

The SEC's Proposed ETF Rules: Implications for Compliance and the Industry

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In April 2008, the SEC proposed two new rules that, if adopted, will reduce compliance burdens for both ETFs and funds that invest in ETFs¹. This article discusses some of the basic compliance requirements for ETFs and funds that invest in ETFs, including how these requirements would be clarified and simplified under the proposed ETF rules. The article concludes by discussing broader implications of the proposed rules for the evolution of the fund industry.

Introduction

Over the last five years, exchange-traded funds or "ETFs" have assumed a prominent role in the fund industry, for many reasons. Fund companies that pioneered the ETF structure have seen their assets under management grow exponentially, and ETFs have made significant inroads into the adviser distribution channel, prompting some in the industry to launch ETFs themselves and many others to consider it. In addition, many traditional funds have invested increasing amounts of their assets in ETFs (to obtain exposure to a specific asset class and/or manage cash), causing even fund companies that have no interest in developing ETFs to join the ETF party as investors in ETFs.

These two industry groups – ETFs and funds that invest in ETFs – face different compliance challenges. The first part of this article discusses the basic compliance requirements for ETFs, including how the proposed rules would change these requirements. The second part of the article discusses compliance issues related to fund investments in ETFs, including the dramatic reduction of the compliance burden for such funds under the proposed rules. The third part of this article discusses potential developments in the ETF area that could grow out of the new rules.

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ETF Compliance

Because ETFs are hybrid investment companies – meaning they display characteristics of both open-end and closed-end funds – they do not fall squarely within the regulatory regime set forth for these types of investment companies in the Investment Company Act of 1940 (the “1940 Act”). As a result, they require an exemptive order from the SEC to operate.

Exemptive Orders

Under the standard ETF exemptive order granted by the SEC, ETFs generally register as open-end funds. In so doing, with a handful of exceptions, they become subject to the same provisions of the 1940 Act, and face the same compliance issues, as other open-end funds. In order to be excepted from these provisions of the Act, however, they agree to comply with certain conditions, which are established in the ETF's exemptive order. Many of the unique compliance issues faced by ETFs are a function of these conditions.²

Standard ETF Conditions. The standard ETF exemptive order contains seven conditions with which an ETF must comply in order to operate. The conditions were developed in the context of applications to permit index-based ETFs – and specifically ETFs based on indexes compiled by a firm that was not an affiliate of the ETF. Such ETFs have come to be called “unaffiliated index-based ETFs.”

Because the ETF structure includes an arbitrage mechanism that depends on, or at least benefits from, full portfolio transparency, most ETFs track indexes for which the identities and weights of the component securities are public. The hallmark of the ETF structure is its arbitrage mechanism, which ensures that ETF shares trade in the secondary market at only small discounts or premia to the net asset value (NAV). “Authorized participants” of an ETF act as arbitrageurs, profitably purchasing creation units by depositing a representative basket of shares (a “creation basket”) when the price of ETF shares in the secondary market is above the value of the shares in the basket and redeeming creation units for the creation basket when the secondary market price is below that value, each of which pushes the market price towards the NAV. Because only authorized participants can actually purchase or redeem shares directly from the ETF, individual and other

investors must purchase and sell ETF shares in the secondary market. The standard ETF exemptive order thus imposes conditions that are intended to support the functioning of the arbitrage mechanism and the secondary market.

The standard ETF conditions can be summarized as follows:

- The ETF's shares must be listed on a national securities exchange, such as the NYSE (Arca) or Nasdaq;
- The ETF's marketing materials, including its prospectus, must make clear that the ETF's shares – unlike a mutual fund's shares – are not individually redeemable;
- The ETF must maintain a public website that provides certain information on its NAV, market price and any premium or discount of the latter relative to the former, and must include some of this information in its prospectus and annual report; and
- The ETF's disclosure documents must make clear that, although the ETF's shares trade like common stocks (e.g., GE, IBM), they are fund securities that are subject to Section 12(d)(1) of the Act, which limits funds of funds.

In addition to these conditions, in order to obtain an ETF exemptive order, ETFs (and their advisers) have typically been required to make certain representations to the SEC in their applications for ETF orders. Among other things, they have generally been required to specify the minimum number of ETF shares in a creation unit and to agree to invest from 80% to 95% of their assets in the securities of the targeted index. They have also had to represent that the full contents of the ETF's portfolio would be disclosed on a daily basis on the ETF's website and/or that they would require, in connection with creation unit transactions, deposits that are pro rata slices of the ETF's portfolio. Each ETF has also been required to state that its listing exchange would disseminate its estimated real-time NAV (which is commonly referred to as an “IOPV” for “intraday optimized portfolio value”) at 15 or 60 second intervals throughout the trading day.

Affiliated Index-Based ETF Conditions. ETFs that are based on indexes compiled by an affiliate have also been permitted by the SEC. These ETFs are commonly referred to as “affiliated index-based ETFs.” The SEC originally did not permit ETFs

to use affiliated indexes because of concerns that the ETF manager could actively manage the index and thus the ETF, thereby impairing portfolio transparency and harming the arbitrage mechanism. However, the SEC ultimately concluded that, with certain protections against managing the index, the use of affiliated indexes would not be harmful. Thus, affiliated index-based ETFs were permitted if they satisfied certain additional requirements, including:

- The index methodology used by the ETF's affiliate to compile the ETF's index, including any changes to it, must be disclosed to the public prior to implementation; and
- The ETF's investment adviser(s) must erect information firewalls to prevent the flow of information between the index compiler and the ETF's investment adviser(s).

Actively Managed ETF Conditions. Since April 2008, there has been yet a third category of ETFs – namely “actively managed ETFs.” Actively managed ETFs are not required to base their portfolios on an index; rather, they can be actively managed through the investment discretion of their manager, just as with any other actively managed investment vehicle. The SEC worked with actively managed ETFs' sponsors for years to address concerns that active managers would, among other matters, not disclose the full contents of their portfolios and thus inhibit the arbitrage mechanism. Under the exemptive orders eventually issued by the SEC to permit such ETFs, actively managed ETFs must satisfy the standard ETF conditions discussed above as well as the following additional conditions:

- Any actively managed ETF must disclose on its website before the beginning of each trading day the securities (and other assets and liabilities) on which its NAV will be based at the end of the day; and
- The actively managed ETF's investment adviser(s) must not cause a security to be deposited into the ETF's portfolio, unless the investment adviser could have bought the security for the portfolio itself.

The Proposed Rules

The proposed rules would simplify the compliance burden imposed on ETFs. Although all ETFs – whether based on an unaffiliated index, an affiliated index or actively managed – would

still have to comply with the standard conditions discussed above, most of the other representations required of ETFs in their exemptive applications and the conditions imposed on them by their exemptive orders would be eliminated.

All ETFs. For all ETFs, the proposed rules would change compliance in several ways. First, the number of ETF shares underlying creation unit transactions would no longer be constrained by representations made to the SEC in an exemptive application. Rather, ETFs could transact in creation units of any size.³ This freedom may

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prove useful in the event that the ETF's share price rises or falls to a level such that it is in the best interest of the ETF to adjust the size of creation unit transactions.

Second, under the proposed rules, index-based ETFs would no longer be required to disclose the full contents of their portfolio on a daily basis on a website or by designating creation deposits that are pro rata slices of the portfolio. Under the proposed rules, these ETFs could avoid disclosing the exact contents of their portfolios provided that (1) they have a “stated investment objective” of tracking a specified securities index and (2) the provider of that index discloses on its public website the index's components and their weights. Under the proposed rules, index-based ETFs also would no longer be required to invest at least 80% of their assets in the securities of the underlying index. Taken together, these two changes would allow ETF managers to mask their portfolio management techniques, which could spur them to develop more cost-effective and innovative ways to track indexes, such as through the use of derivatives and sampling techniques.

Third, under the proposed rules, an ETF's IOPV would not have to be displayed at 15 or 60 second

intervals throughout the trading day. Rather, the NAV would only have to be displayed “at regular intervals.” Although the loosening of this rule only marginally reduces the compliance burden on ETFs, the SEC is recognizing a market reality: arbitrageurs do not actually rely on the published IOPV. Rather, arbitrageurs almost uniformly use their own formulas and do their own calculations of the IOPV in order to identify arbitrage opportunities that make sense in light of their particular portfolio holdings.

[P]resent trends hint at the future development of ETFs. For example, registered advisers increasingly use ETFs in their clients' portfolios, largely because their structure is more tax-efficient than that of mutual funds.

In the future, most, if not all, ETFs will rely on the proposed rules, if adopted, rather than on an exemptive order to operate. In part, this is because recent index-based ETF orders and all actively managed ETF orders contain a sunset provision causing them to expire when the proposed rules are adopted. ETFs currently relying on such orders will be forced to rely on the new rules to operate. Older ETFs will retain the option of relying on their orders, although it is not clear what advantage they would gain.⁴ Moreover, as discussed above, most ETF sponsors would enjoy a reduction in their compliance burden under the new rules.

Affiliated Index-Based ETFs. Under the proposed rules, an affiliated index provider to an ETF would be treated exactly the same as an unaffiliated index provider. Thus, unlike under existing exemptive orders, there would be no additional compliance requirements imposed on an ETF because it opted to track an index compiled by an affiliated person. Specifically, an affiliated index-based ETF would no longer be required to publicly disclose its methodology, or changes to it, prior to implementation. In addition, there would no longer need to be firewalls to prevent the flow of information between the

ETF's investment adviser and the affiliated index compiler. In effect, under the proposed rules, ETF advisers would largely be free to create innovative indexes on which to base ETFs, opening the door to a raft of new ETFs.

Actively Managed ETFs. Actively managed ETFs would similarly enjoy reduced compliance burdens under the proposed rules. While they would continue to have to disclose, before the opening of trading each business day, the securities (and other assets and liabilities) on which their NAVs will be based at the end of the day, they would no longer be subject to the condition that their adviser(s) not cause a security to be deposited into the portfolio unless the adviser itself could have bought the security for the portfolio. As the SEC explained in the Proposing Release, this condition is redundant with Section 48(a) of the 1940 Act, which prohibits one from doing indirectly anything that one cannot do directly. Thus, Section 48(a) prohibits an ETF adviser from acquiring a security for the ETF's portfolio, by including it in the creation deposit, if the adviser could not buy the security for the portfolio. The primary effect of including this condition in past exemptive orders was that the SEC could revoke an ETF's order based on violations of the condition. In choosing not to impose the condition on ETFs under the proposed rules, the SEC appropriately agreed to seek recourse for violations of this statutory principle by enforcing Section 48(a) against the adviser rather than by revoking the ETF's order, which could disproportionately harm shareholders.

Compliance For Funds Investing In ETFs

Funds that invest in other, registered funds must comply with Section 12(d)(1) of the 1940 Act. That statutory provision imposes three strict investment limitations on such “acquiring funds”: they are prohibited (1) from acquiring more than 3% of any registered fund's shares (“acquired fund”), (2) from investing more than 5% of their own assets in any one acquired fund, and (3) from investing more than 10% of their own assets in acquired funds generally. These investment restrictions were designed to address concerns about duplicative advisory fees as well as abuses perpetrated by “pyramiding” investment

companies – i.e., making a sufficiently significant investment in one fund to control it and invest its assets in other funds to obtain a control position over them, then using its control position to abuse them. For example, one abusive strategy was to threaten a large-scale redemption of a mutual fund's shares, which would cause the fund to liquidate assets in a "fire sale" and incur steep losses. Abusive acquiring funds would use such a threat to compel the fund to sell assets below fair value or buy above fair value.

In 1996,⁵ Congress relaxed the application of Section 12(d)(1) to permit acquiring funds to invest in other funds in the same group of investment companies on the theory that affiliated funds have the same manager and thus lack any incentive to abuse one another. At that time, Congress also granted the SEC additional authority to exempt other "fund of funds" structures from Section 12(d)(1).

Exemptive Orders

Since 1999, the Commission has used this authority to grant exemptive orders permitting investments by acquiring funds in acquired funds *not* in the same group of investment companies under certain conditions. Generally speaking, the conditions in such orders are designed to prevent the historical abuses, discussed above, associated with fund of funds structures (i.e., pyramiding) and include the following:

The acquiring fund (and its control affiliates) cannot control an acquired fund within the meaning of Section 2(a)(9) of the Act;

The acquired fund cannot be a "fund of funds" itself and thus must comply with the investment limits in Section 12(d)(1);

The acquiring fund's fees must comply with NASD Conduct Rule 2830;

The acquiring fund cannot use potential or actual investments in the acquired fund to influence the terms of any dealings between the acquiring fund (or an affiliate) and the acquired fund (or an affiliate);

The board of the acquiring fund must have procedures to insure that the acquiring fund

is not basing investments in the acquired fund on consideration received by the acquiring fund (or an affiliate) from the acquired fund (or an affiliate);

The board of the acquired fund must determine that any consideration paid to an acquiring fund (or an affiliate) for services in other contexts is fair;

The acquiring fund (and its affiliates) cannot cause an acquired fund to purchase a security in an IPO being underwritten by an acquiring fund affiliate ("affiliated underwritings");

The board of the acquired fund must have procedures designed to monitor purchases by the acquired fund in affiliated underwritings and review such purchases at least annually;

The board of the acquiring fund must find that the acquiring fund is not paying duplicative advisory fees;

The acquiring fund's adviser must offset, against fees owed to it by the acquiring fund, certain payments received from the acquired fund (or an affiliate); and,

Both the acquiring fund and the acquired fund must sign a "participation agreement" in which they acknowledge their responsibilities under the order and agree to exchange lists of affiliates that permit them to comply with the order.

The Proposed Rules

Under the proposed rules, acquiring funds that invest in ETFs (as acquired funds) would still be required to comply with conditions 1-3 (above). Conditions 4-11 (above), however, would be replaced in their entirety with the following condition:

- Acquiring funds that acquire more than 3% of an ETF's shares under the proposed rule cannot tender such shares to the ETF for redemption; rather, in order to liquidate their investment in the ETF's shares, they must sell their ETF shares on the secondary market.

As the SEC explained in the proposing release for the new rules, this one condition addresses all of the

concerns previously addressed by conditions 4-11 (above). Whereas, historically, acquiring funds had been able to coerce open-end funds (such as ETFs), if at all, by threatening large-scale redemptions no such coercion is possible here as the new condition precludes redemptions altogether if the acquiring fund's position in the ETF exceeds the 3% limit in Section 12(d)(1).

Although the proposed rules would eliminate the requirement that the board of the acquiring fund find that the fund is not paying duplicative advisory fees, fund boards will generally still make this finding to satisfy their fiduciary duties.

Although a few observers have criticized the redemption restriction as draconian, most funds that invest in ETFs have welcomed it. ETFs and funds that invest in them have long argued that the ETF structure, including the manner in which it incentivizes arbitrage transactions, does not permit ETFs to be coerced in the same manner as other open-end funds. Accordingly, they have argued for a simplified approach to investments by funds in ETFs. Based on the industry's reaction to the proposed rules, it appears that the SEC has found an acceptable resolution in the clear, bright-line test set forth in the proposed rules.

Looking Ahead: The Potential Impact of the ETF Rules and Actively Managed ETFs

If the SEC adopts the proposed rules, it will lift significant regulatory burdens on the formation and launch of new and innovative ETFs and on investments by funds in ETFs. These burdens have operated as barriers to entry into the ETF market. Thus, the rules' likely immediate effect will be the introduction of a number of new ETFs and new ETF investment techniques.

The longer-term effects, however, are harder to discern. The past several years have seen a large number of new ETFs and new investment techniques hit the market, with a new ETF focused on a specialized and previously-unrepresented commodity or emerging market seemingly launching every week. Needless to say, many of these have not succeeded in gathering significant assets, and the proliferation of ETFs has not yet radically changed

the fund market. Reports of the death of the mutual fund are greatly exaggerated.

Nonetheless, present trends hint at the future development of ETFs. For example, registered advisers increasingly use ETFs in their clients' portfolios, largely because their structure is more tax-efficient than that of mutual funds. There are several reasons ETFs are more tax-efficient than traditional funds. Since almost all existing ETFs track an index, they have much lower portfolio turnover on average than actively managed funds, which helps them to avoid realizing capital gains that must be distributed to investors and taxed each year. More importantly, whereas traditional funds may have to sell securities to honor redemption requests, existing ETFs generally redeem their creation units through in-kind transactions that are tax-free to them. Finally, in connection with in-kind redemptions, ETFs may transfer out of their portfolio the securities with the lowest tax basis, thereby potentially avoiding the future realization and taxation of capital gains on securities that they do sell.

It is unclear to what extent actively managed ETFs will be able to capture these advantages. Actively managed ETFs should have the same portfolio turnover rate as their mutual fund counterparts. In addition, actively managed ETFs may feel compelled to redeem creation units at least partly in cash, either for reasons of portfolio confidentiality or because of illiquid or small positions. However, some firms will figure out how to adapt their active management styles to large in-kind redemptions, and they will likely enjoy a market advantage over their competitors. Their ability to provide the type of tax efficiency currently associated with ETFs likely will continue to attract assets from the registered adviser channel. In addition, after the 2008 election, the political environment in Washington, D.C. will most likely favor higher taxes, and investment vehicles that capitalize on and ameliorate investor concern about higher taxes will draw attention and assets.

Many new ETFs have tried to gain traction in a crowded market by focusing on narrow indexes in commodities or emerging markets. These are currently investment themes with tremendous appeal because of rising commodities prices and the increasing stability, development and respectability

of emerging economies. However, the appeal and usefulness of these ETFs have been limited by their tracking an index because the indexes for commodities and emerging markets typically capture only a small portion of the possible investments in those markets. Active management will permit managers to develop a range of ETFs that will give investors broader exposure to these markets.

Finally, the proposed rules would make it dramatically easier for a broad swath of funds to invest in ETFs than in mutual funds, which may send assets – and the fund industry's attention – to ETFs. Many funds, of course, invest in other funds to gain exposure to a particular market or sector in which the fund's adviser does not have the requisite expertise. Under the proposed rules, registered funds of all types (mutual funds, closed-end funds, unit investment trusts and business development companies), as well as unregistered funds, including hedge funds, could make such investments in ETFs merely by complying with the four simple conditions set forth in the proposed rule. By contrast, in order to make similar

investments in traditional mutual funds, these funds would be required to obtain an exemptive order from the SEC and comply with the cumbersome and costly conditions noted above. This difference in treatment may allow ETFs to challenge the primacy of mutual funds in the race for assets, and for that reason, firms that have thus far resisted the siren song of ETFs may feel compelled to reconsider entering the ETF space.

Conclusion

The proposed rules mark an important step in the development of ETFs. In the first time that the full Commission has addressed ETFs since 2001, it has moved to liberalize the regulatory regime and to unleash forces of competition that could reshape the fund industry. At the same time, the proposed rules, if adopted, will reduce and rationalize compliance burdens for both ETFs and funds that invest in ETFs. Both developments are good news for compliance professionals and the industry they serve.

ENDNOTES

¹ Exchange-Traded Funds, Investment Company Act Rel. No. 28193 (March 19, 2008) ("Proposing Release").

² This article does not attempt to identify or discuss the full panoply of compliance issues faced by ETFs or funds that invest in ETFs. Rather, it seeks to identify the compliance requirements imposed on ETFs and funds that invest in ETFs by the SEC exemptive orders that have been issued to date and compare them to

the requirements that would be imposed under the proposed ETF rules.

³ The proposed rules, however, do include certain disclosure requirements that incentivize designating creation unit transactions for at least 25,000 ETF shares. This article does not discuss this or any of the other disclosure requirements included in the proposed rules, though such requirements should be reviewed in connection with an ETF's compliance program.

⁴ Exceptions include ETFs that are organized as UITs and/or rely on relief from Section 24(d) of the Act (to avoid delivering prospectuses in connection with secondary market transactions). For a discussion of the relative advantages of the exemptive orders for such ETFs, see Proposing Release at 22 (UITs) and 47-51 (Section 24(d)).

⁵ National Securities Markets Improvement Act of 1996, P.L. 104-290, section 202(4), 110 Stat. 3416 (1996) ("NSMIA").

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