



Spotlight on ETFs: Hot Topics and Other Developments

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Panelists

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Agenda

- The Evolution of Exchange-Traded Funds (ETFs) and other Exchange-Traded Products (ETPs)
- Hot Topics
 - Market volatility
 - Systemic risk and short interest
 - Concerns of non-U.S. regulatory bodies
 - Recent trading scandals
 - Sales practices
 - Volcker Rule
- Q&A



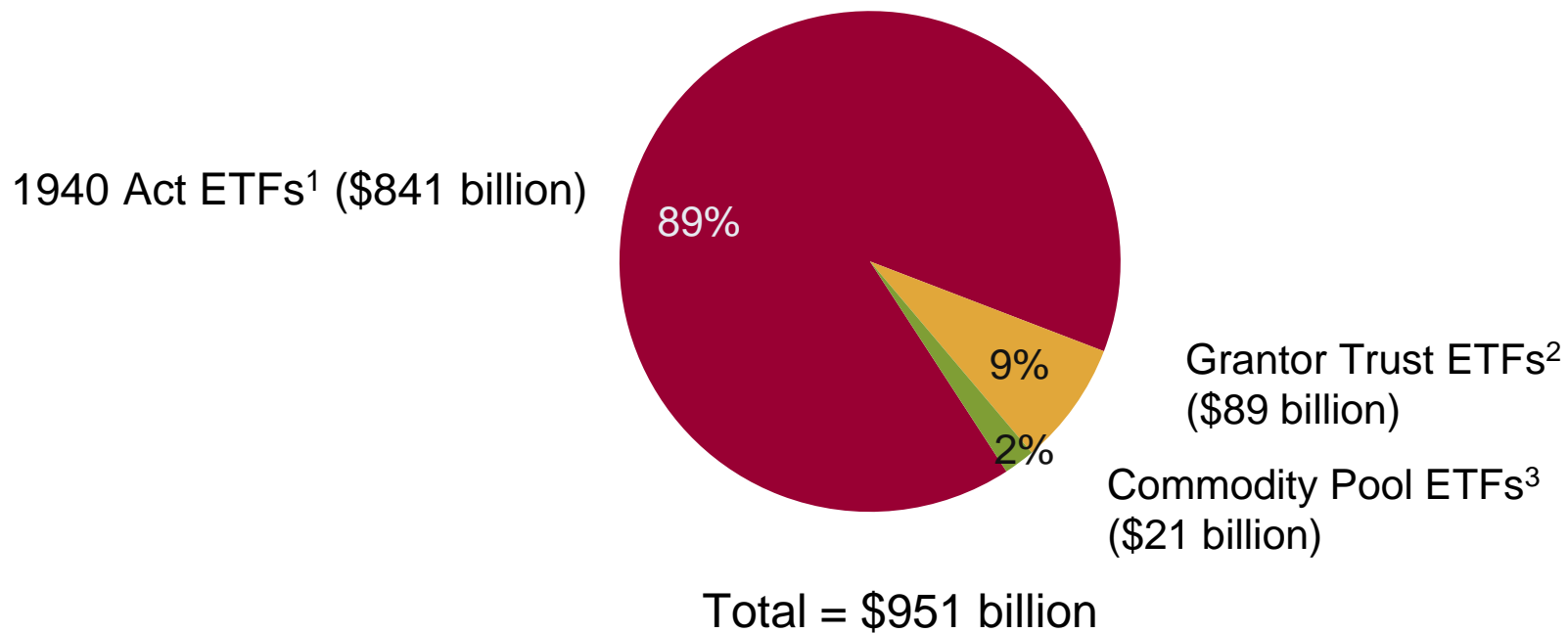
The Evolution of ETFs and Other ETPs

Timeline of ETF Developments

- 1988** The SEC authorizes the trading of index participation contracts
- 1989** Seventh Circuit finds that index participations are futures and not tradable on a securities exchange
- 1993** Creation of the SPDR Trust, a UIT that tracks the S&P 500 Index; other UITs follow
- 1996** First managed open-end ETFs launched – WEBS (now MSCI iShares)
- 2000** Barclays re-brands WEBS as iShares and launches extended family; Vanguard launches Vipers (separate share class of existing funds)
- 2002** iShares launches first fixed income index-based ETF
- 2003** SEC issues relief to iShares to permit mutual funds to invest in iShares ETFs beyond the Section 12(d)(1) limits
- 2004** SPDR Gold Trust and iShares Comex Gold Trust launched; first ETFs based on a commodity
- 2006** ProShares launches first leveraged and inverse index-based ETFs
Wisdom Tree launches first ETFs based on proprietary indexes
DB introduces first ETF structured as a commodity pool
- 2008** SEC issues orders to permit first actively managed ETFs
- 2010** Moratorium on the issuance of exemptive relief for leveraged index-based ETFs and actively managed ETFs using derivatives

US ETFs by Legal Structure

Percentage of total assets, September 2011



1. Registered under the Investment Company Act of 1940 and the Securities Act of 1933.

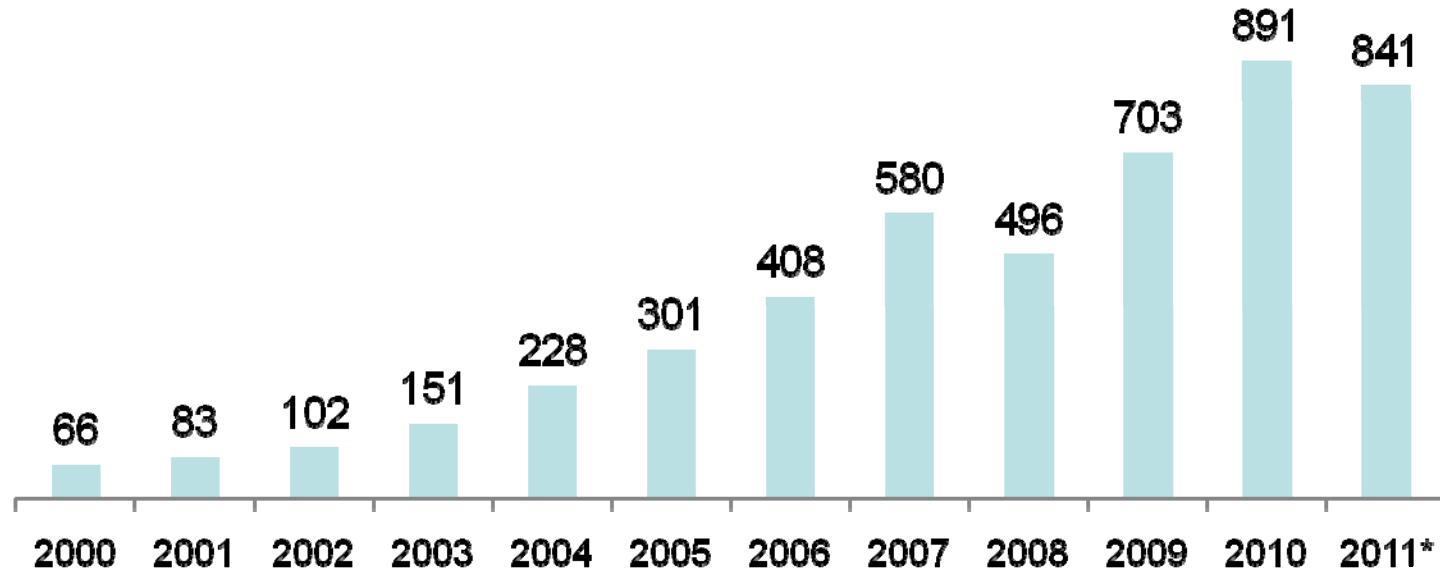
2. Registered under the Securities Act of 1933.

3. Registered under the Securities Act of 1933 and regulated by the CFTC under the Commodity Exchange Act of 1936.

Source: Investment Company Institute

Total Net Assets of 1940 Act ETFs

Billions of dollars, year-end, 2000 – 2011*



Number of 1940 Act ETFs	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011*
	80	102	113	119	151	201	343	601	683	748	869	1,032

*Data through September 2011

Source: Investment Company Institute

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1940 Act ETFs

- **Securities-Based (or “1940 Act”) ETFs**
 - Registered under the Investment Company Act of 1940 and the Securities Act of 1933.
 - Open-end funds (*i.e.*, IYY:US).
 - UITs (*i.e.*, SPY:US).
 - HOLDERS (grantor trust) (*i.e.*, PPH:US).
 - *Not registered under the 1940 Act pursuant to SEC no-action letter (Sept. 3, 1999).*
- **Require Exemptive Relief from the SEC**
 - Relief required to (i) reject redemptions in less than a creation unit and (ii) permit sales by brokers at market prices (*i.e.*, not NAV).
 - Conditions require (i) certain disclosures, (ii) restrictions on investments, and (iii) transparency of portfolio.
 - Use of derivatives by actively managed 1940 Act ETFs is not currently permitted in new ETF orders.

Other Types of ETFs

- **Grantor Trust ETFs**

- Registered under the Securities Act of 1933
- Hold physical commodities or currency
- Do not have an investment adviser
- Usually will file on Form S-1 or S-3 (if a well known seasoned issuer)

- **Commodity Pool ETFs**

- Registered under the Securities Act of 1933 and regulated by the CFTC under the Commodity Exchange Act of 1936
- Hold futures, derivatives contracts on commodities
- Usually will file on Form S-1 or S-3 (if a well known seasoned issuer)

Evolution of ETFs – Regulatory Relief

- **1934 Act Relief (both 1940 Act ETFs and 1933 Act only ETFs)**
 - Both 1940 Act ETFs and 1933 Act ETFs must obtain separate relief from various provisions of the 1934 Act, or otherwise qualify for the class relief.
 - *Because ETFs are in continuous offering, and the value of the shares is based on an underlying NAV, certain of the SEC’s anti-manipulation rules place unnecessary and burdensome restrictions on the trading of ETF shares.*
- **Exchange Listing Requirements (both 1940 Act ETFs and 1933 Act only ETFs)**
 - ETFs must meet exchange listing standards and other requirements
 - Generic listing rules are available for many types of ETFs.
 - Unique products require exchange filing of listing rule (so called, “19b-4” applications).
 - Derivatives use by 1933 Act ETFs is permitted, but Division of Trading & Markets has been applying prioritization and specificity requirements.

Exchange-Traded Notes (ETNs)

- **ETNs**
 - Usually senior, unsecured, unsubordinated debt securities.
 - Designed to provide investors with a way to access returns of a stated benchmark.

The Future of the ETF Market?

- What new strategies and/or indexes can be expected?
- Will actively managed ETFs finally take off?
- Will international cross-listing become vogue?
- What regulatory hurdles can be expected in the future?
- With new strategies and emerging trends in ETFs what operational challenges can be expected?



Hot Topics

In the news...

- *“[F]rom 2:45 p.m. to about 3:00 p.m. broad market indices recovered while at the same time many individual securities and ETFs experienced extreme price fluctuations and traded in a disorderly fashion at prices as low as one penny or as high as \$100,000.” (SEC Flash Crash Report – 9/30/2010)*

Hot Topics – Market Volatility

- What role, if any, did ETFs play in the “flash crash” on May 6, 2010?
- Are ETFs responsible for the recent macro-market volatility?
- Are leveraged/inverse ETFs causing end of day volatility?

In the news...

- *“Plunge in 10 ETFs triggers 'flash crash' memories”.*
(Reuters – 5/31/2011)
- *“Clearly [short selling] creates a serious counterparty risk and quite possibly the potential for a run on an ETF – where the assets held by the fund operator could become insufficient to meet redemptions.”*
(ft.com/alphaville – 9/18/2011)

Hot Topics – Systemic Risk and Short Interest

- Can an ETF collapse from short interest?
- Should there be concern about a “run to unwind”?

What is Short Interest?

- The number of shares of a stock or ETF sold short, often expressed as a percentage of shares outstanding.
- Example: ABC ETF has 13.5M shares outstanding and 69.6M shares sold short => 500% short interest.
- How does this happen?
 - A short seller must locate shares to borrow before selling.
 - Securities may be lent out of any brokerage account with the permission of the account owner.
 - One share may be borrowed multiple times.
 - Authorized Participants (APs) may “locate to the ETF” (i.e., use their ability to create shares as their located shares)
 - BUT: The only owner of the share is the person in possession of it.

Why Can't an ETF Collapse from Short Interest?

- The theory: If there are 83.1M claims on only 13.5M shares, and all shareholders try to redeem, only the first 13.5M shares presented can be redeemed.
- The facts:
 - Only the person in possession of a share may redeem it.
 - APs – the only people who may redeem ETF shares – must represent that they own any shares tendered for redemption.
 - APs can be required to provide proof of such ownership at the request of the ETF.
 - ETFs typically have procedures in place to verify ownership for redemptions over a certain size, and/or for redemptions in funds with certain levels of short interest.

Can ETFs Create Systemic Risk in a Rush to Unwind?

- The theory:
 - In the event of a big market selloff, the “rush to unwind” an ETF will aggravate the selloff and ETF sponsors may not be able to honor their obligations.
 - Conversely, an ETF could be at risk from a “run-up,” if it experiences high share creation and its own demand for securities drives up their price, so that the ETF does not have sufficient cash to track its index.

Can ETFs Create Systemic Risk in a Rush to Unwind?

- The facts: Because ETFs typically create and redeem in kind, they are generally not trading securities at all.
 - If an AP elects to redeem ETF shares in a declining (or rising) market, the ETF must provide a pro rata share of the fund's assets in exchange for the ETF shares – not a specific cash value. Thus, an ETF will always be able to meet its obligations, even if the share value has fallen.
 - When ETFs accept cash in lieu of securities, the cash amount is adjusted to equal the amount needed for the ETF to acquire the specified securities, so it will not end up with insufficient securities due to rising prices.
- ETFs (like traditional index funds) are simply a trading vehicle – investors that sell an ETF during a sell-off are likely the same investors that would have sold the underlying securities.

In the news...

- *“Investors are pulling money from ‘synthetic’ exchange traded funds listed in Europe that hold derivatives as the products draw more attention from regulators.... European regulators have been taking a closer look at synthetic ETFs due to concerns investors may not fully understand how the complex financial products work.” (ETF Trends, 11-1-2011)*

Hot Topics – Concerns of Non-US Regulatory Bodies

- Financial Stability Board note and BIS Working Paper on stability issues/systemic risks raised by ETFs (April 2011).
 - Primarily focused on “synthetic” ETFs that obtain the desired return through entering into an asset swap with a counterparty.
- European Securities and Markets Authority discussion paper on UCITS ETFs and structured UCITS (July 2011).
 - Focused on additional transparency and disclosure for UCITS ETFs.

In the news...

- *“Sources close to the situation named the suspect as 31-year-old Kweku Adoboli, who was working as UBS director of exchange traded funds and so-called Delta 1 trading, according to his profile on LinkedIn. Adoboli was arrested during the night at UBS's London office, the sources told Reuters...”* (Reuters – 9/16/2011)
- *“The Securities and Exchange Commission today charged a former Goldman, Sachs & Co. employee and his father with insider trading on confidential information about Goldman’s trading strategies and intentions that he learned while working on the firm’s exchange-traded funds (ETF) desk.”* (SEC Press Release – 9/21/2011)

Hot Topics – Recent Trading Scandals

- Are recent trading scandals “ETF” issues or are ETFs being unfairly associated with scandal?

Hot Topics – Sales Practices

- Heightened concern regarding sales materials related to leveraged and inverse ETFs.
- Firms must have adequate supervisory procedures in place to ensure that the sales obligations are met.
- “Non-traditional ETFs” are noted as “current area of interest” in 2011 FINRA advertising conference materials.

Hot Topics – Proposed Volcker Rule

- Volcker Rule regulations proposed in October: impose upon banking entities and their affiliated companies (i) restrictions on proprietary trading operations and (ii) restrictions on relationships with private equity and hedge funds.
- Without further regulatory guidance, APs could be substantially hampered by the proposed rules.
- Under the sponsorship of covered funds prong of the proposed rules, APs could be prohibited from acting as AP to commodity ETFs (the majority of which are organized as commodity pools) unless they limit their activity to 3% of the ETF's shares.
 - Despite the exemption for seed capital, this prohibition could effectively require smaller commodities-based ETFs to offer creation and redemption of shares in units small enough to equal less than 3% of the ETF's outstanding shares, which is a constantly changing number.

Hot Topics – Proposed Volcker Rule

- Under the proprietary trading prong of the proposed rules, in order to fit the proposed exceptions, APs would essentially have to act either as market makers for those ETFs for which they act as AP (which would include all ETFs and not just ETFs organized as commodity pools) or be deemed to be acting as underwriters in order to fit an exemption.
 - Acting as a market maker brings about certain obligations to the exchanges on which the ETFs trade and acting as an underwriter triggers strict liability for prospectus and registration statement disclosure.
 - These implications could act as disincentives to smaller broker-dealers from entering into the AP business, which could, in turn, reduce ETF liquidity by reducing the number of APs.



Questions?