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Client Advisory

SEC Proposes New Rules to Streamline ETF Formation

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U.S. exchange-traded funds ("*ETFs*") share elements of both open-end management companies ("*open-end funds*" or "*mutual funds*") and closed-end management companies ("*closed-end funds*"). ETF shares are issued continuously like mutual funds but are not redeemable individually and are, instead, traded on a national securities exchange ("*Exchange*") like shares of closed-end funds. This hybrid structure is not permissible under the Investment Company Act of 1940 ("*Act*"). Therefore, each ETF must engage in a costly and frequently time-consuming process of receiving individual exemptive relief ("*Relief*") from the Securities and Exchange Commission ("*SEC*") before commencing operations. If adopted, the proposed ETF rules and rule amendments published by the SEC on March 11, 2008 ("*Proposed Rules*")[1] would enable new index-based ETFs and fully transparent actively managed ETFs to start up without first receiving Relief. This is likely to accelerate the growth in the ETF industry, which began with the trading of SPDRs on the American Stock Exchange in January 1993 and had expanded to 601 ETFs by the close of 2007.[2]

Proposed Rules Summary

Proposed Rule 6c-11 would codify much, but not all, of the Relief contained in existing exemptive orders granted to ETFs to operate as ETFs ("*Prior ETF Orders*"). The Proposed Rule is not meant to be exclusive, therefore the SEC will continue to consider applications for new ETFs that cannot satisfy the Proposed Rule's requirements. Proposed Rule 12d1-4 would codify and streamline the existing exemptive orders granted to certain ETFs that permit unaffiliated funds to purchase and sell ETF shares in excess of the anti-pyramiding limits set forth in Section 12(d)(1)(A) and (B) of the Act[3] under certain conditions ("*Prior 12(d)(1) Orders*"). The SEC is also proposing amendments to Rule 12d1-2, one of which would permit affiliated investment funds relying on Section 12(d)(1)(G) of the Act to invest in unaffiliated ETFs in excess of the Section 12(d)(1) anti-pyramiding limitations. Finally, the SEC is proposing amendments to the Form N-1A registration statement to provide more useful ETF-oriented information to secondary market investors.

Likely Implementation Date of Final Rules

All comments on the Proposed Rules are due by May 19, 2008. The SEC made many assumptions and choices in its Proposed Rules release and asked more than 60 specific questions about such judgments. The SEC also seeks suggestions for other existing rule and form changes and raised other broad issues that might affect the Proposed Rules. We expect that the likely implementation date for any final rules based on the Proposed Rules would occur no earlier than the beginning of 2009. Final rule implementation may take considerable time due to the public's and the financial industry's

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1 Release Nos. 33-8901; IC-28193; File No. 57-07-08 ("*Proposing Release*"), which can be viewed on the SEC's Web site at: http://www.sec.gov/rules/proposed/2008/33-8901.pdf.

2 The Proposed Rules do not cover other exchange-traded vehicles, such as the streetTracks® Gold Trust, which are not investment companies subject to the Act but are often confusingly referred to as ETFs or "commodity ETFs."

3 Under Section 12(d)(1)(A), for instance, a mutual fund would be prevented from (a) acquiring more than 3% of an ETF's shares ("*3% Limit*"), (b) investing more than 5% of its assets in a single ETF and (c) allowing all investment companies, including ETFs, held in the mutual fund's portfolio to exceed 10% of its total assets.

Under Section 12(d)(1)(B), an ETF and its principal underwriter and any broker or dealer ("*Selling Entities*") are prevented from selling the ETF's shares to a mutual fund, for instance, if (a) more than 3% of the ETF's shares would be owned by the mutual fund or (b) more than 10% of the ETF's shares would be owned by the acquiring mutual fund and any other investment companies ("*Section 12(d)(1)(B) Restrictions*").

interest in ETFs. As a comparison, the SEC's final rules allowing money-market funds to operate without specific SEC exemptive relief took a considerable amount of time to finalize. In our discussions with SEC staff members, we have been advised that parties currently wishing to start up a new ETF should continue to seek Relief and not wait for final ETF rules.

Proposed Rule 6c-11 would codify the Prior ETF Orders and, as currently drafted, would permit both index-based ETFs and fully transparent actively managed ETFs to:

- register under the Act as open-end funds (but not as UITs);
- issue and redeem their shares in specified large block sizes ("*Creation Units*") in exchange for specified securities and other assets ("*Basket Assets*");
- list their individual shares for intraday trading in the secondary market; and
- deliver foreign security Basket Assets up to 12 days following a tender of Creation Units for redemption.

Any ETF relying upon Proposed Rule 6c-11 would be required to:

- have its shares listed and traded on an Exchange;
- disclose Basket Assets composition daily;
- have intraday share values published by the Exchange at regular intervals;
- provide "transparency" to investors either through:
  - daily ETF Web site posting of the identities and weightings of securities and other assets held in its portfolio; or
  - tracking a securities index whose provider posts on its Web site the identities and weightings of all components and other assets of the index;
- post daily ETF Web site disclosure of (i) the prior business day's net asset value ("*NAV*") and closing share price and (ii) the premium or discount of the closing share price against the NAV per share; and
- disclose in any sales literature that it is an ETF which does not sell or redeem individual shares and that investors may trade individual shares in the secondary market through a broker who may charge commissions not reflected in the ETF's prospectus.

Proposed Rule 6c-11 would not limit the types or quantities of portfolio securities that may be held by an ETF operating under the rule, nor would it limit the type of index that an index-based ETF may follow. Unlike Prior ETF Orders, the Proposed Rule would not require a "firewall" to be established between an ETF and its affiliated index provider.

In addition, Proposed Rule 6c-11 would codify the Relief in Prior ETF Orders allowing ETF affiliates to enter into in-kind Creation Unit transactions, which would ordinarily be prohibited by Section 17(a) of the Act. Affiliated person conflicts arise from ownership of 5% or more of an ETF's outstanding voting securities or another control relationship with the ETF ("*First Tier Affiliates*") and from being an affiliate of a First Tier Affiliate ("*Second Tier Affiliates*"). The Proposed Rule would permit in-kind Creation Unit transactions by First and Second Tier Affiliates unless the transaction is a redemption of ETF shares originally acquired by an affiliate relying on Proposed Rule 12d1-4 as discussed below.

Proposal to Eliminate all Relief from Prospectus Delivery Requirement

The Proposed Rule would not codify the prospectus delivery Relief previously obtained by ETFs for the benefit of brokers effecting Exchange purchases of individual ETF shares. The SEC believes that all ETFs will need to comply with the summary prospectus disclosure and delivery requirements that are the subject of another currently pending proposal,[4] which are also to be modified under the Proposing Release's Form N-1A amendments discussed below. Therefore, the SEC also proposes to eliminate all prospectus delivery Relief previously granted.[5]

4 "Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies," SEC Release Nos. 33-8861 & IC-28064 (Nov. 21, 2007), which can be viewed at http://www.sec.gov/rules/proposed/2007/33-8861.pdf.

5 The Proposed Rule would extend existing prospectus delivery Relief until the adoption of the summary prospectus proposal.

Proposed Rule 12d1-4

Proposed Rule 12d1-4 would expand the scope of Prior 12(d)(1) Orders by permitting open-end funds[6] and UITs as well as other funds ("*Acquiring Funds*") to invest in unaffiliated ETFs ("*Acquired ETFs*") in excess of the limits contained in Section 12(d)(1). Among other simplifications from the Prior 12(d)(1) Orders, an Acquiring Fund relying on the Proposed Rule would not be required to enter into a written "participation agreement" with, or to provide lists of certain affiliates to, an Acquired ETF.

Proposed Rule 12d1-4 would apply only to an Acquiring Fund that does not "control" such Acquired ETF. An Acquiring Fund could beneficially own up to 25% of the outstanding Acquired ETF voting securities without needing SEC exemptive relief. An Acquiring Fund otherwise exercising control over an Acquired ETF's policies or management could not rely on the Proposed Rule, even if the Acquiring Fund had less than 25% ownership of such Acquired ETF.

In addition to imposing sales charge limits on Acquiring Funds, Proposed Rule 12d1-4 would add two new ETF redemption prohibitions:

- an Acquiring Fund investing beyond the 3% Limit in reliance on the Proposed Rule could not redeem the Acquired ETF shares, but secondary market sales could still occur; and
- any Selling Entity that relies on Proposed Rule 12d1-4 to sell or dispose of Acquired ETF shares in excess of the Section 12(d)(1)(B) Restrictions to an Acquiring Fund cannot redeem the Acquiring Fund's Acquired ETF shares that exceed the 3% Limit.

The SEC has proposed a "safe harbor" to address practical difficulties associated with the latter redemption prohibition for any Selling Entity that has received from the Acquiring Fund a representation that it did not rely on the Proposed Rule in acquiring the Acquired ETF's shares in excess of the 3% Limit and that the Selling Entity has no reason to believe otherwise.

Proposed Rule 12d1-4 is not exclusive. An Acquiring Fund may continue to rely upon Prior 12(d)(1) Orders that do not restrict ETF share redemptions, subject to compliance with applicable order conditions. To date, no ETF has been permitted to organize and operate as a "fund of funds," and Proposed Rule 12d1-4(a)(4) would codify this by expressly prohibiting an Acquired ETF from itself being "a fund of funds" – and preventing three-tiered fund structures.

Proposed Rule 12d1-4 would also provide limited relief from Section 17(e)(2) of the Act to permit an Acquiring Fund to pay commissions, fees or other remuneration to a Second Tier Affiliate broker-dealer without complying with quarterly board review and recordkeeping requirements set forth in Rules 17e-1(b)(3) and 17e-1(d)(2) under the Act.

Proposed Amendments to Rule 12d1-2

The proposed amendments to Rule 12d1-2 affecting ETFs would permit funds that invest in affiliated funds in reliance on Section 12(d)(1)(G) of the Act also to invest in unaffiliated ETFs beyond the 3% Limit.

Proposed Amendments to Form N-1A

The proposed amendments to Form N-1A seek to make an ETF prospectus more "retail friendly" and therefore would clarify and simplify certain existing disclosures as well as add to the prospectus certain information currently found in an ETF's Statement of Additional Information, such as daily and historical market price/NAV premium and discount information.

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6 As currently drafted, the Proposed Rule would apply to unregistered funds, such as hedge funds, relying on Sections 3(c)(1) or 3(c)(7) of the Act, although the text of the Proposing Release mentions only closed-end funds and business development companies.

For Additional Information

If you have any questions regarding the SEC's proposed ETF rules discussed in this Advisory, please contact one of the Katten Muchin Rosenman LLP Financial Services attorneys listed below.

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