Report

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BEHIND THE CURTAIN

A look at the firms that keep the ETF industry running smoothly

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Dechert Paves Way For Improved ETF Regulations

One of the leading law firms for ETFs knows the ins and outs of the industry and its structure

By Debbie Carlson

In the early days of the exchange-traded fund industry, every time an ETF sponsor wanted to launch a new fund, the firm had to get exemptive relief from the Securities and Exchange Commission.

"To initially launch products, it was a time-consuming process. We had extensive interaction with regulators getting exemptive relief, getting exchange listings approved, getting no-action relief," said Stuart Strauss, a partner at law firm Dechert LLP.

The SEC now standardizes much of this regulatory relief, making it easier to launch new ETFs, says Jeremy Senderowicz, partner at Dechert.

A lot of that's because of Dechert's work on the regulatory side for the ETF industry. The firm's been involved in the ETF industry since 2005, while the team of Strauss, Senderowicz and Allison Fumai, another partner, has worked at Dechert since 2009. During that time, the firm has become one of the largest global specialist law firms.

CLIENTS OF INCREASING SIZE

Its practice evolved from representing smaller entrepreneurial organizations wanting to enter the ETF space to the large mutual fund organizations that want to expand their operations to be part of the ETF ecosystem.

Dechert helps clients who want to launch an ETF product—from start to finish, Strauss and Senderowicz say, with such aspects as discussing investment strategies, suitability, whether the product can be created in a manner consistent with the limitations under the Investment Company Act, and other issues.

Because so many mutual fund sponsors are entering the ETF business, much of the advice Dechert gives now focuses on the distinctions between the two types of business, such as regulatory differences and differences in service-provider relationships, Senderowicz notes.

"A lot of that's informed by how we've seen the industry evolve over the past decade. … What we continually emphasize is that the way the ETFs are distributed is dramatically different than mutual funds," he said. "[They] need to understand that at the outset, and develop a strategy and not necessarily assume that the extensive distribution network they have in place for distributing their mutual fund shares is automatically extended and effective to ETFs."

REGULATORY EXPERTISE & EXPERIENCED TEAM

Dechert has depth in two areas, Senderowicz says. First, there's the depth of high-level regulatory practical expertise that a sponsor would expect from law firm partners. Second is a deep practice and groups of associates that do a great deal of ETF work. He notes that having both at one firm is unusual.

Because Dechert has been in the ETF industry since its infancy, Strauss and Senderowicz say clients understand that the firm has the legal practical knowledge to give advice.

"We have such a large diversified practice; we see everything in the industry. So when clients have a question—how to do this, is this permissible—we can give quick, practical responses. It's not necessary to go back and do research on a lot of things. We can get back to clients quickly and efficiently. We're known for that," Strauss explained.

Dechert helps clients who want to launch an ETF product—from start to finish

The firm has worked on a number of novel ETF products that have become precedents. When a firm approaches Dechert with a first-of-its-kind idea, there are a number of issues to be addressed.

"The challenges that we face in that regard are, No. 1, is this the sort of strategy that can be translated into specific objective rules; is this really a rules-based approach? Is it permissible under the exemptive application?" Strauss said.

Senderowicz says that whenever a sponsor wants to create an ETF out of a new type of asset or asset class, Dechert has had to work with the sponsor's clients and the regulators extensively. Not only must they persuade the regulators whether the fund is consistent with exemptive relief, they must convince the markets that the assets in question are liquid and transparent enough to support an ETF based on that asset class.

NOVEL MLP ETF

One novel ETF Dechert worked on was the ALPS Alerian MLP ETF (AMLP). Strauss says under the 1940 Investment Act, if a fund invests more than 25% of its assets in master limited partnerships, it doesn't qualify for pass-through tax treatment under the Internal Revenue Service code; instead, it's taxed as a corporation.

Dealing with an MLP ETF based on an index presented unique issues, Strauss says. For all fund shareholders to bear their fair share of gains once those positions are distributed, AMLP effectively accrues a deferred tax liability every day—to the extent there are gains in the fund—which is deducted from the fund's net asset value daily.

"We had to work closely with management, tax, accounting and operational people to draft appropriate disclosure, and then negotiated with the SEC on what was appropriate," Strauss noted. "I think that, ultimately, the structure we developed and the disclosure template we developed are going to become the standard for the products that launch subsequent to that target MLP investment."

One challenge facing the industry now for novel products is that a sponsor can neither include a derivative in an index nor build in leverage in the index.

"So you face some challenges where people want to have some degree of derivative exposure because they can't invest directly in the product," said Strauss. "How do you accomplish that? We face that challenge with respect to a number of products: How do we gain exposure to assets in an index-based product?"

SHAPING REGULATION

The firm has helped to shape regulations throughout the years by regularly commenting on rules that impact the ETF space. Dechert also has built a good working relationship with the SEC, on both a formal and informal basis, Strauss notes.

"I think we have the type of relationship with the regulators where we're often consulted on an informal basis [such as], 'here's an issue we're addressing at the SEC; how would your clients respond to this? What is the market practice? What are issues associated with this?'" he said. "Or we may have issues from a particular client and we'll talk to the SEC informally about them: 'Here's the concern, how can we address this issue?' We are an informal source of information for the SEC." ●