

Morgan Lewis

**Research, Marketing, Financing and Selling
Restrictions Relating to ETFs**

**ETF Breakfast Roundtable
Session 2
September 27, 2011**

Agenda

- FINRA requirements
- Non-conforming prospectus issues
- Liability Considerations
- FINRA enforcement and exams
- Sales practices
- Section 11(d)(1)
- Section 13D/G and Section 16 No Action Letters

Marketing and Research Materials – 1940 Act ETFs

- FINRA Filing (Rule 2210(c))
 - “Sales Literature” must be filed within 10 days or, if materials include rankings, must be filed 10 days prior to first use
 - “Institutional Sales Material” (i.e., research reports provided only to institutional investors) need not be filed with FINRA (but are deemed filed with FINRA for purposes of Section 24(b) of 1940 Act and R. 24b-3)
 - Recirculation of filed material is required if FINRA has material comments
- Subject to FINRA content standards (NASD Rule 2210)
 - No projections
 - Performance must comply with Rule 482(d) (NAV & Price)
 - *Rule 482 applies where communications precede prospectus delivery*
 - *Rule 34b-1 applies where prospectus precedes or accompanies communications*
 - *Standards for performance data are the same*
 - Limited ability to use rankings

Marketing and Research Materials – Commodity ETFs

- Materials must be filed with FINRA since ETFs are deemed to be Direct Participation Program (DPP) due to pass through tax treatment
- Subject to content requirements of NASD Rule 2210
- NFA approval not required except for television/radio ads and to make a specific trade recommendation or reference past or potential profits

New FINRA Rule

- Filed with SEC July 14, 2011 (extended to November 1, 2011)
- Incorporates NASD Rules 2210 and 2211 and Interpretive Materials 2210-1 and 2210-4

NASD Rule 2210	FINRA Rule 2210
<ul style="list-style-type: none">•Advertisements•Sales Literature•Correspondence•Institutional Sales Material•Independently Prepared Reprint•Public Appearance	<ul style="list-style-type: none">•Institutional Communication<ul style="list-style-type: none">•Written (electronic) communications distributed or made available only to institutional investors.•Retail Communication<ul style="list-style-type: none">•26 or more retail investors•Correspondence<ul style="list-style-type: none">•25 or fewer retail investors

New FINRA Rule

- Clarifies that registered investment companies includes '40 Act ETFs
- Requires certain non-independent research, such as research prepared by a member or its affiliate on mutual funds or exchange-traded funds (“ETFs”) to be filed with FINRA

Non Conforming Prospectus Issues 1940 Act ETFs

- Broker-Dealers -- How to avoid sale material being “illegal prospectus”
 - Rule 482
 - “Free Writing” (No ability to Rely on R. 433)
 - *Rule 34b-1 supplemental sales literature – may be used if accompanied or preceded by a full prospectus.*
 - *May deliver summary prospectus*
 - Rule 139 (by analogy)
 - 135a generic ads – any person may publish or distribute a Rule 135a generic advertisement, including, fund underwriters, broker-dealers and sponsors. Very limited in scope
 - Rule 134 -- limited

Non Conforming Prospectus Issues

1940 Act ETFs (continued)

- Rule 482 is the primary advertising rule for '40 Act funds. Most importantly, it permits performance advertising. And unlike sales literature under Rule 34b-1, a Rule 482 advertisement is a “prospectus” as defined in Section 10(b) of the 1933 Act and thereby satisfies the prospectus delivery requirements of Section 5(b)(1). A 482 “omitting” prospectus is not intended to replace the statutory prospectus, which must be delivered to an investor prior to or at the time of delivery of fund shares, e.g., when the confirm is provided.
 - *Because 482 ads are prospectuses, statements made therein carry potential Section 12(a) liability; however no Section 11 liability is implicated because it is not part of a reg statement.*

Non Conforming Prospectus Issues 1940 Act ETFs (continued)

- Other Issues:
 - Rule 139 under the '33 Act unavailable for research reports relating to investment companies, although it may be possible, as a policy matter, to apply both Rule 139 (a) and (b) by analogy.
 - GAO Report on Mutual Fund Advertising

Non-Conforming Prospectus Issues '33 Act Funds

- Rules 138 and 139
 - Issuer specific reports
 - Industry reports
- Free writing prospectus – Rule 433
 - Issuer vs Broker FWP (uncommon)
 - Prospectus delivery requirement for unseasoned issuers
 - Legend and Filing requirement
 - SEC
 - FINRA – DSPP filing requirements
 - 12(a)(2) liability
- “Free writing”

Non-Conforming Prospectus Issues

'33 Act Funds (continued)

- Rule 159A(b) limits an underwriter's liability for an issuer FWP filed as an FWP rather than as part of the registration statement
- APs should ensure right to review amendments to Registration Statement to mitigate liability

Non-Conforming Prospectus Issues '33 Act Funds (continued)

- Free writing sales materials – Section 2(a)(10) exclusion
 - Electronic or physical delivery of final prospectus
 - Filing requirements
 - 17(a)/ 10b-5 liability
- NFA Requirements
 - The NFA rule requirements are similar to those for ordinary-course, equity research, e.g. comments must be fair and balanced, not misleading, must have a reasonable basis for view expressed, opinion distinguished from facts.

Liability Considerations

'40 Act ETFs

- Materials prepared under Rule 482 are deemed to be “prospectuses” that carry liability under Section 12(a)(2)
- APs have liability for materials they use

Marketing Materials Reps – '40 Act ETF Form of AP Agreement

- The AP represents, warrants, and agrees that it will not make any representations concerning ETF Shares, the Trust or the ETFs, other than those contained in the ETFs' then current Prospectus or in any promotional materials or sales literature furnished to the AP by the Distributor. The AP agrees not to furnish or cause to be furnished to any person or display or publish any information or materials relating to ETF Shares (including, without limitation, promotional materials and sales literature, advertisements, press releases, announcements, statements, posters, signs, or other similar materials), except such information and materials as may be furnished to the AP by the Distributor and such other information and materials as may be approved in writing by the Distributor. The AP understands that the ETF will not be advertised or marketed as an open-end investment company, (i.e., as a mutual fund), and that any advertising materials will prominently disclose that the ETF Shares are not individually redeemable. In addition, the AP understands that any advertising material that addresses redemption of ETF Shares will disclose that ETF Shares may be tendered for redemption to the issuing ETF only in Creation Units. Notwithstanding the foregoing, the AP may without the written approval of the Distributor prepare and circulate in the regular course of its business research reports that include information, opinions, or recommendations relating to ETF Shares (i) for public dissemination, provided that such research reports **compare the relative merits and benefits** of ETF Shares with other products and are not used for purposes of marketing ETF Shares **and (ii) for internal use by the AP**.

Marketing Materials Reps – '33 Act ETF Form of AP Agreement

- (a) The Authorized Participant represents, warrants and covenants that (i), without the written consent of the Managing Owner, the Authorized Participant shall not make, or permit any of its representatives to make, any representations concerning the Shares or any AP Indemnified Party other than representations contained (A) in the then-current Prospectus, (B) in printed information approved by the Managing Owner as information supplemental to such Prospectus or (C) in any promotional materials or sales literature furnished to the Authorized Participant by the Distributor or the Managing Owner, and (ii) the Authorized Participant shall not furnish or cause to be furnished to any person or display or publish any information or material relating to the Shares, any AP Indemnified Person or the Trust that are not consistent with the Trust's then current Prospectus. Copies of the then current Prospectus and any such printed supplemental information will be supplied by, or caused to be supplied by, the Distributor to the Authorized Participant in reasonable quantities upon request.
- (b) Notwithstanding the foregoing, the Authorized Participant may without the written approval of the Managing Owner prepare and circulate in the regular course of its business research reports, marketing material and sales literature that includes information, opinions or recommendations relating to the Shares (i) for public dissemination, provided that such research reports, marketing material or sales literature **compare the relative merits and benefits** of Shares with other products; **and (ii) for internal use by the Authorized Participant. The Authorized Participant shall file all such research reports, marketing material and sales literature related to the Shares with FINRA to the extent required by the FINRA Conduct Rules.**

FINRA/SEC Sales Practices

- Heightened concern regarding Sales materials related to leveraged and inverse ETFs
- Firms must have adequate supervisory procedures in place to ensure that these obligations are met
- Training
- **SEC & FINRA Investor Alert: Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors (August 2009)**
- **FINRA Non-Traditional ETFs FAQ**

FINRA/SEC Sales Practices

- **FINRA Regulatory Notice 09-31: Non Traditional ETFs (June 2009)**
- “Inverse and leveraged ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets”
- Recommendations must be suitable and based on a full understanding of the terms and features of the product recommended

FINRA/SEC

Sales Practices (continued)

- General Regulatory concerns regarding retail customers
- Cases

Margining ETFs

- ETFs are “margin securities”
- Section 11(d)(1) of 1934 Act
 - Prohibition on margining new issues to avoid “share pushing”
 - Because of ETFs’ continuous offering, 30 day freeze never ends
 - 2005 Class relief - APs and broker-dealers may margin beginning 30 days after launch of ETF (restriction on APs only) – provided no promotional or sales fees are paid by the ETF sponsor, adviser or ETF to the broker-dealer
 - Custom relief granted for commodity ETFs, fund-of-fund ETFs and actively-managed ETFs
 - Rule 11d1-2 – may margin shares held by customer for 30 days

11(d)(1) as applied to 1940 Act ETFs on broad-based indices

Criteria of Security Needed to Qualify for Financing	Conditions to use of exemptive order if security qualifies	Relevant No-Action Letters or Exemptive Relief
<p>Shares must be of “qualifying ETFs” that meet each of the following three criteria:</p> <ol style="list-style-type: none"> 1. Registered open-end investment company or UIT 2. Shares are listed and trade on an approved exchange, and 3. ETF has at least 20 component securities with no single security representing more than 25% 	<p>If broker-dealer is acting as an AP for the ETF, it must meet the following two conditions:</p> <ol style="list-style-type: none"> 1. Neither broker-dealer nor any natural person associated with it, directly or indirectly, receives compensation (other than non-cash compensation under NASD R. 2830) from the fund complex to promote or sell the Shares to persons outside the ETF complex, and 2. Broker-dealer does not extend credit on the Shares until 30 days after the Shares initially commence trading (unless otherwise permitted under Rule 11d1-1) <p>If broker-dealer is not acting as an AP for the ETF, it must meet only the first condition above and need not wait to finance shares until 30 days after initial launch of the ETF</p> <p>In either case, the broker-dealer may also treat the Shares as “registered open-end investment company shares” under Rule 11d1-2 permitting extension of credit after customer owns Shares for 30 days.</p>	<p><i>Derivative Products Committee of the Securities Industry Association (Nov. 21, 2005)</i></p>

11(d)(1) as applied to other 1940 Act ETFs

Name of Security	Criteria of Security Needed to Qualify for Financing	Conditions to use of exemptive order if security qualifies	Relevant No-Action Letters or Exemptive Relief
Actively-Managed 1940 Act ETFs	ETF must be a registered open-end investment company or UIT and the Shares must be listed and trade on an approved exchange	Same conditions as the <i>Securities Industry Association</i> letter apply Also may treat shares as “registered open-end investment company shares” under Rule 11d1-2, permitting extension of credit after customer owns shares for 30 days.	<i>Wisdom Tree Trust</i> (May 9, 2008)
Fund of Funds ETFs	ETFs are treated as “qualifying ETFs” as set forth in <i>Securities Industry Association</i> , despite fund of funds structure All underlying funds must be “qualifying ETFs” or have obtained individual relief from the SEC staff No ETF can hold more than 20% of an underlying ETF	Same conditions as the <i>Securities Industry Association</i> letter apply	<i>Index IQ ETF Trust</i> (Mar. 25, 2009)

11(d)(1) as applied to Non-1940 Act ETFs

Name of Security	Criteria of Security Needed to Qualify for Financing	Conditions to use of exemptive order if security qualifies	Relevant No-Action Letters or Exemptive Relief
Non-1940 Act ETFs (other than metals-related ETFs)	ETFs are treated as “qualifying ETFs” as set forth in <i>Securities Industry Association</i> , even though ETFs are not open-end investment companies or UITs	Same conditions as the <i>Securities Industry Association</i> letter apply (relief expressly excludes application to the distributor) Also may treat shares as “registered open-end investment company shares” under Rule 11d1-2, permitting extension of credit after customer owns shares for 30 days.	<i>DB Commodity Index Tracking Fund and DB Commodity Services LLC (Jan. 19, 2006)</i>
Non-1940 Act ETFs (single metal ETFs)	ETFs are treated as “qualifying ETFs” as set forth in <i>Securities Industry Association</i> , even though indices may not meet same criteria	Same conditions as the <i>Securities Industry Association</i> letter apply	<i>iShares COMEX Gold Trust (Jan. 27, 2005), as modified by iShares COMEX Gold Trust (Dec. 12, 2005)</i>

Section 13 and Section 16

- PDR Services Corporation, SEC No Action Letter, 1998 WL 870706 (December 14, 1998) – Section 13(d)
 - No Action Relief covering ownership of SPDRs, MidCap SPDRs, and DIAMONDS UITs.
 - Applicability to actively managed ETFs?
- Select Sector SPDR Trust, SEC No Action Letter, <http://prod.resource.cch.com/resource/scion/document/default/09013e2c854cd3af> (May 6, 1999) - Section 16
 - No Act Relief covering funds