Chapter 17

Exchange-Traded Funds

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§ 17:1 Background

Exchange-traded funds (ETFs) are true hybrid investment vehicles. Their shares trade on a securities exchange like any other stock, but may also be purchased and redeemed in large blocks (typically 50,000–100,000 shares) at net asset value per share on a daily basis. ETFs therefore possess characteristics of both open-end investment companies and unit investment trusts (UIT), which issue redeemable securities and closed-end investment companies which issue shares that are purchased and sold on securities exchanges throughout the trading day.

Unlike traditional open-end investment companies and unit investment trusts, ETFs afford investors the opportunity to capitalize on market movements (upward or downward) during the trading day. In this respect, they are similar to closed-end investment companies. A key distinction between ETFs and closed-end investment companies, however, is the ability to continually purchase and redeem shares of the ETF at net asset value per share (NAV). This feature is intended to create an arbitrage pricing discipline which minimizes the occurrence of discount and/or premium pricing historically experienced by closed-end investment companies. Another distinguishing feature of ETFs is that typically purchases and redemptions are effected by an in-kind tender of a specified basket of securities. The in-kind mechanism is designed to limit portfolio turnover and related transaction expenses by minimizing the need to liquidate portfolio securities to meet redemptions and/or to acquire portfolio securities in connection with purchases of ETF shares.

In this chapter, we first look at organizational issues surrounding ETFs and then examine regulatory issues under the Investment Company Act of 1940 (the "Investment Company Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). Except as otherwise indicated, this chapter relates to ETFs which are investment companies under the Investment Company Act.

§ 17:2 Organizational Issues

§ 17:2.1 Form of Organization

An ETF may be organized as a unit investment trust[1] or as an open-end management company.[2] A UIT holds a specified portfolio of securities; no element of discretion to alter the composition of the portfolio is permitted. A management company is any company other than a UIT. Unlike UITs, management companies have discretion to purchase and sell securities and engage in various other investment techniques.

Either form is appropriate in the case of an ETF which holds all of the securities in the specified index (the Benchmark Index) in the proportion represented in the index. This is known as full replication. The UIT form would not be appropriate, however, for an ETF which utilizes sampling techniques rather than full replication in seeking to track the index. Sampling involves selection of a representative sample of securities which, in the aggregate, are expected to perform like the Benchmark Index as a whole. Sampling, therefore, involves an element of investment discretion not permissible for UITs.

Sampling techniques, rather than full replication, may be utilized for a variety of reasons. These include: (i) the Benchmark Index may be comprised of a large number of securities; (ii) some of the securities in the index may be illiquid; and (iii) one of the securities in the index comprises more than 25% of the index, in which case the security could not be held in proportion to its representation in the index without running afoul of Subchapter M of the Internal Revenue Code.[3]

Additional distinctions between UITs and open-end management companies which may influence the form of organization chosen include: (i) UITs may not reinvest dividends; instead, dividends are held in a non-interest bearing account and paid out quarterly; (ii) UITs do not pay management fees (although they do pay Trustee's fees); and

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1. *See, e.g.*, SPDRs, which seek to track the S&P 500; NASDAQ 100-Trust which seeks to track the NASDAQ 100; DIAMONDS (SM) which seeks to track the Dow Jones Industrial Average.
2. Since 1997, very few ETFs have been organized as UITs.
3. Registered investment companies structure their operations to qualify as regulated investment companies under Subchapter M of the Internal Revenue Code and thereby minimize or avoid taxation at the fund level. One requirement of Subchapter M is that at the close of each quarter of the fund's taxable year, no more than 25% of the value of the fund's total assets may be represented by securities of any one issuer.

(iii) management companies may engage in securities lending and other income enhancement techniques.

§ 17:2.2 *Mechanics of Purchases and Sales*

[A] Exchange Transactions

ETF Shares ("Shares") are listed on a securities exchange and may be purchased and sold throughout the trading day at market prices. Normal brokerage commissions are payable in connection with these transactions.

[B] Transactions

[B][1] Purchases

Shares may be purchased at NAV in large block sizes known as Creation Units. Creation Units are typically at least 50,000 shares. Purchases are effected through the deposit with the ETF of a specified basket of securities ("Deposit Basket"), generally intended to replicate or represent the securities included in the Benchmark Index.[4] A cash payment generally must also be made. The list of the names and number of shares comprising the Deposit Basket applicable to purchases on a particular trading day is made available daily to market participants prior to the opening of trading, typically through the facilities of the National Securities Clearing Corporation, a clearing agency registered with the Securities and Exchange Commission (NSCC).[5]

Cash payments by the purchaser to the ETF or by the ETF to the purchaser are required to the extent that the market value of the Deposit Basket is, at the time that NAV is calculated, lower or higher than NAV. These payments are intended to insure that total payments by the Purchaser, that is, the market value of the Deposit Basket plus cash, are (consistent with Rule 22c-1 under the Investment Company Act) equal to NAV next calculated following receipt of the purchase order in proper form.

Purchases may only be effected through a firm which is either a participant in NSCC or in the Depository Trust Company (DTC) and has entered into an agreement with the ETF and with the ETF's

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4. An investor subject to a legal restriction with respect to a particular security within the Deposit Basket may be offered the opportunity to tender a custom Deposit Basket which excludes the applicable securities. In addition, certain ETFs that invest in non-U.S. securities or fixed income securities may accept and deliver Creation Units for cash rather than in kind.
5. The Deposit Securities are generally selected by the investment adviser to the ETF or, in the case of a unit investment trust, by the Trustee.

Distributor (an "Authorized Participant"). Purchases of ETFs, which invest in U.S. equity securities, are generally effected through NSCC.[6] This process involves the automated transfer of the entire Deposit Basket to the ETF. NSCC guarantees delivery to the ETF of the Deposit Basket and/or required cash. Currently, transactions involving non-U.S. securities or fixed income securities must be effected outside of NSCC, through DTC. This is a more cumbersome process since it involves manual transfers to the ETF of each security within the Deposit Basket.

[B][2] Redemptions

Redemptions work the same way but in reverse. Shares may be redeemed in Creation Unit size at NAV. Redemptions are effected in exchange for a specified basket of securities (the "Redemption Basket"). The names and number of shares comprising the Redemption Basket applicable to redemption requests on a particular day are disseminated prior to the opening of trading typically through the facilities of NSCC. In some instances, the Redemption Basket may differ slightly from the Deposit Basket.

Redemption proceeds include the Redemption Basket plus cash in an amount equal to the difference between the net asset value of the Shares being redeemed and the value of the Redemption Basket. If the value, however, of the Redemption Basket is greater than the net asset value of the Shares, a cash payment equal to the differential must be paid to the ETF.

As in the case of purchases, redemptions may only be effected by or through an Authorized Participant either through NSCC or through DTC.

§ 17:2.3 The Arbitrage Process

The market prices for Shares and information respecting the value of the Deposit and Redemption Baskets, the value of the Benchmark Index and the ETFs' approximate NAV are disseminated to the marketplace throughout the trading day. As a result, market participants are able, on an ongoing basis, to compare NAV and the market prices of the Shares. To the extent they differ, arbitrage opportunities are present. For example, if Shares are trading at a discount to NAV, an arbitrageur may purchase Shares at the discounted price and tender them for a basket of securities which have a higher market value. This purchase activity should tend to prevent Shares from trading at a material discount from NAV for any extended period of time. Conversely, if Shares are trading at a premium to NAV, arbitrageurs can

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6. Currently, transactions involving non-U.S. securities or fixed income securities must be effected outside of NSCC.

acquire Shares through the tender of a basket of securities which have a market value lower than the market price of Shares and resell the Shares at the higher market price. This selling activity should tend to insure that Shares do not trade at a premium to NAV for any extended period of time.

§ 17:2.4 Tax Matters

[A] ETFs As Compared to Mutual Funds

As noted above, purchases and redemptions of ETFs generally are effected in kind. The in-kind feature may make an ETF more tax efficient than an open-end investment company. In particular, an ETF is less likely to generate capital gain than an open-end investment company to the extent that the in-kind feature minimizes the need to sell portfolio securities to satisfy redemption requests. Also, the in-kind mechanism affords ETFs the flexibility, not available to an open-end investment company, to choose to include in the basket of securities transferred to the redeemer upon redemption securities with the lowest cost basis, and thereby to eliminate from the ETFs portfolio, tax-free, securities with the highest unrealized tax liability.

[B] Tax Implications for Purchaser

A purchase of Shares through a tender of Deposit Securities is a taxable event to the purchaser. The purchaser incurs a taxable gain or a loss equal to the difference between the market value of the Shares at the time and the purchaser's aggregate basis in the securities tendered and any amount of cash paid.

[C] Tax Implications for Redeemer

A redemption of Shares is a taxable event to the redeeming Shareholder. The redeemer incurs a taxable gain or loss equal to the difference between such person's basis in the Shares and the aggregate market value of the securities and any cash received.

§ 17:3 Investment Company Act Issues

§ 17:3.1 Registration As an Open-End Company or a Unit Investment Trust

The Investment Company Act contemplates two types of investment companies, those which issue "redeemable securities" ("open-end investment companies" and UIT); and those which do not ("closed-end investment companies"). ETFs do not fit clearly within either category. The term redeemable security is defined in section 2(a)(32) of the Investment Company Act as "any security under the terms of which, the owner, upon its presentation to the issuer . . . is entitled to receive approximately his proportionate share of the issuer's net assets or the cash equivalent thereof." ETF Shares are redeemable within the meaning of section 2(a)(32) but only in Creation Unit size, not individually. Therefore, it is not certain whether ETFs can be viewed as issuing redeemable securities. Due to their uncertain status under the Investment Company Act, ETFs have been required to seek exemptive relief from the SEC to permit registration as an open-end investment company or a UIT.

The first ETF exemptive order was issued by the SEC in 1990 to Super Trust, an ETF that sought to accomplish its objective through investment in shares of an underlying open-end fund rather than investing directly in a portfolio of securities.[7] Due in large part to its complex structure, Super Trust proved to be a commercial failure and terminated in 1996. In 1992, the SEC issued similar exemptive relief to Standard & Poor's Depository Receipt Trust (SPDR), a unit investment trust that seeks to replicate the performance of the S&P 500 Index.[8] The SPDR is one of the most actively traded stocks in the world.

In light of the novelty of the relief sought, both the Super Trust and SPDR orders took several years to obtain. There have, however, been many ETF exemptive orders issued since the SPDR order, and the period necessary to obtain exemptive relief is now shorter, although still considerable. Moreover, it is now possible for an ETF sponsor to obtain exemptive relief that extends automatically to ETFs it may organize in the future[9] subject to compliance with the various representations made in the exemptive application.

§ 17:3.2 Section 17(a)

Section 17(a)(1) of the Investment Company Act makes it unlawful for any affiliated person of a registered investment company, acting as principal, knowingly to sell any security or other property to such registered company (with certain exceptions not here relevant). Section 17(a)(2) of the Investment Company Act makes it unlawful for any affiliated person, acting as principal, knowingly to purchase any security of other property from such registered company (with one exception not here relevant).

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7. Investment Company Act Release No. 17,809 (Oct. 19, 1990).
8. Investment Company Act Release No. 19,055 (Oct. 26, 1992).
9. *See, e.g.*, In the Matter of State Street Bank and Trust Company, et al.; Investment Company Act Release No. 24,666 (Sept. 25, 2000) (Order) and 24,631 (Sept. 1, 2000) (Notice).

Section 2(a)(3)(A) of the Investment Company Act defines an affiliated person as any person owning 5% or more of an issuer's outstanding voting securities ("5% holder"). Section 17(a) would prohibit such 5% holder from purchasing and redeeming Shares to the extent that purchases and redemptions in kind of Shares are deemed to involve the purchase or sale of the securities comprising the Deposit or Redemption Basket.

In light of the foregoing, ETFs have applied for exemptive relief from section 17(a) to permit 5% holders to purchase and redeem Shares. ETFs have argued that purchases and redemptions in kind effected by ETFs do not give rise to any of the concerns designed to be addressed by section 17(a). In particular, they note that purchases and redemptions in kind are effected in exactly the same manner, regardless of size or number or the person's status as an affiliated person. In addition, they point out that the method of valuing portfolio securities for purposes of calculating NAV is the same as that used for calculating the value of the securities comprising the Deposit Basket and the Redemption Basket. The Commission has been willing to grant the requested relief from section 17(a) based principally on the foregoing arguments.[10]

§ 17:3.3 Section 18

Section 18 of the Investment Company Act generally prohibits an open-end investment company from issuing more than one class of shares representing an interest in the same investment portfolio. In 1995, however, the SEC adopted Rule 18f-3 to permit open-end investment companies to issue multiple classes of shares. Rule 18f-3 permits certain differences among classes respecting the manner of distribution and/or in the services provided to shareholders. It does not, however, contemplate the limited redeemability and exchange trading features of ETFs. As a result, relief from section 18 is necessary in order for an existing open-end fund to add a new ETF class.

In December of 2000, the SEC granted section 18 relief to the Vanguard Index Trust to permit it to offer a class of ETF Shares, the VIPERSTM.[11] The principal arguments advanced in favor of the requested relief were that an ETF share class will not: (i) present opportunities for leverage; (ii) give rise to any conflicts of interest between classes different than those presented in any multiclass structure; or (iii) generate investor confusion to the extent that the ETF shares are marketed and sold separate and apart from the other

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10. Pacific Investment Management Company LLC and PIMCO ETF Trust, Investment Company Act Release No. 28,752 (June 1, 2009).
11. *See* Vanguard Index Trust et al., Investment Company Act Release No. 24,789 (Dec. 12, 2000) (Order) and 24,680 (Oct. 6, 2000) (Notice).

share classes. Vanguard agreed, among other things, to take certain measures designed to insure that investors understood the differences between the ETF class and the Conventional Class of Shares. In addition, in connection with the exchange privilege offered by the ETF to holders of the Conventional Class of Shares of the Vanguard Index Trust, Vanguard agreed to (i) record and preserve any investor complaints or reports of confusion concerning the exchange option, and (ii) record data tracking the number of investors that purchase the Fund's Conventional Shares and, within ninety days, exchange those shares for VIPER Shares.

To date, Vanguard is the only ETF sponsor that has obtained section 18 relief in order to offer an ETF share class.

§ 17:3.4 Section 22(d) and Rule 22c-1

Section 22(d) of the Investment Company Act, among other things, prohibits a dealer from selling a redeemable security that is currently being offered to the public by or through an underwriter except at a current public offering price described in the prospectus. Rule 22c-1 under the Investment Company Act generally requires that a dealer selling, redeeming or repurchasing a redeemable security do so only at a price based on its net asset value per share. Transactions in ETF Shares on an Exchange are effected at market prices, not at the price specified in the fund's prospectus and not at net asset value per Share. Accordingly, such transactions are not effected in compliance with section 22(d) and Rule 22c-1. ETFs have addressed the issue of compliance with section 22(d) and Rule 22c-1 through applications for exemptive relief to permit secondary market transactions at market prices rather than at net asset value.

ETFs have argued that secondary market trading in Shares does not involve the ETF and therefore cannot result in dilution of shareholder interests, a concern underlying section 22(d) and Rule 22c-1. In addition, secondary market trades in Shares will not lead to discrimination or preferential treatment among purchasers since anyone can purchase Shares at prevailing market prices. Finally, ETFs have noted that their distribution system will be orderly because the combination of intraday liquidity at market prices and purchases and redemptions at NAV creates potential arbitrage activity that insures that the difference between the market price of Shares and NAV remains narrow.

To date, the Commission has been persuaded by the foregoing arguments, and accordingly, has been willing to grant relief from section 22(d) and Rule 22c-1.[12]

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12. *See, e.g.*, PIMCO ETF Trust, *supra* note 10.

§ 17:3.5 Section 22(e)

Section 22(e) of the Investment Company Act generally prohibits a registered open-end investment company or UIT from suspending the right of redemption or postponing the date of payment or satisfaction of redemption requests more than seven days after the tender of a security for redemption. The seven-day requirement presents difficulties for ETFs which invest in non-U.S. markets with settlement cycles greater than seven days. ETFs which encounter this problem have sought exemptive relief from section 22(e) to permit extension of the seven-day delivery requirement to a period consistent with the settlement cycle in the local market.

To date, the Commission has been willing to grant such relief, but only to the extent necessary to accommodate local settlement practices and holidays.[13] Accordingly, detailed information respecting the settlement cycle in each market for which relief is requested and other information respecting settlement dates (including local holidays) is required in any application seeking 22(e) relief.

§ 17:3.6 Section 26

Section 26(a)(2)(c), prohibits payments to a UIT's sponsor, other than payments for administrative services. ETFs organized as UITs have obtained exemptive relief from this provision to permit the ETF to reimburse the sponsor for certain non-administrative expenses it incurs, including registration, marketing and organizational expenses. Such exemptive relief has, among other things, been subject to a representation that the sponsor will be reimbursed only for its actual out of pocket expenses.[14]

§ 17:4 Exchange Act Issues

There are a variety of issues which arise under the Securities Exchange Act of 1934 (the "Exchange Act") due to the fact that ETF Shares are continuously offered and are also traded in secondary markets.

§ 17:4.1 Regulation M

Regulation M is an antimanipulative rule which is intended to prohibit the manipulation of stock prices during the course of a distribution of that security. The term "distribution" is defined in

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13. *Id.*
14. *See, e.g.*, In the Matter of Diamonds Trust et al., Investment Company Act Release Nos. 22,979 (Dec. 30, 1997) (Order) and 22,927 (Dec. 5, 1997) (Notice).

Regulation M as an offering of securities that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.[15] Regulation M prohibits a "distribution participant"[16] from purchasing or attempting to induce others to purchase, during the course of a distribution, the security subject to the distribution. Since ETF Shares may be purchased and redeemed on a daily basis, they effectively are continuously in distribution. Accordingly, broker-dealers who purchase shares could, in certain circumstances, be deemed to be distribution participants and limited in this activity by Regulation M. For this reason, ETFs have sought confirmation from the SEC Staff that Regulation M is not applicable to transactions in ETF shares.

The SEC Staff has consistently taken the position in response to ETF requests that Regulation M is not applicable to transactions in ETF Shares. The Staff's reasoning in this regard is that the exceptions set forth in Rules 101(c)(6) and 102(d)(4) for purchases and redemptions of shares of open-end investment companies and UITs are applicable to ETFs, since ETFs register as open-end investment companies or UITs.[17]

The purchase of a security that would otherwise be prohibited by Regulation M is excepted from Regulation M if it is part of a "Basket Transaction" or an "Actively Traded Security." A Basket Transaction is defined in Rule 101(b)(6) as: (i) bids or purchases, in the ordinary course of business, in connection with a basket of twenty or more securities in which a covered security does not comprise more than 5% of the value of the basket purchased; or (ii) adjustments to such a basket in the ordinary course of business as a result of a change in the composition of a standardized index. An Actively Traded Security is defined in Rule 101(c)(1) as a security that averages daily trading volume of at least $1 million and is issued by an issuer whose common equity securities have a public float of at least $150 million.

ETFs have sought to extend the exemptions for Basket Transactions and Actively Traded Securities to permit the purchase of any security which is part of the Deposit Basket if made for the purpose of acquiring the Deposit Basket. To date, however, the SEC Staff has been unwilling to do so.

§ 17:4.2 Tender Offers

Rule 14e-5 under the Exchange Act, restricts the ability of various persons involved in a cash tender offer or an exchange offer of an

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15. Regulation M, Rule 100(b).
16. *Id.*
17. *See, e.g.*, PowerShares Lux Nanotech Portfolio, SEC No-Action Letter (pub. avail. Oct. 26, 2005).

equity security, including dealer-managers of the offer ("Covered Persons"), from directly or indirectly purchasing securities outside the tender offer. These restrictions would extend to transactions by Covered Persons in ETF Shares to the extent ETF Shares are viewed as indirect purchases of the security subject to the tender offer.

The SEC Staff has been willing to grant exemptive relief in this regard to ETFs to permit Covered Persons to redeem Shares for the Redemption Basket which may include a security, subject to the tender offer or exchange offer, and to engage in secondary market transactions in the Shares during such tender or exchange offer.[18]

Similar to Regulation M, the purchase of a security which is part of a "Basket Transaction" is exempt from Rule 14e-5. As in the case of Regulation M, however, the SEC Staff has been unwilling to extend the exemption for Basket Transactions to permit the purchase of any security which is part of the Deposit Basket if made for the purpose of acquiring the Deposit Basket.

§ 17:4.3 Margin

Section 11(d) of the Exchange Act generally restricts the ability of a broker-dealer to extend margin credit in connection with the purchase of a security that is part of a new issue if the broker-dealer was a member of the selling syndicate within the prior thirty days. Since ETF Shares are continuously offered as well as traded in the secondary market, these restrictions could be considered applicable to the purchase of ETF Shares. The SEC Staff has, however, been willing to grant no-action relief to permit margin credit to be extended in connection with purchases of shares on an exchange by broker-dealers.[19] The relief is subject to the condition that the broker-dealer not receive, from the ETF or an affiliated person of the ETF, any payment, compensation or other economic incentive to promote the shares of the ETF. The SEC staff has also confirmed that shares may be treated as issued by an open-end investment company or UIT and therefore, pursuant to Rule 11d-1 of the Exchange Act, marginable if held for more than thirty days.

§ 17:4.4 Disclosure Requirements

[A] Confirmations

Rule 10b-10, under the Exchange Act, requires a broker or dealer effecting a transaction for a customer to give or send written notification to such customer disclosing the information specified in

18. *Id.*
19. *Id.* For exemptive relief regarding ETFs, see Securities Industry Association, SEC No-Action Letter (pub. avail. Nov. 21, 2005).

paragraph (a) of Rule 10b-10, including the identity, price and number of shares of units or principal amount of the security purchased or sold. Compliance with Rule 10b-10 would be extremely burdensome to the extent that all of its requirements were viewed as applicable to each of the securities comprising the Deposit Basket or Redemption Basket. ETFs, therefore, have sought and obtained relief from Rule 10b-10 to permit broker-dealers to omit, from the confirmation, information respecting the identity, price and number of shares of each individual security tendered or received.[20] The relief is conditioned upon the representation that all information required under Rule 10b-10 will be furnished by the broker-dealer, upon request, and that such requests will be fulfilled in a timely manner.

[B] Broker Relationship

Rule 15c1-5, under the Exchange Act, provides that a broker-dealer must disclose to its customers any control relationship between the broker-dealer and the issuer of the security being purchased or sold. In a similar vein, Rule 15c1-6, under the Exchange Act, provides that a broker-dealer that effects a transaction with a customer in connection with any distribution in which the broker-dealer is interested, must disclose to its customer the existence of such interest. The SEC has issued no-action relief to the effect that these rules do not require a broker-dealer in connection with transactions in ETF Shares to disclose to its customer any broker-dealer relationship with any issuer of a security within the Deposit Basket or Redemption Basket.[21]

[C] Advance Notice of Corporate Actions

Rule 10b-17, under the Exchange Act, requires an issuer of a class of publicly traded securities to give advance notice of certain specified actions (for example, dividends, stock splits, rights offerings). The rule does not, by its terms, apply to redeemable securities issued by registered open-end investment companies and UITs. Because of the limited redeemability of ETF Shares, it is not clear that the exemption is applicable to ETFs. As a result, ETFs have sought exemptions from the requirements of Rule 10b-17. The Staff has consistently granted these requests based primarily on the exemptive relief obtained by ETFs permitting them to register as open-end investment companies.[22]

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20. *See* PowerShares Lux Nanotech Portfolio, SEC No-Action Letter (pub. avail. Oct. 26, 2005).
21. *Id*.
22. PowerShares Exchange-Traded Fund Trust, SEC No-Action Letter (pub. avail. Oct. 24, 2006).

§ 17:4.5 Generic No-Action Relief

The SEC has issued generic no-action relief, which obviates the need for index-based ETFs to obtain the no-action relief described in sections 17:4.1–17:4.4 above, provided that certain conditions are satisfied.[23] In the case of an equity-based ETF, the ETF must consist of twenty or more different stocks ("Component Stocks") and no one stock may constitute more than 25% of the total value of the ETF. In addition, at least 70% of the ETF must be comprised of Component Stocks that have a minimum public float value of at least $150 million and a minimum average daily trading volume (ADTV) of at least $1 million during each of the previous two months of trading prior to formation of the relevant ETF; provided, however, that if the ETF has 200 or more Component Stocks, then 50% of the Component Stocks must meet the $150 million public float and the $1 million ADTV thresholds.

Also, the ETF must be managed to track a particular index, all of the Components of which have publicly available last-sale trade information. The intra-day proxy value of the ETF per share and the value of the "benchmark" index must be publicly disseminated by a major market data vendor throughout the trading day. In the case of a fixed-income ETF, the ETF must include a minimum of thirteen non-affiliated investors (except where the fund consists entirely of exempted securities). No component security (excluding a Treasury Security) may represent more than 30% of the weight of the ETF, and the five highest weighted component securities in the ETF may not in the aggregate account for more than 65% of the weight of the ETF.[24]

The foregoing requirements are not applicable where the fixed-income ETF is wholly comprised of non-convertible fixed-income securities that are rated "investment grade" by at least one recognized rating agency. In addition, the intra-day proxy value of the ETF per share and the value of the underlying index must be publicly disseminated by a major market data vendor during the trading day.

§ 17:4.6 Sections 13(d) and 16(a)

Section 13(d) requires beneficial owners of more than 5% of an issuer's outstanding securities to file reports with the SEC. Section 16(a) requires each officer, director and beneficial owner of more than 10% of a public company's outstanding shares ("Insiders") to file reports with the SEC disclosing the number of shares beneficially owned, and reports

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23. *See* American Stock Exchange, SEC No-Action Letter (pub. avail. Aug. 17, 2001).
24. Fixed Income Exchange, SEC No-Action Letter (pub. avail. Apr. 9, 2007).

regarding changes in ownership. The SEC staff has granted no-action relief to ETFs with respect to the reporting obligations under sections 13(d) and 16(a) to the effect that: (i) owners of more than 5% of the ETFs Shares are not required to file reports under section 13(d), and (ii) insiders are not required to file reports under section 16(a).[25]

The no-action relief, with respect to sections 13(d) and 16(a), is based primarily on representations that the ETF's Shares trade at prices that do not deviate materially from NAV. The letters caution, in this regard, that if the ETF's Shares begin to trade at prices that materially deviate from NAV, the no-action relief would no longer be available.

§ 17:4.7 Exchange Listing

In order for an ETF to be listed on a national securities exchange, the exchange must have in place a rule that authorizes the trading of the product. Each of the exchanges have adopted generic listing rules pursuant to which most index-based ETFs are automatically eligible for trading on the exchange. There are, however, no generic listing rules for actively managed ETFs. As a result, in the case of each and every actively managed ETF, the exchange must file with the SEC's Division of Trading and Markets an application for a rule change pursuant to Rule 19b-4 under the Exchange Act. The proposed rule change must be reviewed and approved by the SEC.

§ 17:5 New Products and Recent Developments

§ 17:5.1 Actively Managed ETFs

The SEC has issued a number of exemptive orders permitting the offering of fully transparent actively managed ETFs.[26] The relief is subject to essentially the same terms and conditions as index-based ETFs. A key additional condition of the orders is a portfolio transparency requirement, that is, the ETF must disclose on its website on a daily basis the identities and weightings of its portfolio securities.

The transparency requirement has been an inhibiting factor in the development of actively managed ETFs. Many active managers are reluctant to disclose their portfolios, because of concerns that it will open up the possibility for others to replicate and possibly undermine each portfolio manager's trading strategy.

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25. Select Sector SPDR Trust, SEC No-Action Letter (pub. avail. May 6, 1999).
26. *See, e.g.*, In the Matter of PowerShares Capital Management LLC, et al., Investment Company Act Release No. 28,171 (Feb. 27, 2008).

The feasibility of non-transparent actively managed ETFs has been the subject of much debate. A key concern in this regard is the extent to which the arbitrage process, which keeps market prices in line with NAV, can effectively function without a fully transparent portfolio. Absent real-time disclosure of the composition of the underlying portfolio, an arbitrageur will be hindered in its ability to compare intra-day NAV and market prices and to evaluate the risk/rewards of an arbitrage transaction. The SEC has received several applications for exemptive relief for a non-transparent actively managed ETF. These applications propose a variety of approaches designed to allow sufficient information to be revealed to the marketplace to enable the arbitrage process to work without sacrificing the confidentiality of a portfolio manager's trading.[27] The SEC, to date, has not been willing to grant exemptive relief to non-fully transparent actively managed ETFs.

§ 17:5.2 ETFs on Alternative Asset Classes

ETF sponsors have begun to offer ETFs on assets other than securities. For example, ETFs linked to gold, silver, platinum, and palladium are now being offered. These ETFs are organized as trusts (the "Trusts"). The sole assets of the Trusts are the underlying physical commodity and, from time to time, cash. Shares in the Trusts are issued and redeemed in Creation Unit size and traded on an exchange like any other ETF. There are now also publicly offered Commodity pools that are structured like ETFs ("Commodity ETFs"). While the Trusts and the Commodity ETFs operate similarly to other ETFs, because they do not invest primarily in securities, these products are not investment companies within the meaning of the Investment Company Act. As a result, exemptive relief under the Investment Company Act is not required to offer these products, and the Trusts and the Commodity ETFs are not otherwise regulated under the Investment Company Act. They are, however, subject to regulation under the Exchange Act and, therefore, no-action relief under the Exchange Act, similar to that described above for other ETFs, is required for the Trusts and for the Commodity ETFs.

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27. *See, e.g.*, In the Matter of Precidian ETFs Trust, et al., No. 812-14116 (Jan. 25, 2013, as amended Feb. 12, 2013, and July 23, 2013); In the Matter of T. Rowe Price Equity Series, Inc., et al., No. 812-14214 (Sept. 23, 2013); In the Matter of Eaton Vance Management, et al., No. 812-14139 (Mar. 27, 2013, as amended Sept. 12, 2013); In the Matter of Claymore Advisors, LLC, et al., No. 812-13524 (Apr. 22, 2088); In the Matter of Vanguard Fixed Income Securities Funds, et al., No. 812-13362 (Feb. 9, 2007).

ETFs that are not registered investment companies under the Investment Company Act are not eligible for the pass-through tax treatment afforded regulated investment companies under the Internal Revenue Code. Therefore, sponsors of non-Investment Company Act ETFs need to seek alternative means of assuring that the ETF itself is not subject to taxation. For example, the Trusts are intended to qualify as grantor trusts for federal income tax purposes. As grantor trusts, the trusts themselves are not subject to taxation. Instead, each shareholder of a trust is treated as the direct owner of a *pro rata share of the trust's assets*. Commodity pools structured as ETFs seek to be treated as partnerships for tax purposes.

§ 17:5.3 Investment in ETFs by Fund of Funds

Section 12(d) of the Investment Company Act prohibits a registered investment company from acquiring securities of an investment company if, among other things, such securities represent (i) more than 3% of the total outstanding voting stock of the acquired fund or (ii) more than 5% of the assets of the acquiring fund. ETFs are investment companies for purposes of these limitations (other than the non-Investment Company Act ETFs described above in section 17:5.2). Section 12(d)(1) is intended to address certain abuses perceived to be associated with funds of funds. These abuses include, among other things, the threat of large-scale redemptions of the acquired fund shares, layering of fees and unnecessary complexity.

The SEC has issued to a number of ETF sponsors exemptive relief from section 12(d) to permit investment by registered investment companies in that sponsor's ETFs in excess of the limits imposed under section 12(d). The relief is subject to a number of conditions designed to ameliorate the concerns intended to be addressed by section 12(d).[28]

§ 17:5.4 Investment in ETFs by Retirement Plans

A number of firms have recently introduced products and services designed to make investment by 401(k) and other retirement plans in ETFs easier and less costly. These products include (i) target maturity funds which invest primarily in ETFs (the funds are registered investment companies with specified maturity dates; as the funds near their specified maturity date, investments are shifted from ETFs to less risky investments); (ii) collective funds composed exclusively or primarily of ETFs; and (iii) the online offering of model portfolios composed mainly of ETFs coupled with the bundling of retirement plan trades to save on brokerage commissions.

28. *See, e.g.*, PIMCO ETF Trust, *supra* note 10.

§ 17:5.5 Proposed Rule 6c-11

In March of 2008, the SEC proposed Rule 6c-11, which would eliminate the need for index-based ETFs and fully transparent actively managed ETFs to obtain exemptive relief.[29] The Rule would effectively codify most of the exemptions previously granted by the SEC to index-based ETFs and to fully transparent actively managed ETFs. No formal action has been taken by the SEC with respect to proposed Rule 6c-11 and its prospects for adoption are unclear.

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29. Investment Company Act Release No. 28,193 (Mar. 11, 2008).