

SEC Provides Class Relief for Fixed Income Exchange-Traded Funds

April 11, 2007

On April 9, the SEC's Division of Market Regulation issued class relief from certain rules and regulations under the Securities Exchange Act of 1934 (Exchange Act) for exchange-traded funds (ETFs) that invest in fixed income securities (Fixed Income ETFs). The class relief is similar to relief that was recently provided to ETFs investing in equity securities. Specifically, the class relief provides exemptive and no-action relief, as well as interpretive advice, with respect to Rules 10a-1 and 10b-17 under the Exchange Act, Rules 101 and 102 of Regulation M, and Rule 200(g) of Regulation SHO for Fixed Income ETFs that meet certain conditions.

The relief extends to all Fixed Income ETFs that continuously redeem, at net asset value, Creation Unit Aggregations of shares (Shares), where the secondary market price of Shares do not vary substantially from the net asset value of such Shares (which will be based on the value of the Component Securities).

Conditions

In order to qualify for the class relief, Fixed Income ETFs must meet the following conditions:

1. The Shares must be issued by an open-end investment company or unit investment trust registered with the SEC under the Investment Company Act of 1940 (1940 Act);
2. The Shares must be listed and traded on a national securities exchange or on a facility of a national securities association that has obtained approval from the SEC of a proposed rule change regarding the listing and trading of Shares on a national securities exchange or on a facility of a national securities association (or that is relying on Rule 19b-4(e) to list and trade Shares);
3. The Fixed Income ETF must seek to (i) provide investment results that correspond to the performance of a particular underlying index, (ii) exceed the performance of a particular underlying index by a specified multiple, or (iii) correspond to the inverse of the performance of a particular underlying index by a specified multiple;
4. The underlying index must consist of only fixed income securities, which include notes, bonds, debentures, or other evidence of indebtedness that include, but are not limited to, U.S. Department of Treasury Securities (Treasury Securities), government-sponsored entity securities, municipal securities, trust preferred securities, supranational and sovereign debt, and convertible bonds (Fixed Income Securities);
5. The Shares must be issued and redeemed in Creation Unit Aggregations of 50,000 Shares or such other amount where the value of a Creation Unit is at least \$1 million at the time of issuance; and
6. The intra-day proxy value of the Fixed Income ETF per Share and the value of the underlying index must be publicly disseminated by a major market data vendor during the trading day.

The class relief is also subject to certain “rule specific” terms as follows:

Regulation M—Rule 101

The SEC staff confirmed prior interpretations of Regulation M that have been provided to issuers of Fixed Income ETFs where the following conditions are satisfied (Regulation M Conditions):

- No individual fixed income security that is part of the Fixed Income ETF basket that is assembled to correspond to the performance of the specified Component Securities (excluding Treasury Securities) represents more than 30% of the weight of the Fixed Income ETF, and the five highest-weighted Component Securities in the Fixed Income ETF do not in the aggregate account for more than 65% of the weight of the Fixed Income ETF; and
- The Fixed Income ETF must include a minimum of 13 nonaffiliated issuers (except where the fund consists entirely of exempted securities).

The staff stated that the Regulation M Conditions will not apply to Fixed Income ETFs that are wholly composed of nonconvertible Fixed Income Securities that are rated “investment grade” by at least one nationally recognized statistical rating organization (as that term is used in Rule 15c3-1) in one of its generic rating categories that signifies investment grade.

The SEC staff confirmed that Fixed Income ETFs meeting the Regulation M Conditions will qualify for the exception in Rule 101(c)(4), which permits persons who may be deemed to be participating in a distribution of Shares to bid for or purchase Shares during their participation in such distribution.

The staff also confirmed that the creation and redemption of Creation Unit Aggregations of Shares and the receipt of Component Securities in exchange therefor by a participant in a distribution of Shares would not constitute an “attempt to induce any person to bid for or purchase a covered security during the applicable restricted period” under Regulation M.

Regulation M—Rule 102

The staff further confirmed that Fixed Income ETFs that satisfy the Regulation M Conditions will be excepted under Rule 102(d)(4) of Regulation M and therefore will be permitted to redeem Shares during the continuous offering of Shares. Similar to Rule 101, the SEC staff stated that the Regulation M Conditions will not apply to Fixed Income ETFs that are wholly composed of nonconvertible Fixed Income Securities that are rated “investment grade” by at least one nationally recognized statistical rating organization.

Exchange Act—Rule 10a-1

The SEC staff stated that given the composite and derivative nature of Fixed Income ETFs, it would not appear that trading in such Shares would be susceptible to the short selling practices that Rule 10a-1 is designed to prevent. Therefore, the SEC granted an exemption from the “tick test” under Rule 10a-1.

Regulation SHO—Rule 200(g)

The SEC staff stated that it will not recommend an enforcement action under Rule 200(g) of Regulation SHO if a broker-dealer trading ETFs marks “short,” rather than “short exempt,” a short sale, subject to the following conditions:

1. For each exempt short sale, the various market centers that execute such sales have instituted procedures to “mask” the short sale character of the transaction so that they are executed as short exempt;
2. The market centers monitor activity on a regular basis to confirm that any such product or transaction continues to meet the conditions for exemptive relief and to reinstitute the price test for any product or transaction that fails to satisfy the conditions;
3. A broker-dealer executing exempt short sales will mark such sales as “short,” and in no event will

such sales be marked as “long”; and

4. The market centers maintain an audit trail of all such trade executions that is capable of being produced and subject to review upon request by the SEC and other appropriate regulatory authorities.

Exchange Act—Rule 10b-17

The SEC staff stated that with respect to a Fixed Income ETF that has been registered under the 1940 Act as an open-end management investment company or unit investment trust, the SEC will exempt such Fixed Income ETFs from the requirements of Rule 10b-17 with respect to transactions in Shares, notwithstanding that the Shares are issued and redeemed in Creation Unit Aggregations.

We note that while the aforementioned class relief may be used by all persons or entities engaging in transactions in shares of Fixed Income ETFs who meet the conditions discussed in the letter, any requests for relief for products not meeting the aforementioned criteria will continue to be considered by the SEC staff on a case-by-case basis.

[Please click here to view the class relief.](#)

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