held by the Broker-Dealer in its own inventory that may be used in the creation of an ETF share. This letter also does not seek relief for the acquisition of Insider Securities upon an ETF share redemption if such shares are held in the Broker-Dealer's inventory.

vi. Each step in the creation, redemption and hedging activities for which the Broker-Dealer is seeking relief is in compliance with the Diversity Standards (as defined below).

We submit this letter in compliance with Securities Act Release No. 6269 and Securities Act Release No. 7427.

Facts

Description of ETFs Generally

An ETF is typically organized as a series of a corporation or trust that is registered as an investment company under the Investment Company Act. Under the Investment Company Act, ETFs are classified as "open-end management companies" or "unit investment trusts," similar to traditional mutual funds. Attractive features of ETFs as an investment alternative include their low costs, tax efficiencies, liquidity and ability to provide diversification and risk-mitigation to retail investors.

ETFs are structured as equity securities that track the value of a published Index. An ETF share

[1] Accordingly, references in this letter to "ETFs" should be understood to refer only to Index-based equity ETFs that do not contain foreign private issuer securities in their portfolios.

tracking an Index is issued by the ETF and delivered through an agent (generally a custodian) on behalf of the ETF (the "**ETF Agent**") to a broker-dealer in exchange for the delivery by the broker-dealer to the ETF Agent of the component securities of such Index. Such issuance may only happen once a day at 4:00 pm Eastern time, although ETF shares are listed and traded and may be priced throughout the day. The component securities are held by the ETF, or by the ETF Agent.

Broker-dealers are critical in the process by which ETF shares are created, redeemed and borrowed. In contrast to traditional mutual funds, which permit end investors to purchase and redeem shares directly with the fund, ETF Agents only permit certain broker-dealers that have agreed to act as APs to create and redeem ETF shares. The Broker-Dealer, in providing a full range of broker-dealer services in the ordinary course of its business, acts as an AP with respect to many currently available ETFs.

ETF shares are issued to APs in block-size aggregations referred to as "**Creation Units**." The Creation Unit size for a particular ETF is described in such ETF's prospectus, but typically consists of round lots (*i.e.*, a group of shares that can be divided by 100) of a minimum of 50,000 or 100,000 ETF shares. The AP has no role in determining the component securities of an ETF, or the selection or weighting of the securities in the Index.

On each business day, an ETF Agent will publish a list of the names and quantities of specified securities along with a specified amount of cash, if any[2] (together, the "**Deposit Basket**"). The securities portion of the Deposit Basket generally mirrors the underlying portfolio of Index securities held by the ETF, and the cash portion of the Deposit Basket generally mirrors the amount of cash held by the ETF (each on a per-Creation Unit basis) on such day.

At any given time, the Broker-Dealer may be an insider for purposes of Section 16 of the Exchange Act ("**Section 16**") of one or more companies with securities that are included in the Deposit Basket of an ETF for which the Broker-Dealer is an AP (such securities, the "**Insider Securities**"). The number of Insider Securities included in Deposit Baskets is typically very small due to the large number and diversity of the component securities of each Index.

[2] ETFs normally only hold cash to the extent that the dividends or distributions from the issuers of component securities that have not yet been reinvested or distributed to investors in the ETF.

ETF Share Creation and Redemption Process

<u>Overview</u>

Generally, ETFs may be created in one of two ways: (i) through the AP purchasing the Deposit Basket and transferring it to the ETF Agent in exchange for the ETF shares, or (ii) through the AP borrowing the Deposit Basket and transferring it to the ETF Agent in exchange for the ETF shares.

The redemption of an ETF follows the same pattern in reverse: (i) in those circumstances where the AP had purchased the Deposit Basket to create the ETF shares, the AP would transfer the ETF shares to the ETF Agent in exchange for the Deposit Basket and then either deliver the securities in the Deposit Basket to the redeeming customer or sell them into the public market, and (ii) in those circumstances where the AP had borrowed the Deposit Basket to create the ETF shares, the AP would transfer the ETF shares to the ETF Agent in exchange for the Deposit Basket and then either return the securities in the Deposit Basket to the counterparties from which the AP borrowed the securities or utilize the securities in connection with another ETF creation.

In any of these redemption scenarios, the Broker-Dealer does not exercise discretion with respect to the disposition of any individual component security (including any Insider Security) following the receipt of the Deposit Basket from the ETF Agent, and a single order is effected with respect to all component securities of the ETF (*i.e.*, all securities are either sold to the redeeming customers or to the public market at the same time, or in the case of a loan transaction, used to settle the loan or create new ETF shares).

Because ETF shares are created or redeemed once a day but may be priced as soon as a customer order comes in, the AP may hedge against any potential price movement of the ETF component securities between the time at which the order is priced and the end of the day when the creation or redemption occurs. This intraday hedging is immediately initiated with respect to all ETF component securities following the pricing of an order, and the AP does not exercise any discretion with respect to whether to hedge any individual component security, including any Insider Security.

Those circumstances where the AP purchases the Deposit Basket to create the ETF shares (and upon redemption of the ETF shares receives and sells the Deposit Basket), along with the associated hedging activity described in the preceding paragraph, are referred to herein as an "**ETF Cash Transaction**". Those circumstances where the AP borrows the Deposit Basket to create the ETF shares (and upon redemption of the ETF shares returns the borrowed Deposit Basket or utilizes the Deposit Basket to create another ETF), along with the associated hedging activity described in the preceding paragraph, are referred to herein as an "**ETF Loan Transaction**". The trade flows for an ETF Cash Transaction and ETF Loan Transaction are as follows:

Figure 1.1: Creation of ETF

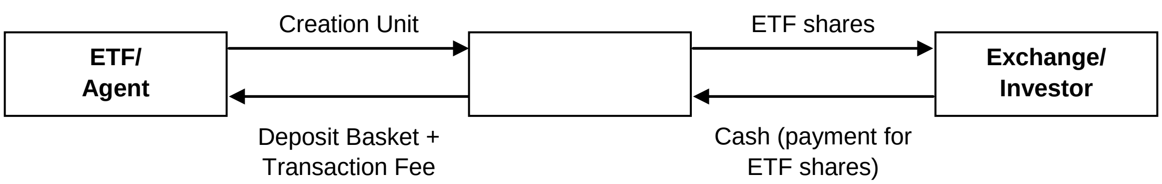
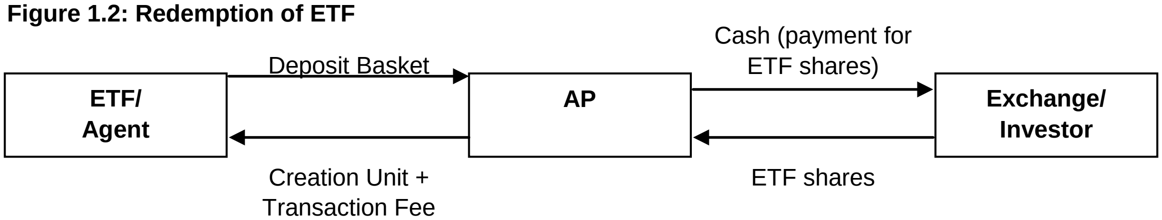


Figure 1.2: Redemption of ETF



ETF Cash Transactions

With respect to an ETF Cash Transaction, the Broker-Dealer is seeking relief that, assuming it complies with the Diversity Standards, it does not have a Pecuniary Interest in any Insider Security (i) purchased by the Broker-Dealer to create a Deposit Basket, (ii) transferred by the Broker-Dealer to an ETF Agent in exchange for ETF shares, (iii) received by the Broker-Dealer from an ETF Agent in a Deposit Basket when the Broker-Dealer redeems ETF shares, (iv) transferred by the Broker-Dealer to its clients or others in a disposition of the component securities received from an ETF Agent or (v) purchased or sold in order to hedge against exposure to intraday trading prices of component securities in the period between the order of an ETF share and the end of the day of the order when ETF shares are created or redeemed.

ETF shares are created by an AP tendering a Deposit Basket to an ETF Agent in exchange for a Creation Unit of ETF shares. The Broker-Dealer, in its capacity as an AP with respect to an ETF, creates the Deposit Basket by purchasing or taking from its own inventory each component security of the Deposit Basket. Specifically, the Broker-Dealer may acquire the underlying securities by buying them as principal on the open market or from the interested customer or obtaining them from its own inventory. Following the receipt of a Creation Unit, the AP may sell all or a portion of the ETF shares to other brokerage firms, institutional investors or individual investors.

ETF Cash Transactions are usually executed mechanically; the AP buys all of the securities in the Deposit Basket at the same time using a computer-driven execution facility to enter orders to acquire all of the securities in the Deposit Basket simultaneously. When a client wishes to purchase or sell ETF shares, an AP may guarantee the client a price for the ETF shares or the ETF share price may be based on the price at which the AP purchases the securities in the Deposit Basket.[3] Where the AP has guaranteed the client a price for the ETF shares, the basis for that guaranteed price is related to the value of the securities in the Deposit Basket when compared to the value of the ETF share on the market, rather than the value of any individual security in the Deposit Basket. In some cases, the AP may profit from the difference between the value of the securities in the Deposit Basket and the market value of the ETF shares, but these value considerations are not based on the value of any individual security in the Deposit Basket. Where a price for the ETF shares has not been guaranteed, the cost for the ETF shares to the client is directly tied to the execution price of the underlying component securities plus a cash commission.

The process for redeeming ETF shares is essentially the reverse of the creation process described above. Redemption of ETF shares can only be effected in Creation Unit aggregations, and only by or through an AP. If an AP has accumulated enough ETF shares to make up a Creation Unit (*i.e.*, minimum of 50,000 or 100,000 ETF shares), the AP can tender the Creation Unit to the ETF Agent

[3] In the case of the AP guaranteeing the client a price for the ETF shares, the intraday hedging described in the preceding section would apply.

in exchange for a Deposit Basket of securities and, to the extent applicable, cash. Following the receipt of the Deposit Basket, the AP in a single order sells the securities comprising the Deposit Basket either to the market or to the institutional investor whose ETF shares were redeemed. Occasionally, the AP may sell all or a portion of the component securities to other brokerage firms, institutional investors or individual investors. In any event, the disposition of the component securities following the AP's receipt of the Deposit Basket are largely automatic and in response to customer facilitation; the AP does not exercise any discretion with respect to the disposition of any individual component security, including any Insider Security.

Basket Substitution and Cash-In-Lieu in ETF Cash Transactions

Under most circumstances, the securities portion of the deposit made by an AP in connection with an ETF creation will be entirely in-kind (*i.e.*, the AP will tender all of the securities that the ETF Agent has published for the Deposit Basket on a particular day). However, an ETF may also permit an AP to substitute an amount of cash for one or more of the securities in the Deposit Basket. The substitution of cash for a security, referred to as a "**cash-in-lieu amount**," may be permitted by the ETF in its discretion if, among other reasons, the AP is restricted from trading in the substituted security, which could occur in absence of the relief we are seeking. An ETF may also substitute a cash-in-lieu amount for a security in the Deposit Basket in connection with a redemption order.

An ETF Agent will generally treat any creation or redemption order from an AP that requires the ETF to use a cash-in-lieu amount as a "non-standard order," and will charge a substantially higher transaction fee for processing the order. There is significant technological difficulty in executing such orders (*e.g.*, manually entering the issuer name of each component security in a Deposit Basket when there may be 2,000 securities in the Deposit Basket, having to be aware of the cash substitution and invest it correctly to avoid tracking error). As a result, certain ETF Agents may refuse to accept such orders altogether. In such case, the market may lose the liquidity large APs provide. Because of the breadth of their operations, it is these larger APs who are more likely to have ETF component securities be Insider Securities. In addition, in the event of any tracking error caused by a cash-in-lieu transaction, holders of the ETF could be adversely impacted given that such error may adversely impact the value of the ETF. Even when cash-in-lieu orders are permitted, due to the size of the Transaction Fee for a non-standard order, an AP that is required to submit the cash-in-lieu amount in respect of a restricted security may be unable to effectively compete with other APs who are not so restricted. The restricted AP may, in effect, be priced out of the market for the particular ETF.

The use of cash-in-lieu amounts for any Insider Securities in a Deposit Basket by an AP would also cause the AP to be hedged with respect to all component securities in the Deposit Basket other than the Insider Securities, which would not be consistent with the Diversity Standards and the intent of Section 16 (see discussion in the last paragraph under "ETF Loan Transaction Hedging").

ETF Loan Transactions

With respect to an ETF Loan Transaction, the Broker-Dealer is seeking relief that, assuming it complies with the Diversity Standards, it does not have a Pecuniary Interest in any Insider Security (i) transferred by the Broker-Dealer to an ETF Agent in exchange for ETF shares, (ii) received by the Broker-Dealer from an ETF Agent in a Deposit Basket when the Broker-Dealer redeems ETF shares, (iii) purchased or sold in order to hedge against exposure to intraday trading prices of component securities in the period between the order of an ETF share and the end of the day of the order when ETF shares are created or redeemed or (iv) hedged during the life of the ETF, as detailed below. As noted in the "Discussion" section, it has been well settled that the lending or borrowing of securities does not raise any Section 16 concerns; therefore, we do not request relief with respect to the borrow of securities and the unwind of the borrow in an ETF Loan Transaction.[4]

As part of the Broker-Dealer's stock loan services business, a client desiring short exposure with respect to an ETF (the "**ETF Borrower**") may wish to borrow shares of the ETF from the Broker-Dealer. To provide this service, the Broker-Dealer must obtain shares of such ETF to lend. The Broker-Dealer may already have in its possession shares of the ETF that the ETF Borrower wishes to borrow. The Broker-Dealer may also seek to acquire shares of the ETF by borrowing them from another party.

Alternatively, in lieu of lending shares of the ETF from its own inventory or its customers' margin accounts, or borrowing them from a third-party, the Broker-Dealer may seek to create shares of the ETF through an ETF Loan Transaction, as follows:

1. The Broker-Dealer borrows (as opposed to purchases) each of the securities in the ETF's Deposit Basket. The Broker-Dealer pays a prevailing market fee to borrow securities from another party if such method is utilized.

2. The Broker-Dealer, in its capacity as an AP, tenders the Deposit Basket (made up of securities borrowed by the Broker-Dealer) to an ETF Agent in exchange for a Creation Unit of ETF shares.

3. The Broker-Dealer lends the ETF shares to the ETF Borrower. This may be on an overnight or term (usually 30 days) basis.

4. At the end of the loan term, the shares of the ETF are returned by the ETF Borrower to the Broker-Dealer.

5. The Broker-Dealer redeems the returned shares of the ETF with the ETF Agent in exchange for a Deposit Basket of securities and cash. The securities or share quantity of a particular security in the Deposit Basket received by the Broker-Dealer at the time of redemption may be different than securities or number of a particular security in the Deposit Basket transferred by the Broker-Dealer to the ETF Agent at the time of the creation of the ETF shares due to the rebalancing of the securities in the ETF's portfolio in the interim, as described below.

Following the ETF Loan Transaction, the Broker-Dealer may return the component securities of the ETF to the parties from whom it borrowed them in step 1 of the ETF Loan Transaction, or the securities may be used for another loan, provided the Broker-Dealer is not otherwise obligated to return the securities at that time. As noted above, the Broker-Dealer does not exercise any discretion with respect to the disposition of any individual component security, including any Insider Security. In any situation where securities borrowed in step 1 of the ETF Loan Transaction are required to be returned prior to the completion of step 5 of the ETF Loan Transaction, the Broker-Dealer will borrow the securities from another source. For example, if a customer's margin account balance goes to zero (*i.e.*, the margin loan is paid off) during the term of the ETF Loan Transaction, the securities that were borrowed from that customer's margin account are required to be returned immediately, even if that precedes step 5 of the ETF Loan Transaction; under such circumstances, the Broker-Dealer will find an alternate source to borrow the securities.

[4] Certain activities for which we seek relief may be covered by the existing relief for borrow transactions, in addition to the relief we seek based on compliance with the Goldman basket-trading diversity requirements (described below).

The Broker-Dealer's financial interest in an ETF Loan Transaction is to realize the "spread" between the cost to borrow the securities in the ETF's Deposit Basket and the return the Broker-Dealer will receive for lending the ETF shares, which generally takes the form of the use of cash collateral by the Broker-Dealer and/or a fee paid by the ETF Borrower to the Broker-Dealer. To the extent the ETF Loan Transaction is for a set period of time, the Broker-Dealer can reasonably estimate the economic value of the transaction by calculating the spread it expects to receive for the days the shares are borrowed and lent, and subtracting from that amount certain costs incurred during the transactions with the ETF Agent and costs associated with maintaining an active hedge, as described below. In general, the profit opportunity to the Broker-Dealer is a function of the length of the borrow term of the shares of the ETF by the ETF Borrower after taking into account the cost of the hedge to the Broker-Dealer as the AP.

It should be emphasized that the opportunity to arbitrage between the borrow cost and the revenue generated by the loan of the ETF shares is the Broker-Dealer's sole financial motivation for ETF Loan Transactions. The Broker-Dealer does not intend to take any investment risk with regard to any particular security in the ETF's Deposit Basket or the ETF shares themselves, and is indeed indifferent to all aspects of the constituent and component securities in the Deposit Basket apart from ease and cost of borrowing. The hedging activities described in more detail below are largely automated, and are intended solely to minimize or eliminate any directional exposure for the Broker-Dealer in regard to particular securities in the Deposit Basket or ETF shares arising from the ETF Loan Transaction. In other words, trading decisions in connection with hedging activity are not dictated in any way by the AP's view of market movements of the Deposit Basket, but instead are dictated by a third-party, specifically the Index provider.

ETF Loan Transaction Hedging

As noted above, the securities in the Deposit Basket that the Broker-Dealer transfers to the ETF or the ETF Agent in step 1 of the ETF Loan Transaction and the securities in the Deposit Basket that the Broker-Dealer receives back from the ETF Agent in step 5 of the ETF Loan Transaction may be different. This is because ETFs tracking an Index are "rebalanced" periodically ("**ETF Rebalancing**"), meaning that the component securities comprising an ETF may change on any given day. This change occurs generally as a result of either (i) movements in the value of the securities underlying the Deposit Basket, or (ii) the addition or deletion of a security from the Deposit Basket. As described above, each ETF publishes the names and quantities of specified securities in its Deposit Basket on each business day.

With respect to ETF Rebalancing, the Broker-Dealer is seeking relief that the Broker-Dealer does not have a Pecuniary Interest in any security purchased or sold in order to hedge against market risk in relation to ETF Rebalancing.

As an example of hedging activity precipitated by market movements of a security in the Deposit Basket, assume an ETF Borrower wishes to borrow from the Broker-Dealer shares of an ETF that is required to maintain 1% (in value) of its portfolio in ABC Corp common stock. The Broker-Dealer borrows the securities in such ETF's Deposit Basket on the day of creation of the ETF shares, with ABC Corp common stock representing 1% of the shares borrowed. Assume also that the Broker-Dealer borrows all of the shares of ABC Corp common stock from third-party lenders for this purpose. The Broker-Dealer then transfers the Deposit Basket, including shares of ABC Corp common stock, to the ETF Agent, who transfers to the Broker-Dealer a Creation Unit of ETF shares. The Broker-Dealer then lends the ETF shares to the ETF Borrower. ABC Corp common stock subsequently experiences a price increase, and the ETF rebalances by selling enough shares of ABC Corp common stock to once again achieve a 1% position of ABC Corp common stock in its portfolio. This causes a change in the securities in the ETF's Deposit Basket and means that, if the

Broker-Dealer were to redeem the ETF shares at that point, it would receive fewer shares of ABC Corp common stock in the redemption than it had originally transferred to the ETF Agent during the creation of the ETF shares. This is a problem because the Broker-Dealer must return to the third-party lenders the same number of shares of ABC Corp common stock it borrowed from them in the first instance. In order to hedge against this market risk, the Broker-Dealer would purchase the same number of shares of ABC Corp common stock as sold by the ETF, which purchase would allow the Broker-Dealer to return the same number of shares of ABC Corp common stock to the third-party lenders upon the redemption of the ETF shares.

As an example of a rebalancing precipitated by the deletion and addition of a component security to the ETF, assume an ETF tracks the Russell 2000 Index, and a particular company is deleted from the index and another added. In this instance, the ETF would rebalance its portfolio by selling the securities of the company dropped from the index and purchasing the securities of the company added to the index so that the securities underlying the ETF would again mirror the index that the ETF is intended to track. To effect its hedge in this scenario, the Broker-Dealer would purchase the same amount of securities as sold by the ETF in order to have the same number of securities available to return to the lender of such securities upon redemption of the ETF shares.

The Indices that ETFs track regularly publish a list of, or otherwise disclose, the rebalancing actions they intend to take or have taken. An ETF's decisions in this regard are made without any input from or participation by any AP or other third party, and must be consistent with the ETF's governing documents as disclosed to investors.

The Broker-Dealer intends to take no market risk with respect to the shares of the ETF created in the ETF Loan Transaction or with respect to any component security of the ETF during the term of the ETF Loan Transaction. The Broker-Dealer also intends to avoid potential financial exposure to ETF rebalancing that results in the Broker-Dealer receiving different securities in the Deposit Basket received from an ETF or the ETF Agent upon a redemption of ETF shares than the Broker-Dealer included in the Deposit Basket transferred to an ETF or the ETF Agent in the creation of such ETF shares. To accomplish these objectives, the Broker-Dealer hedges its exposure to ETF Rebalancing. The Broker-Dealer commits that when hedging its exposure to ETF Rebalancing it will not trade in derivative securities that would limit the Broker-Dealer's risk to Insider Securities.

The Broker-Dealer's hedging trades are not motivated by any actual or perceived additional profit or loss potential generated by market movements in the ETF component securities. Any profit or loss incurred in connection with rebalancing adjustments is incidental to the primary purpose of this activity, which is to hedge the Broker-Dealer's market risk. It should also be noted that hedging activity precipitated by rebalancing generally does not involve the Broker-Dealer selling or buying a particular security in a Deposit Basket, but instead usually involves the Broker-Dealer buying or selling all of the securities in a Deposit Basket, although in certain limited circumstances, the Broker-Dealer may enter into hedging transactions that involve only securities that are affected by the rebalancing (for example, if a component security is replaced by another component security of equal weighting in the Index that an ETF tracks, the Broker-Dealer's hedging transactions may involve only the two affected securities rather than all securities in the Deposit Basket). Such hedging activity takes place on an automated, programmatic basis and is always in response to actions taken by third parties (*i.e.*, rebalancing actions taken by the Indices).

Notwithstanding the SEC's prior guidance that transactions with respect to component securities traded independently of the basket would not qualify for basket-trading relief (*See* Exchange Act Release No. 28869, note 138), we believe that relief would be appropriate with respect to transactions in individual Insider Securities if such transactions are intended to keep the

Broker-Dealer's position neutral with respect to the overall basket of securities. We would note that such individual transactions in Insider Securities allows the Broker-Dealer to have its overall position track the Diversity Standards. In fact, failure to provide such relief would cause the Broker-Dealer to be hedged with respect to all component securities in the Deposit Basket other than the Insider Securities. Ironically, in the absence of relief, the Broker-Dealer would have market exposure only to the Insider Securities, which would not be consistent with the Diversity Standards and the intent of Section 16 (*e.g.*, the Diversity Standards requires that the Broker-Dealer will not simultaneously enter into a derivative or other transaction that has the effect of eliminating the economic risk of all or substantially all of the equity securities in the Deposit Basket that are not Insider Securities so that only the economic risk of the Insider Securities remain).

Relief Requested

We respectfully request that the Staff concur with our positions that the Broker-Dealer does not have a Pecuniary Interest in any Insider Security:

(i) obtained by the Broker-Dealer to create a Deposit Basket to be delivered to an ETF Agent in exchange for ETF shares;

(ii) transferred in a Deposit Basket by the Broker-Dealer to an ETF Agent in exchange for ETF shares when creating an ETF in connection with an ETF Cash Transaction or ETF Loan Transaction;

(iii) received in a Deposit Basket by the Broker-Dealer from an ETF Agent when redeeming an ETF in connection with an ETF Cash Transaction or ETF Loan Transaction;

(iv) transferred by the Broker-Dealer to its clients or others in a disposition of the component securities received from an ETF Agent after redeeming the ETF;

(v) purchased or sold in order to hedge against exposure to intraday trading prices of component securities in the period between the order of an ETF share and the end of the day of the order when ETF shares are created or redeemed; and

(vi) in connection with an ETF Loan Transaction, purchased or sold in order to hedge against market risk in relation to ETF Rebalancing.

Discussion

As the Staff has long recognized, "Section 16 was designed both to provide the public with information on securities transactions and holdings of . . . principal shareholders and to deter those individuals from profiting on short-term trading" while in possession of material nonpublic information. The reporting requirements of Section 16(a) supplement the disgorgement requirements of Section 16(b) and were also intended to "give public investors information concerning purchases and sales by insiders, which might in turn indicate such insiders' private opinions of the Company's prospects".[5] Those policy goals are not implicated by transactions in the ETF component securities when creating or redeeming ETFs, in either an ETF Cash Transaction or ETF Loan Transaction, or when hedging market exposure as a result of ETF Rebalancing. None of these transactions present any opportunity for abuse or illegal benefit from the use of material nonpublic information. Requiring the Broker-Dealer to report such transactions on Form 4 would not convey any useful information to the public and would needlessly subject the

[5] *See* Exchange Act Release No. 26333, December 2, 1988, Part II.

Broker-Dealer to the risk of Section 16(b) litigation. Moreover, it would obstruct the ETF market generally, thus inhibiting the public's ability to trade efficiently in ETFs.

The securities involved in creating and redeeming ETFs, as well as hedging in connection with ETF Rebalancing activities, are part of a large diversified basket of securities that is governed by publicly disclosed documents. In addition, as noted above, such creation, redemption and hedging activities are precipitated by customer interest (including other trading desks at the Broker-Dealer), not by the trading desk transacting in the securities.

The transactions for which we seek relief are directly determined by the independent actions of the ETF and the Index it tracks and are in response to orders from the Broker-Dealer's customers, and not by any discretion exercised by the Broker-Dealer. In its no-action letters to *Goldman Sachs & Co.*, October 15, 1997 and June 7, 1996, the Staff has recognized that trades involving a sufficiently large and diversified basket of securities do not permit the transacting entity to profit from inside information it may have or be presumed to have about discrete securities included within the basket. In the 15 years since the Staff provided such relief, the ETF market has developed and evolved, and the same principles underlying such relief – *i.e.*, a recognition of the lack of pecuniary interest in individual securities when securities are traded in a basket approach meeting certain criteria – naturally extend to ETFs. The same analysis as applied in the *Goldman Sachs & Co.* no-action letters should apply to the transactions for which we seek relief.

In this regard, the Broker-Dealer notes that all ETFs for which it may engage in creation, redemption and hedging activities will meet certain diversity standards (the "**Diversity Standards**"), which are largely patterned on the conditions set forth in the Staff's No-Action Letter to *Goldman Sachs & Co.*, October 15, 1997 and are as follows:

- The securities underlying the ETF consist of at least 40 issuers;
- The securities obtained by the Broker-Dealer that underlie the ETF comprise (i) at least 75% of the weighted capitalization or weighted security value reflected in the capitalization-weighted or price-weighted Index or (ii) 75% of the equity securities in the Index;
- The equity security with the largest value in the Index that the ETF is based off of does not exceed 25% of the market value of all of the equity securities in the Index;
- The equity security with the second largest value in the Index that the ETF is based off of does not exceed 20% of the market value of all of the equity securities in the Index;
- No other equity security exceeds 10% of the market value of all of the equity securities in the Index that the ETF is based off of;
- The Insider Security or Insider Securities constitute, in the aggregate, less than 3% of the market value of all of the equity securities in the Index that the ETF is based off of; and
- The Broker-Dealer will not simultaneously enter into a derivative or other transaction that has the effect of eliminating the economic risk of all or substantially all of the equity securities in the Deposit Basket that are not Insider Securities so that only the economic risk of the Insider Securities remain.

The Indices tracked by the ETFs at issue in this letter closely track the spirit of those referenced in the *Goldman* letters and it is appropriate to cover such Indices to take account of how indices have developed in the 15 years since the *Goldman* letters. The *Goldman* letters require baskets to track "standard domestic or foreign indices" which would be traded derivative instruments (*i.e.*, regulated instruments). Similarly, ETFs and the Indices they track are also required to fulfill various regulatory requirements. For example:

- NYSE Arca Equities Rule 5.2(j)(3) and NASDAQ Equities Rule 5705 require the Index tracked by an ETF to meet the following requirements: (i) the Index must include a minimum of 13 U.S. or 20 non-U.S. component stocks; (ii) the most heavily weighted component stocks may not represent more than 30% (U.S.) or 25% (non-U.S.) of the Index, (iii) the five most heavily weighted component stocks may not represent more than 65% (U.S.) or 60% (non-U.S.) of the Index, and (iv) (a) under the NYSE Arca Equities Rule 5.2(j)(3), component stocks that in the aggregate account for at least 70% of the weight of the Index must have a minimum monthly trading volume of 250,000 shares or minimum notional volume traded per month of at least $25,000,000, averaged over the last six months, and (b) under NASDAQ Equities Rule 5705, component stocks that in the aggregate account for at least 90% of the weight of the Index must have a minimum monthly trading volume of 250,000 shares during each of the last six months. (An exchange may apply to the SEC to relax these requirements with respect to particular ETFs that is seeks to list.)

- Pursuant to no-action relief granted by the Staff under Regulation M under the Exchange Act (*See* No-Action Letter *Re*: Class Relief for Exchange Traded Index Funds, File No. TP 07-07, dated October 24, 2006), an Index must have at least 20 component stocks and the most heavily weighted component stock may not represent more than 25% of the Index. (An ETF sponsor may also apply to the SEC for no-action relief to relax these requirements with respect to a particular ETF that it sponsors.)

- The Investment Company Act requires ETFs that are classified as "diversified" open-end funds to invest at least 75% of their assets in cash and cash-equivalent assets and in securities with respect to which (i) no single issuer represents more than 5% of the total assets of the fund and (ii) the fund does not own more than 10% of the outstanding voting securities of an issuer.

- Subchapter M of the Internal Revenue Code also requires a registered fund, including any ETF, to meet certain diversification requirements in order to obtain tax treatment as a "regulated investment company."

Each step in the creation, redemption and hedging activity for which the Broker-Dealer is seeking relief (*i.e.*, obtaining securities to create a Deposit Basket, transferring securities in a Deposit Basket in exchange for ETF shares and receiving securities in a Deposit Basket in connection with the redemption of an ETF, purchasing or selling securities to hedge against exposure to intraday trading and purchasing or selling securities to hedge against market risk due to ETF Rebalancing) is in compliance with the Diversity Standards, as each step is carried out in relation to the entire Deposit Basket or, in certain limited circumstances, with respect to individual component securities solely for the purpose of hedging economic risk for the entire Deposit Basket and preserving the Diversity Standards (see discussion in the last paragraph under "ETF Loan Transaction Hedging").

Also, as noted above, none of the transactions involved in the creation, redemption or hedging of ETF shares is motivated by a desire to profit from, or indeed any investment intent with regard to, any component security of the respective ETF. To the contrary, the Broker-Dealer's activities are all designed to avoid any exposure to, rather than to profit from, fluctuations in the values of the constituent securities of the ETFs. Even where the Broker-Dealer guarantees the price of the ETF to a customer in an ETF Cash Transaction, the guarantee is provided for the overall basket of component securities and not the value of any individual security, which keeps the ETF transactions within the spirit of the Goldman letters. *See Goldman Sachs & Co.*, (October 15, 1997) (relief available if no derivative transactions limit insider risk to the securities to which it had insider status, but instead the risk, if any, is tied to the entire basket).

Hedging related to ETF Rebalancing is not initiated by or on the basis of knowledge of any fact or information specific to or relating to any particular component security of the ETF. The Broker-Dealer has no input into rebalancing decisions made by the ETF and there is no ability (or intention) by the Broker-Dealer to influence such decisions. Moreover, as noted above, the Broker-Dealer's hedging activities are highly automated, which further ameliorates any risk of misuse of inside information with respect to the small number of Insider Securities involved.

In addition to the considerations described above, we note that the Commission in a related context has recognized that Index-driven trades such as the transactions described herein do not present an opportunity for abuse if the Index meets specified size and, implicitly, diversification criteria. *See* Rule 16a-1(a)(5)(iii), which deems interests in securities comprising part of certain broad-based, publicly-traded market baskets or indices of stocks not to confer beneficial ownership for purposes of Section 16, and Rule 16a-1(c)(4), which exempts derivative securities based on broad-based market baskets or indices from the definition of "derivative security" subject to Section 16. In this regard, we note that ETFs of the size and diversification discussed in our request are like such "broad-based, publicly traded market baskets or indices."

In regard to the borrowing of component securities in connection with ETF Loan Transactions, we note that stock lending has long been recognized as a financing activity that does not present Section 16 concerns. *See* Exchange Act Release No. 18114, September 23, 1981, Question 50; confirmed by Exchange Act Release No. 28869, February 8, 1991. The Staff has recognized that such transactions are not subterfuges for sales, but rather straightforward commercial transactions that contemplate the return of the borrowed securities to their owner with no consequent change in beneficial ownership for purposes of Section 16(a). *See* Exchange Act Release No. 18114, September 23, 1981, Question 50. Therefore, an insider who loans securities to another person is not required to report the loan. *See* Exchange Act Release No. 18114, September 23, 1981, Question 50. Similarly, an insider who borrows securities should not be required to report the acquisition of the borrowed securities, meaning that the Broker-Dealer's borrowing of component securities that are Insider Securities should not be a reportable event under Section 16(a). *See Log On America, Inc. v. Promethean Asset Management L.L.C.*, 223 F. Supp. 2d 435, 450 (S.D.N.Y. 2001). For the same reasons, the returning of securities should not raise any Section 16 concerns.

Finally, the SEC has also recognized that Section 16 should be administered to "avoid undue interference with the day-to-day business of banks, broker-dealers"[6] and other financial institutions whose ordinary course activities are both highly regulated and necessary to the orderly functioning of financial markets.

Conclusion

In conclusion, we respectfully request that the Staff issue the interpretations presented above. We would be happy to further discuss our request at the Staff's convenience. Please contact Jean McLoughlin at 212-450-4416 or jean.mcloughlin@davispolk.com should you desire additional information or clarification on any of the matters we have presented. We greatly appreciate your consideration of our request.

[6] Exchange Act Release No. 27148, August 18, 1989, III.4.3.a.

Very truly yours,

Jean M. McLoughlin

212-450-4416