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SEC Proposes New ETF Rules That Would Enhance Speed to Market (Update)

On March 11, 2008, the Securities and Exchange Commission (the "SEC") published a release (the "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.¹ In the Release, the SEC also proposes disclosure amendments relating to ETFs and a rule to provide flexibility to traditional mutual funds to invest in ETFs. Comments on the proposal are due by May 19, 2008.

Background

How ETFs Work. ETFs are investment companies that are registered with the SEC under the 1940 Act, typically as "open-end management investment companies." (An "open-end management investment company" is the technical term for what we commonly think of as a "mutual fund.") As is the case with investment companies generally, ETFs register their shares with the SEC under the Securities Act of 1933 (the "1933 Act").

Unlike mutual funds, ETFs do not sell or redeem their individual shares at net asset value ("NAV"). Instead, ETFs sell and redeem their shares at NAV only in large blocks called "creation units" (such as 50,000 shares). Brokerage houses or large institutional investors that purchase blocks of ETF shares in creation units generally do so through "in-kind" transactions involving a basket of securities or other assets ("basket assets") that mirrors the composition of the ETF's portfolio, plus a small amount of cash to account for the difference between the value of the basket assets and the NAV of the ETF shares. The ETF's sponsor (typically the fund's investment adviser) announces the basket assets at the beginning of each business day. The value of a creation unit is typically in the range of several million dollars.

ETF shares are not redeemable to the ETF itself except in creation units. Like creation unit purchases, creation unit redemptions are typically effected on an in-kind basis, with the redeeming investor receiving basket assets that are identified by the ETF sponsor at the beginning of the day (plus a small amount of cash) in exchange for the ETF shares being redeemed. An ETF's shares are listed on a national stock exchange (such the New York Stock Exchange or the American Stock Exchange) and can be purchased or sold in amounts smaller than a creation unit in the secondary market at market prices, just like shares of stock of any public company. The investor pays customary brokerage commissions on such a purchase or sale. Thus, an ETF is something of a hybrid between a traditional mutual fund and a "closed-end" fund, with creation units of ETF shares being bought and sold from the ETF at NAV like a mutual fund and smaller amounts of shares being traded at market prices in the secondary market like a closed-end fund.

¹ Exchange-Traded Funds, Investment Company Act Release No. 28193, File No. S7-07-08. See also Sutherland Asbill & Brennan LLP Legal Alert: SEC Proposes New ETF Rules That Would Enhance Speed to Market (March 11, 2008).

ETFs have historically been “index-based,” with investment objectives of tracking the performance of the specified index (or the inverse of such performance) by investing in all or a representative sample of the securities of the index. More recently, however, the SEC has begun issuing exemptive relief to “actively managed” ETFs that do not attempt to track the performance of any index.

Benefits of ETFs. ETFs are designed to provide investors with the opportunity to invest in a diversified portfolio of securities through the purchase of a single exchange-traded security. As a result, investors may obtain the diversification benefits of an investment company with the trading flexibility of a stock. In addition, ETFs may avoid the discounts in market price as compared to NAV often associated with closed-end fund shares (and, of course, forego the potential for premiums) by continuously issuing and redeeming ETF shares at NAV in creation units. Also, issuing and redeeming creation units on an in-kind basis may enable ETFs to minimize the trading costs associated with buying and selling portfolio securities and provide certain tax efficiencies to shareholders.

Current Regulatory Background. 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 file an application requesting 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 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 “statutory” prospectus, provided that a shorter “product description” is provided instead. In addition, 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 Exemptive Rule

Proposed Rule 6c-11 would provide relief to an ETF that complies with the rule’s conditions so that the ETF would not need to file an individual exemptive application 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. While the time required to obtain routine SEC exemptive orders for ETFs has shortened considerably over the course of the past several years, obtaining an exemptive order for an innovative or novel ETF can still take six to twelve months or more.²

The Nature of the Relief. Proposed Rule 6c-11 would:

- deem ETF shares to be “redeemable securities” under Section 2(a)(32) of the 1940 Act;

² ETFs typically also need relief from various provisions of and rules under the Securities Exchange Act of 1934 (the “1934 Act”). The staff of the SEC’s Division of Market Regulation has issued a number of letters granting class-based relief from those provisions and rules to ETFs meeting the conditions of such letters. *See* Willkie Farr & Gallagher, LLP (Apr. 9, 2007); PowerShares Exchange-Traded Fund Trust (Oct. 24, 2006); Derivative Products Committee of the Securities Industry Association (Nov. 21, 2005). If an ETF does not meet such conditions, however, a separate no-action request may be necessary. A detailed discussion of these letters and the 1934 Act provisions and rules is beyond the scope of this client alert.

- provide relief from Section 22(d) and Rule 22c-1 to permit purchases and sales of ETF shares in the secondary market at market prices; and
- provide relief from Sections 17(a)(1) and 17(a)(2) to persons who are “affiliated persons” of an ETF solely by reason of holding more than 5 percent of the voting securities to the ETF (and to affiliated persons of such persons) or more than 5 percent of the voting securities of another investment company under common control with the ETF to permit the in-kind deposit and receipt of basket assets.

The proposed rule would also provide relief from Section 22(e) of the 1940 Act so that an ETF would be able to delay delivery of a foreign security that is part of the basket assets applicable to a redemption request if: (i) a foreign holiday prevents timely delivery; (ii) the ETF discloses in its registration statement the holidays that it expects may prevent timely delivery and the maximum number of days that it anticipates it will need to make delivery; and (iii) the foreign securities are delivered no later than 12 calendar days after the tender of the ETF shares for redemption.

Notably, the proposed rule would not provide the prospectus delivery relief from Section 24(d) that ETFs have typically obtained through their individual exemptive orders. The SEC explained that this was because many broker-dealers selling ETF shares in secondary market transactions actually transmit a full prospectus to purchasers, and because the SEC believed that such a prospectus delivery exemption would be unnecessary given its recent summary prospectus proposal.³ In this regard, the Release states that, if the SEC were to adopt Rule 6c-11 before the summary prospectus proposal, it would expect to permit delivery of a product description in lieu of a prospectus pending a final determination on the summary prospectus.

The Rule’s Conditions. Essentially, in order to rely on the relief that would be provided by proposed Rule 6c-11, an open-end investment company would have to meet the definition of “exchange-traded fund” set forth in the rule.⁴ The elements of the ETF definition are as follows:

- Probably the most obvious element of the definition is that an ETF must be approved for listing and trading on a national securities exchange under Section 12 of the Securities Exchange Act of 1940.⁵
- The ETF must issue or redeem creation units in exchange for basket assets the current value of which is disseminated on a per share basis by a national securities exchange at regular intervals during the trading day.

³ While the SEC did not explain why broker-dealers have not relied on the Section 24(d) relief in practice (and requested comments if its understanding in that regard is correct), we understand that (1) broker-dealers are uncomfortable relying on the relief in light of certain provisions of the 1933 Act that might require prospectus delivery notwithstanding the relief from Section 24(d), and (2) prospectus fulfillment facilities have difficulty accommodating the delivery of different ETF documents in different circumstances.

⁴ Some of the first ETFs were organized not as open-end investment companies, but as unit investment trusts. Because essentially all ETFs organized recently have been structured as open-end companies, the SEC did not propose to make the rule applicable to unit investment trusts.

⁵ The major national securities exchanges have adopted generic listing standards for ETF shares. *See, e.g.*, American Stock Exchange Rule 1000A. If a particular ETF cannot rely on the generic listing standards, the listing exchange must submit a formal exemptive application to the SEC under Rule 19b-4 under the 1934 Act to allow the ETF to be listed. A discussion of the applicable exchange listing standards is beyond the scope of this client alert.

- In any sales literature, the 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 on an exchange.
- The ETF must disclose each business day on its Web site the prior day's NAV and closing market price and the premium or discount of the market price against NAV (as a percentage of NAV).
- The ETF must either (1) disclose each business day on its Web site the identities and weightings of the securities and other assets held by the ETF, or (2) have a stated investment objective of obtaining returns that correspond to those of a specified index, if the index provider discloses on its Web site the identities and weighting of the component securities and other assets of the index.

It should be noted initially that the elements of the proposed definition are similar to the express conditions that have typically been included in individual applications for exemptive relief. In addition to the express conditions, however, such applications have generally included extensive factual background on the ETF, and the relative brevity of the proposed rule suggests that much of that background information essentially is irrelevant from the 1940 Act perspective. In addition, the following aspects of the application of the proposed rule should be noted.

Actively-Managed ETFs. As noted above, the SEC has recently begun granting exemptive orders to ETFs that are not index-based, after seeking comment on such ETFs in a concept release published in 2001.⁶ The proposed rule would generally reflect the view there should be no significant difference from a regulatory standpoint between index-based and actively-managed ETFs as long as an actively-managed ETF is willing to comply with the "transparency" conditions of the rule, including by making its holdings public on a daily basis. Of course, the adviser to an actively-managed fund may be reluctant to provide this degree of transparency, because it might provide the market with the ability to divine information about the adviser's investment strategy. In this regard, the SEC states in the Release that it will consider individual applications for exemptive relief for actively-managed ETFs that would not satisfy the rule's transparency conditions.

Affiliated Index Providers. Historically, index-based ETFs represented in their exemptive applications that they or their advisers were not affiliated with the entity that formulates and calculates the index that the ETF seeks to track (the "index provider"). More recently, the SEC has begun granting exemptive relief to ETFs with affiliated index providers, and proposed Rule 6c-11 would not specify any requirements with respect to the identity of the index provider.

Intra-Day Value. As noted above, proposed Rule 6c-11 would require that the value of an ETF's basket assets be disseminated at regular intervals during the trading day; it would not require that these intra-day values be disseminated at any specified interval. The rules of the national securities exchanges, which must be approved by the SEC, establish this frequency, which for most ETFs is every 15 seconds. However, the rule would appear to require that the intra-day value be determined based on the current value of the basket securities, even though exchange rules generally permit more flexibility in the calculation of intra-day values (e.g., use of either the value of the basket assets or the value of ETF's benchmark index to calculate intra-day values).

⁶ Actively Managed Exchange-Traded Funds, Investment Company Act Rel. No. 25258 (Nov. 11, 2001), File No. S7-20-01.

Use of the Term “Mutual Fund.” While the proposed rule would require an ETF to identify itself as an “exchange-traded fund” in sales literature, it would not include the express prohibition on referring to an ETF as a “mutual fund” that was included in the exemptive orders. It is not clear whether the SEC intended to permit referring to an ETF as a mutual fund, or whether it might interpret the requirement to use the term exchange-traded fund to preclude using the term “mutual fund” as well.

Location of Web Site Information. As noted above, the rule would require most of the required information to be available on the ETF’s Web site, but the intra-day value would be required to be disseminated by the listing exchange, and the index provider could post to its Web site information on the component securities of the relevant index. One might question whether the identity of the party publishing the information or the location of the Web site matters as long as investors can readily access the information and are made aware of how to access it. In this regard, could an ETF provide a link on its Web site to all of the required information on the listing exchange’s or some other entity’s Web site?

Effect on Existing ETFs. In the Release, the SEC proposes to amend existing ETF orders so that they more closely reflect the proposed rule by eliminating the prospectus delivery exemptions, which would effectively require existing ETFs to comply with the disclosure changes discussed immediately below. The Release states that, in other respects, the proposed rule would provide more flexibility than the outstanding exemptive orders; therefore, the SEC expects that most, if not all, ETFs would rely on the rule instead of any order they had previously obtained.

The Disclosure Changes

The Release also includes amendments to Form N-1A, the form on which open-end investment companies register under the 1940 Act and register their shares under the Securities Act of 1933, so that ETF prospectuses: (i) would include in the average annual return tables total returns based on both the market value and the net asset value of the ETF; (ii) would include information about the extent and frequency of premiums and discounts; and (iii) could omit disclosure regarding the creation and redemption process. The proposed amendments to the prospectus requirements are intended to provide relevant disclosure to secondary market purchasers (including retail investors), rather than purchasers of creation units. In general, the proposed amendments would take information that is required by the exemptive orders to be disclosed in some form, and require that such information be disclosed in an ETF’s prospectus. This reflects the SEC’s decision to eliminate the prospectus delivery relief that has historically been granted and use the prospectus (or the summary prospectus, as discussed above) as the primary disclosure document for retail investors.

The Fund-of-ETFs Exemption

As noted above, 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 fund-of-funds limitations of that section. Specifically, Section 12(d)(1) generally prohibits an investment company from (i) acquiring more than 3 percent of any other investment company’s outstanding voting securities, (ii) investing more than 5 percent of its total assets in any one investment company, and (iii) investing more than 10 percent of its total assets in investment companies in the aggregate. The exemptive relief obtained by ETFs in this area has generally included a substantial number of conditions that are similar to those to which funds seeking relief to invest in unaffiliated traditional mutual funds have been subject, including a number of conditions designed to limit the influence that an acquiring fund may exercise over a fund that it acquires. In response to industry input that some of those conditions are unnecessary in the context of a fund-of-ETFs, the SEC has proposed a new rule, Rule 12d1-4 under the 1940 Act, that would provide a fund-of-ETFs exemption with conditions substantially less burdensome than those that have heretofore been included in Section 12(d)(1) exemptive orders for both funds-of-funds and funds-of-ETFs.

Specifically, the conditions of proposed Rule 12d1-4 are as follows:

- No acquiring fund or any of its investment advisers or depositors, and any company controlling, controlled by or under common control with the acquiring fund or any of its investment advisers or depositors, may control an underlying ETF, individually or in the aggregate.⁷
- An acquiring fund may not redeem ETF shares, and instead must sell its shares in the secondary market. The SEC stated in the Release that this would prevent an acquiring fund from threatening large-scale redemptions as a means of coercing an ETF. However, one might question whether such coercion might be possible through the threat of large-scale secondary market sales, as such sales might result in creation unit redemptions.
- Any sales charges and service fees charged in connection with the purchase, sale or redemption of securities issued by the acquiring fund must not exceed the limits for funds-of-funds set forth in Rule 2830(d)(3) of FINRA's conduct rules.⁸
- An underlying ETF may not make investments in other investment companies in excess of the Section 12(d)(1) limits (*i.e.*, funds-of-ETFs-of-funds are not permitted).

Exchange-Traded Vehicles

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 “commodity-based ETFs” or “exchange-traded vehicles” (“ETVs”), which are 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 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. (In the Release, the SEC acknowledges the existence of commodity-based ETFs and indicates that they typically are not investment companies under the 1940 Act.) 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.

⁷ Section 2(a)(9) of the 1940 Act establishes a presumption that any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percent of the voting securities of a company controls such company.

⁸ Proposed Rule 12d1-4 would also provide that, with respect to an insurance company separate account that invests in an acquiring fund: (i) the acquiring fund and underlying ETF may not charge a sales load; (ii) any asset-based sales charge (as defined in the FINRA rules) or service fees is charged only by the acquiring fund or the ETF, but not both; and (iii) the fees associated with the variable insurance contract that invests in the acquiring fund and the sales charges and service fees charged by the acquiring fund and underlying ETF, in the aggregate, must be reasonable in relation to the services rendered, the expenses expected to be incurred and, with respect to the variable insurance contract, the risks assumed by the insurance company.



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:

Marguerite C. Bateman	202.383.0107	marguerite.bateman@sutherland.com
W. Thomas Conner	202.383.0590	thomas.conner@sutherland.com
Eric C. Freed	212.389.5055	eric.freed@sutherland.com
David S. Goldstein	202.383.0606	david.goldstein@sutherland.com
Bibb L. Strench	202.383.0509	bibb.strench@sutherland.com