

Securities and Exchange Commission Staff Permit Exchange-Traded Funds to Track Their Indexes by Investing in Other Exchange-Traded Funds

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The SEC staff recently issued a no-action letter permitting certain exchange-traded funds (Upper Funds) to meet their investment objectives by investing all or part of their assets in other exchange-traded funds (Underlying Funds), instead of investing directly in the component securities of the Upper Funds' indexes, subject to the conditions outlined below. As discussed in greater detail in the no-action letter, the Upper Funds generally track broad market indexes composed of many securities, while the Underlying Funds track indexes each of which may be a narrow segment of a broader market index composed of fewer securities. In many cases, a broad market index may be composed of the same components as the aggregate of two or more narrow segment indexes.

The Upper Funds' adviser explained that an Upper Fund may effectively track its index, while operating more efficiently, by holding shares of Underlying Funds in proportion to the weighting of the Underlying Funds' holdings in the Upper Fund's index. For example, rather than investing directly in index component securities, an Upper Fund that seeks to track the S&P Composite 1500 Index could invest in an Underlying Fund that tracks the S&P 500 Index, another that tracks the S&P 400 Index and, finally, another that tracks the S&P 600 Index. The component securities of these three Underlying Fund indexes, in the aggregate, compose the securities that are included on the S&P Composite 1500 Index.

Under the no-action letter, an Upper Fund could also invest in Underlying Funds whose indexes are not subsets of the Upper Fund's index but rather are highly correlated to the Upper Fund's index. In addition, an Upper Fund may continue to invest directly in securities composing its index, in circumstances where the Upper Fund cannot adequately replicate the performance of its index by investing only in Underlying Funds. This might occur, for example, when there is no Underlying Fund that tracks a particular segment of the Upper Fund's index.

It is worth noting that one of the benefits cited by the Upper Funds' adviser resulting from the proposed "fund of funds" structure is the ability of an "authorized participant" to submit or receive relatively few easily tradable securities (i.e., Underlying Fund shares) as part of the creation or redemption process rather than a basket of hundreds or even thousands of index component securities. The adviser also discussed increased efficiencies in pricing of both Upper and Underlying Funds expected to result from the proposed structure and noted that it expected arbitrage opportunities will exist in the market pricing of Upper Fund shares, of which market participants will take advantage.

The staff's no-action position was conditioned on each Upper Fund's compliance with existing SEC

orders permitting the Upper Fund to operate as an exchange-traded fund. In addition, the position was conditioned on each Upper Fund's representation that it would take the following actions prior to relying on the no-action relief:

- The Upper Fund's board must determine that investing in Underlying Funds to seek the Upper Fund's investment objective is in the best interest of the Upper Fund and its shareholders
- The Upper Fund must notify each fund that previously entered into a "fund of funds" participation agreement with the Upper Fund that the fund will no longer be able to acquire shares of the Upper Fund beyond the limits of Section 12(d)(1) of the Investment Company Act of 1940
- The Upper Fund must disclose in its prospectus and website that it will seek its investment objective by investing in Underlying Funds.

Morgan, Lewis & Bockius will continue to monitor this issue and will update you with any new information as it becomes available. If you have any questions about any of the issues raised in this Morgan Lewis Investment Management FYI, please contact:

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