

Securities and Exchange Commission Staff Confirms Ability of iShares ETFs to Use Affiliated Indices as Benchmarks

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Securities and Exchange Commission (SEC) staff recently issued a no-action letter confirming the oral no-action relief it had granted to Barclays Global Fund Advisors (BGFA) and certain funds in the iShares Trust (each a Fund; collectively, the Funds) permitting the Funds to continue to use benchmark indices after the sponsor of the indices became an affiliated person. The Funds, advised by BGFA, are exchange-traded funds (ETFs) operating pursuant to SEC exemptive orders (ETF Orders). The SEC granted the ETF Orders based on, among other things, representations from the Funds that no entity that creates, compiles, sponsors, or maintains a benchmark index would be an affiliated person of the Funds or an affiliated person of an affiliated person of the Funds, BGFA, the promoter, or the distributor of the Funds.

However, after Barclays Capital Inc.'s purchase of certain assets of Lehman Brothers Holdings, Inc. (Lehman) following Lehman's petition for bankruptcy, Lehman, as sponsor to certain indices the Funds used as benchmarks, became an affiliated person. Prior to the completion of the purchase, the SEC staff granted oral no-action relief to the Funds that it would not take any enforcement action against BGFA or the Funds under the Investment Company Act of 1940 (the Act) if they continued to rely on the ETF Orders, even though they failed to adhere to the representation that index providers would not be affiliates. BGFA and the Funds recently received written assurance of this relief.

Discussion and Analysis

On September 16, 2008, Barclays Capital Inc. (Barclays), an affiliate of BGFA, agreed to purchase certain of Lehman's assets, including indices originally compiled, sponsored, and maintained by a division of Lehman (the Index Sponsor) that the Funds use as benchmark indices (the Lehman Indices). As a result, the representation the Funds made in their applications for the ETF Orders pursuant to the Act—that they would not use an index created, compiled, sponsored, or maintained by an affiliate or by an affiliate—was no longer true.¹ BGFA advised the SEC staff that it wished to continue using the Lehman Indices for the Funds, but it also explained the necessity of completion of the purchase as quickly as possible, in order to maximize the value of Lehman's assets. BGFA explained to the SEC staff that it would be impractical to seek an amendment to the ETF Orders to allow the continued use of these indices before the consummation of the purchase.

In seeking permission to continue to rely on the ETF Orders while using indices provided by an affiliate, BGFA agreed to a series of conditions designed to protect against any improper exchange of information between BGFA and the Index Sponsor. BGFA argued that the Lehman Indices were not created solely for the Funds' use, were created well in advance of the launch of the Funds, and were used by other Funds that were not affiliated with the Index Sponsor. BGFA represented that it would comply with all other representations and conditions in the ETF Orders.

¹ Certain other ETFs obtained exemptive orders from the SEC allowing them to use affiliated index providers. See e.g., WisdomTree Investments, Investment Company Act Release Nos. 27324 (May 18, 2006) (notice) and 27391 (order).

The SEC staff initially granted the requested no-action relief orally, particularly given the need to expedite Barclay's purchase of Lehman's assets. Under the no-action letter, BGFA and the Funds are subject to following conditions:

- (1) BGFA and the Index Sponsor have been and will continue to be separate legal entities that have no overlapping officers, directors, or employees
- (2) There is an effective information barrier between BGFA and the Index Sponsor, and BGFA has not been and will not be provided with information about a change in index methodology by the Index Sponsor before such information is provided to other persons outside of the Index Sponsor
- (3) BGFA has not had and will not have a preferential ability to influence the index methodology determined by the Index Sponsor over other institutional investors
- (4) BGFA has not sought and will not seek to influence the index methodology determined by the Index Sponsor in a way that would disproportionately benefit the Barclays organization.

It is worth noting that, under the no-action letter, the relief provided would expire on the effective date of any SEC rule under the Act that provides relief permitting the operation of index-based ETFs. The current SEC rule proposal for the operation of ETFs does not include specific terms to address potential conflicts of interest, specifically the prevention of the misuse of nonpublic information, between a Fund and an affiliated index provider. Rather, in the letter, the SEC states that the federal securities laws and the rules of national securities exchanges that require a Fund to adopt procedures addressing such conflicts are sufficient.²

Consequently, if the SEC adopts the proposed rules as currently drafted, ETFs such as the Funds, which originally had conditions in their ETF Orders prohibiting affiliated relationships with index sponsors, could theoretically use affiliated index sponsors without having to obtain additional relief, provided that they have in place appropriate Rule 38a-1 procedures designed to address potential conflicts of interest.

Morgan Lewis will continue to monitor this issue and will update you with any new information as it becomes available.

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² See Proposed Rules: Exchange-Traded Funds, available at <http://www.sec.gov/rules/proposed/2008/33-8901.pdf>.