

## **SEC Proposes Rules to Allow Index-Based and Fully Transparent Actively Managed ETFs**

**March 5, 2008**

At an open meeting on Tuesday, March 4, the Securities and Exchange Commission (SEC) voted unanimously to propose two new rules under the Investment Company Act of 1940 (Act) to permit exchange-traded funds (ETFs) to operate without the need to obtain individual exemptive orders from the SEC. The SEC also proposed amendments to disclosure Form N-1A to include additional information for ETF investors who purchase shares in the secondary markets.

### **Background**

ETFs are similar to traditional mutual funds, but issue shares that trade throughout the day on securities exchanges. The proposed rules would codify the more than 61 exemptive orders the SEC has granted, which allow the operation of both index-based and actively managed ETFs. The proposed rules would also allow unaffiliated funds to purchase ETF shares in an amount in excess of the limits of the Act, again codifying exemptive relief previously granted by the SEC.

### **The New Rules**

First, proposed Rule 6c-11 under the Act would provide several exemptions from the Act to permit ETFs to form and operate without the need to obtain individual exemptive relief from the SEC. The rule would codify most of the exemptions previously granted by the SEC to index-based ETFs and, pursuant to several recently issued exemptive orders, to fully transparent actively managed ETFs. Rule 6c-11 would embody the standard set of conditions now imposed on index-based ETFs and would also apply to fully transparent actively managed ETFs. This may come as a surprise to some, given that the SEC issued the first exemptive order permitting actively managed ETFs just last week.

With respect to nontransparent actively managed ETFs, SEC staff was not ready to include them in the proposed new rule because of the differing approaches that product sponsors wish to take to provide necessary information about portfolio components and characteristics. The staff acknowledged that they are working with proponents of such products, but have not had the opportunity to resolve these issues, and thus did not view it as timely to bring to the SEC at this point.

Second, proposed Rule 12d1-4 under the Act would allow investment companies to make larger investments in ETFs than currently permitted under Section 12(d) of the Act, which limits one investment company to acquiring no more than 3% of another investment company's shares. The exemptions in the proposed rule would be subject to several conditions designed to address the historical abuses associated with "pyramiding" schemes that historically occurred with fund investment in other funds (so-called "fund of funds" arrangements). Although the SEC and the staff regarded this proposed rule as a codification of prior exemptive orders, from the discussion at the meeting it appears that Rule 12d1-4 will have fewer conditions than the 12(d) relief provided in the prior orders. In discussing this change with Commissioners at the open meeting, the staff noted that it took a fresh look at prior conditions and believed that the fewer conditions contained in proposed Rule 12d1-4 would achieve the same regulatory objective. Interestingly, the staff indicated that it was also using this rule proposal to fix a "glitch" in the Section 12(d) rules adopted in June 2006 so that funds of funds would now be allowed to invest in unaffiliated mutual funds, securities, and other instruments, such as futures and swaps.

Finally, proposed amendments to Form N-1A, which open-end funds use both to register under the Act and to register their shares under the Securities Act of 1933, would accommodate the use of the form by ETFs. The proposed amendments are designed to provide key information to investors who purchase ETF shares in secondary market transactions, where most ETF investors (including retail investors) purchase shares. For several reasons, the staff did not propose to codify the exemptive relief that allows broker-dealers to give ETF purchasers a "product description" rather than the full prospectus. As discussed at the open meeting, one reason for this is the staff's belief that the product description is too rarely used due to operational barriers and risk concerns by industry. More important, the staff expects that when the SEC adopts the short-form "summary prospectus" proposal, it will be designed to serve the purpose of the product description and, the SEC believes, will be a much more viable alternative to the full prospectus than the product description.

## Next Steps

The proposing release is available on the SEC's website at <http://www.sec.gov/rules/proposed/2008/33-8901.pdf>. The comment period for the proposal will end 60 days from the date of publication of the proposed rule in the Federal Register.

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