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SEC Proposes New ETF Rules That Would Enhance Speed to Market

The Securities and Exchange Commission (the “SEC”) today voted unanimously to publish a release proposing for comment new rules and rule amendments under the Investment Company Act of 1940 (the “1940 Act”) that would enable exchange-traded funds (“ETFs”) to register with the SEC and commence operations without obtaining individual exemptive orders from the SEC. The SEC also voted to propose related disclosure amendments and a rule to provide flexibility to traditional mutual funds to invest in ETFs.

Because of their unique structure, ETFs now must obtain exemptive relief from certain provisions of the 1940 Act. Specifically, an ETF, because it is organized as an open-end fund, generally is required to request an order granting relief from: (i) Sections 2(a)(32) and 5(a)(1) so that the ETF may issue shares that are redeemable only in large “creation units;” (ii) Section 22(d) and Rule 22c-1 to permit the purchase and sale of individual ETF shares in the secondary market at negotiated prices; and (iii) Sections 17(a)(1) and (a)(2) to permit in-kind purchases and redemptions of creation units by persons that may be affiliated with the ETF by reason of owning more than 5% of its outstanding securities. ETFs have also generally obtained relief from Section 24(d) of the 1940 Act to permit secondary market sales of ETF shares unaccompanied by a full prospectus, provided that a shorter “product description” is provided instead, and many ETFs have obtained relief from Section 12(d)(1) to permit other investment companies to purchase shares of the ETF in excess of the 1940 Act’s fund-of-funds limitations.

The proposed rule changes would provide relief to ETFs that comply with the rules’ conditions, obviating the need for ETFs to file individual exemptive applications and obtain exemptive relief before commencing operations. If adopted, the new rules would make it substantially easier to establish new ETFs, by reducing organizational costs and the time it takes to bring new ETFs to market. (Obtaining an ETF exemptive order ordinarily takes at least several months.)

While the precise nature of the ETFs that will be eligible to rely on the rule and the applicable conditions were not entirely clear from the discussion of the proposals at an open meeting of the SEC held today, we understand that the primary conditions of proposed rule 6c-11 are: (1) the ETF must be “transparent” (*i.e.*, its holdings must be made public on a daily basis or it must track a similarly transparent index); (2) the ETF must be traded on a national securities exchange; and (3) the current value of the ETF’s holdings or its “creation basket” must be published on an ongoing basis throughout the trading day. Based on the discussion at the open meeting, we understand that the following are other aspects of the proposals:

- the rule would cover actively-managed as well as index-based ETFs, provided that they meet the transparency requirement;
- the relief permitting the delivery of a product description rather than an ETF’s prospectus ultimately would no longer be available, with the SEC instead permitting the use of the recently proposed “summary prospectus” for investment companies;
- relief from the fund-of-funds limitations would be subject to conditions that are substantially less burdensome than those that have generally been included in Section 12(d)(1) exemptive orders; and

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1

- the proposed disclosure amendments would (1) require ETFs to present returns based on both the market value and the net asset value of their shares; and (2) enable ETFs to omit from their prospectuses disclosure regarding the creation and redemption process, as such disclosure has little or no relevance to retail investors.

The proposed rules, if adopted, may cause somewhat of a shift in the competitive forces existing in the ETF industry today. As you may know, there has been significant interest recently within the ETF industry in launching so-called “exchange-traded vehicles” (“ETVs”), such as products designed to track the performance of commodities indexes. Absent an applicable exemption, shares of ETVs are required to be registered under the Securities Act of 1933 (the “1933 Act”) and trading of the shares in the secondary market is regulated in accordance with the Securities Exchange Act of 1934 (the “1934 Act”). ETVs are *not* required to register under the 1940 Act, but this aspect of federal ETV regulation has proved a mixed blessing.

On the one hand, ETVs have not been required to run the 1940 Act exemption gauntlet. On the other, the fact that ETVs are not regulated investment companies has subjected product sponsors to a unique set of regulatory challenges under the federal securities laws, as well as federal tax laws. This competitive calculus would change if the proposed exemptive rules are adopted – ETVs would no longer enjoy a competitive advantage over ETFs resulting from ETFs having to obtain exemptive relief; at the same time, ETVs would continue to be subject to the unique regulatory issues resulting from not being regulated under the 1940 Act.

We will provide a detailed analysis of the proposed rules after the proposing release has been published by the SEC.



If you have any questions on the proposed rules and their impact on ETFs and ETVs, please contact any of the following attorneys or the attorney with whom you regularly work:

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