

Morgan Lewis

ETFs 360°

Formation, Regulation and Trading

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Agenda

- Structure and formation of domestic ETFs (McGuire)
- Regulatory issues and concerns (Donohue)
- Trading and liability concerns (Bullitt)

Note:

- We will address both “issuer” side and “AP” side concerns
- We will discuss registered investment company ETFs and 1933 Act ETPs (i.e., commodity ETPs)

What Are ETFs?

- Open-ended, collective investment vehicles whose shares are listed and traded on organized securities exchanges
 - ETF shares are traded on exchanges at market prices which may differ from the net asset value (“NAV”) of the fund
 - Unlike mutual funds, ETF shares may only be created and redeemed through broker-dealers designated as APs and only in block size, referred to as “creation units”
- Vast majority of ETFs are open-end investment companies, but varieties in structure are increasing
- ETFs typically track the performance of indexes of securities or commodities or hold a single type of commodity or currency; since 2008, ETFs may be actively managed

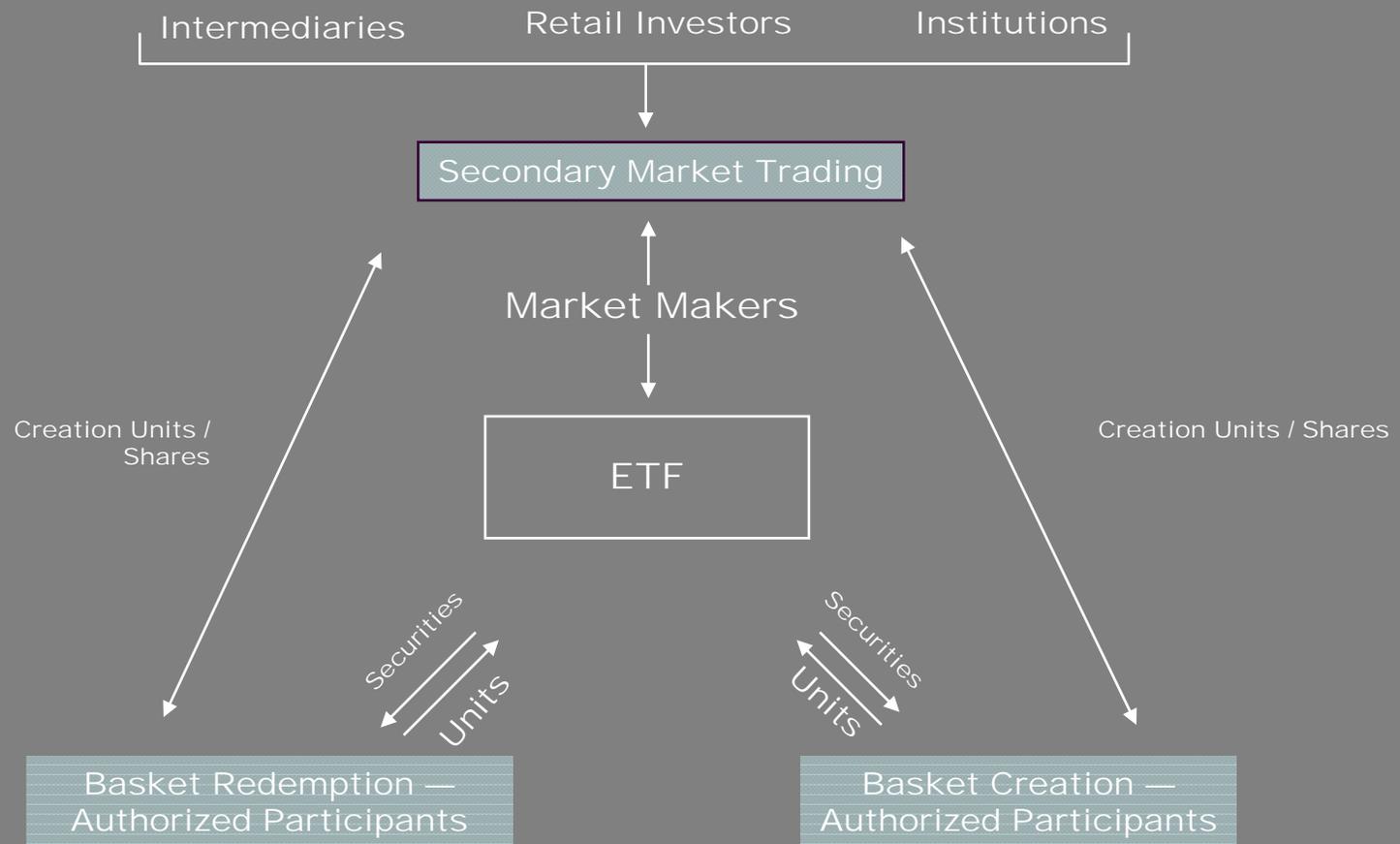
Evolution of ETFs

- 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 followed, including Mid Cap SPDRs (1995), Diamonds (1998), Nasdaq 100 Trust (1999), and BLDRS (2002)
- 1996** First managed open-end ETFs launched – WEBS (now MSCI iShares)
- 2000** Barclays re-brands WEBS as iShares and launches extended family and 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 both offer 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

Growth of ETFs in the U.S.

- According to the ICI, by the end of 2011:
 - There will be over 1,000 ETFs trading in the U.S.
 - Aggregate ETF assets in the U.S. will be approximately \$1 trillion
 - ETFs will equal 25% of all equity trading volume on U.S. national exchanges

How ETFs Work



ETFs vs. Mutual Funds: The Typical Investor Transaction

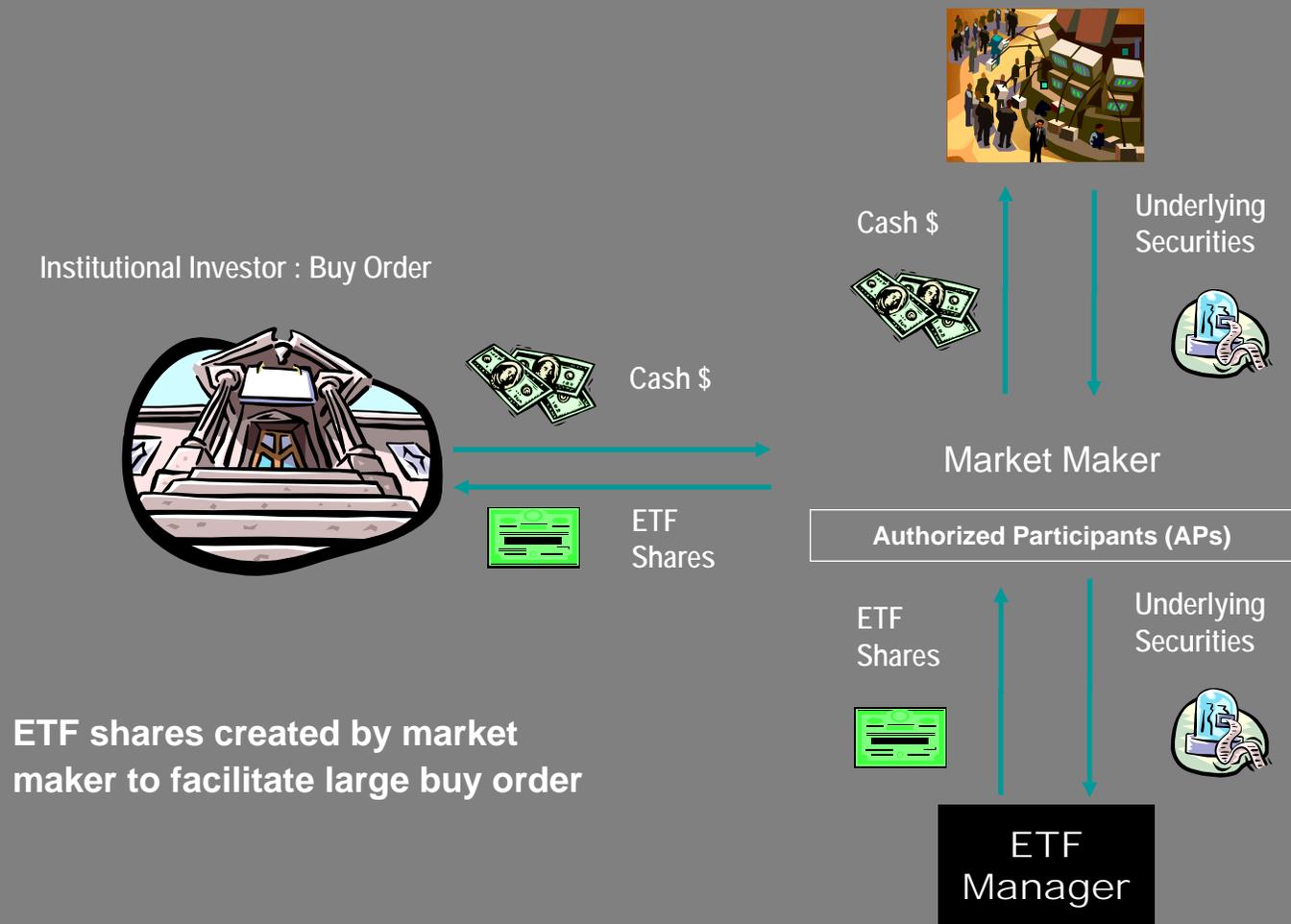
Mutual Fund Transaction: End of day and directly with fund



ETF Transaction: Throughout the day on an exchange



ETF Creation Process: Market Maker



Regulatory Process For ETFs

- **I. EXEMPTIVE APPLICATION AND ORDER**

- ETFs need relief from various sections and rules under the Investment Company Act: 2(a)(32), 5(a)(1), 22(d), 22(e), 22c-1, 17(a)(1), 17(a)(2), 12(d)(1)
- Can take one year for basic/simple relief, longer for more novel requests
- Future relief available
- Pending the SEC’s Division of Investment Management’s completion of its review, and possible update, of its various positions on derivatives, use of derivatives by actively managed 1940 Act ETFs is not currently permitted in new ETF applications. This creates an un-level playing field and increases the market value of existing “active management” applications/orders that permit the use of derivatives
- Certain disclosure required under exemptive relief (i.e., not individually redeemable)

- **II. 1934 ACT TRADING RELIEF**

- ETFs get relief from various 1934 Act sections and rules, including: 11(d)(1), 10b-10, 10b-17, 14e-5, 15c1-5, 15c-6, Rule 101 and 102
- Class relief is available and can be relied on for most types of ETFs

Regulatory Process For ETFs (cont.)

- **III. EXCHANGE LISTING REQUIREMENTS (1940 Act ETFs and 1933 Act ETPs)**
 - ETFs must meet exchange listing standards and other requirements
 - Generic listing rules are available for many types of ETFs (which can be approved by the Exchange under Exchange Act Rule 19b-4(e))
 - Unique products require exchange filing of listing rule (so called, “19b-4” applications)
 - For new 19b-4 applications, SEC’s Division of Trading & Markets takes increasingly activist positions
 - Derivatives use by 1933 Act ETPs is permitted but Trading & Markets has been applying prioritization and specificity requirements (exchange-traded over privately negotiated transactions)
- **IV. REGISTRATION STATEMENT**
 - 1940 Act ETFs must comply with requirements of Form N-1A; reviewed by Division of Investment Management (2009 amendments for ETFs)
 - 1933 Act ETPs must comply with requirements of Form S-1 (or S-3 if a well-known, seasoned issuer); reviewed by Division of Corporate Finance

Exotic ETFs/ETPs/ETNs

- In light of market saturation of plain vanilla ETFs, exotic ETFs are proliferating (particularly those with alternative strategies that seek alpha), including:
 - Long/short, managed futures, leveraged/inverse (up to 3X, -3X)
- Because of relatively recent market demand for commodity and currency exposure, Commodity ETPs are popular:
 - Commodity ETPs may be formed under the 1940 Act or as 1933 Act ETPs
 - CFTC has proposed changes to CPO Rule 4.5, which would require dual registration for 1940 Act funds investing in commodities and futures
- ETNs are unsecured and unsubordinated debt obligations typically issued by large banks

Affiliation Issues for Issuers

- 1940 Act imposes restrictions on ETF activities with affiliates
 - Trading
 - Service providers
- Service contracts with other ETFs may include anti-competitive restrictions that are triggered

Suspension of Creations and Redemptions

- **Suspending Creations**
 - An issuer may need to suspend due to numerous events or market conditions (e.g., SEC short sale ban, unexpected or elongated foreign exchange closing, sector disruptions)
 - Permissible under the 1940 Act, as long as consistent with charter documents, disclosure documents and Board directives
 - Suspending creations will likely necessitate press release and close coordination with service providers and the listing exchange
- **Suspending Redemptions**
 - Generally not permitted under the 1940 Act or the exemptive relief obtained thereunder
 - No CFTC, NFA, FINRA rule would prohibit a 1933 Act-only ETF from suspending redemptions although the ETF and its sponsor should consider that: (i) there may be a reputational risk in doing so; and (ii) the listing exchange may consider this a violation of the listing agreement and listing application if suspensions continue for a period of time.

Regulatory Issues

- SEC Staff views
 - Proposed 2008 exemptive rule
 - Concerns about custom baskets
 - *Tax issues*
 - *Pricing concerns*
- SEC and CFTC Harmonization
 - Commodity pool registration as an “end-around” of SEC

Regulatory Issues

- Flash Crash
 - Causes and Effect on ETFs
 - SEC-CFTC Joint Report issued September 30, 2010
 - Up/Down Limits
 - *On April 5, 2011, SEC announced forthcoming “limit up-limit down” proposal*

Regulatory Issues

- Potential for System Risk
 - Short sales - A single share may be borrowed multiple times, but only the person in possession of the share owns it
 - “Run on Funds”
 - Regulation by Financial Stability Oversight Council?

AP Agreements

- 1940 Act ETFs
 - Between AP and Distributor
 - Often include or are accepted by Transfer Agent
 - Procedures for creation and redemption transactions typically included as handbook or annex and can only be minimally modified
 - Funds and Advisers typically not party to agreement, but may execute side letter with prospectus representation
 - Note: “underwriter” language and scope of indemnities

AP Agreements

- 1933 Act ETPs
 - Between AP, Funds and Sponsor/Managing Owner
 - Many provisions similar to 1940 Act ETF AP agreements
 - Include Officer's Certificate from Sponsor/Managing Owner (analogous to side letter in 1940 Act ETF context)
 - Language regarding treatment of AP as statutory underwriter typically bolder than 1940 Act ETF agreements
 - Note: scope of indemnities

Statutory Concerns

- Because creation of shares is ongoing, ETFs are deemed to be in continuous distribution under 1933 Act
- APs, depending on facts and circumstances, could be treated as statutory underwriters
- 1933 Act: underwriters are strictly liable for
 - material misstatements/omissions in registration statement (§11)
 - material misstatements/omissions in prospectus (§12(a)(2))
- 1933 Act provides affirmative due diligence defense – “reasonable investigation” (§11) and “exercise of reasonable care” (§12)
 - What is the right framework within which to do diligence on a fund in continuous distribution?

Prospectus Delivery – 1940 Act ETFs

- §5(b)(2) of 1933 Act requires offer or sale of security to be accompanied or preceded by a §10 prospectus, unless exemption available
 - APs and broker-dealers acting as dealers are obligated to deliver a prospectus and cannot rely on “access equals delivery” (Rule 172(d)(1))
 - *Exchange listing rules require broker-dealers to deliver the prospectus (so firms acting as “dealers” do not have Rule 174)*
 - *APs must deliver final prospectus for on-exchange sales unless Rule 153 exception is available when AP is acting as exchange market maker*
 - *Delivery required for off-shore sales made to foreign investors*
 - *Availability of 4(4) exemption – read narrowly; unsolicited sale*
 - Rule 15c2-8 – 48-hour rule for new issuers
 - *In connection with an issue of securities, the issuer of which has not previously been required to file reports pursuant to [Sections 13\(a\)](#) or [15\(d\)](#) ... such broker or dealer shall deliver a copy of the preliminary prospectus to any person who is expected to receive a confirmation of sale at least 48 hours prior to the sending of such confirmation*
 - Delivery prior to sale so that investor can make an informed investment decision
 - No Rule 139 for research on 1940 Act funds

Prospectus Delivery

- 1933 Act ETPs:
 - Although CFTC and NFA regulated, interests in 1933 Act ETPs are still “securities” and §5 prospectus delivery applies
 - May rely on “access equals delivery” (Rule 172) but cannot take advantage of because of contractual obligations
 - Exchange rules do not appear to impose delivery obligations
 - CFTC and NFA rules regarding disclosure document delivery apply only to commodity pool operator
 - *CPOs pass on obligations to APs contractually*
 - *Non-AP dealers should be able to rely on Rule 174 to not deliver*

Extension of Credit on ETF Shares

- §11(d)(1) of 1934 Act
 - Generally prohibits a person acting as both a broker and a dealer from extending, maintaining or arranging for credit on any security sold by it as part of a new issue in the distribution of which the person participated as a member of a selling syndicate until thirty days after breaking syndicate.
 - Interpreted to apply to secondary market transactions.
- Rule 11d1-2
 - Provides an exemption from § 11(d)(1) for securities issued by a registered investment company with respect to transactions by a broker-dealer who extends credit on such shares, provided the person has owned the security for more than thirty days.
- Class relief granted in Nov. 2005 and subsequent grants of exemptive relief thereafter permit APs and broker-dealers to extend credit on ETF shares beginning 30 days after launch of ETF – provided no receipt of 12b-1 fees or revenue share
 - Custom relief granted for commodity ETFs, fund-of-fund ETFs and actively-managed ETFs

Affiliation of APs with 1940 Act ETFs

- Holding in excess of 5% - Section 17(a) of 1940 Act prohibits trading as principal and 17(e) requires procedures for agency trading
- Section 2(a)(3) of 1940 Act defines “affiliate” as (i) holding 5% of voting securities, or (ii) controlled, controlling, or under common control with
 - Irrevocable proxy (can be built into AP agreement)
- Section 2(a)(9) of 1940 Act presumes control at 25%; other considerations of “control”:
 - Board representation
 - Agreements or arrangements
 - Discretion of ETF managers (i.e. index licensor?)

Marketing and Research Materials – 1940 Act ETFs

- Research and other sales materials (other than institutional sales materials) required to be filed with FINRA within 10 days of use
 - If materials include Rankings, must be pre-filed
- Material must be deemed to be an “offer” or recommendation
 - Issues for quantitative research
- How to avoid sale material being “illegal prospectus”
 - Rule 482 – imposes strict requirements for display of performance
 - Firm will have prospectus liability on materials
- FINRA content requirements: no projections; must show NAV performance (although may show price performance as well); must avoid exaggerated/unwarranted claims
 - Recirculation required if FINRA has material comments

Marketing and Research Materials – 1933 Act ETFs

- Must be filed with FINRA as DPPs; subject to content requirements of R. 2210
- Communications must also comply with NFA requirements, including:
 - Review and approval in writing by a supervisory employee
 - Performance must be calculated under CFTC Rule 4.25(a)(7)
 - *Based on 12 consecutive months of performance and current as of a date no more than three months preceding the date of the material (i.e., figures should not be stale and include year-to-date figures)*
 - *Computed on a monthly compounded basis*
 - *Calculated by dividing net performance by the beginning NAV of the ETF or some other method approved by the CFTC*
 - *Must use time-weighting for additions and withdrawals, and*
 - *Must reflect compounded rate of return*
 - NFA approval not required except for television/radio ads and to make a specific trade recommendation or reference past or potential profits

Marketing and Research Materials - ETNs

- No FINRA filing required unless free writing prospectus that is “broadly disseminated” (i.e., on website)
 - **FINRA has been focused on marketing material for structured notes**
 - *FINRA Sweep in 2010 on ETN Marketing Materials*
 - *NTMs on reverse convertibles (Reg. Notice 10-09, Feb 2010);*
 - *UBS settlement on Lehman notes (2/2011 – material misstatements and omissions in sale of Lehman principal protected notes)*
 - failed to disseminate adequately to its FAs and provide sufficient guidance on the use of certain information, including issuer credit risk and widening of credit default swap spreads, as they related to Lehman’s financial strength during the relevant period;
 - *Santander settlement (2/2011 – unsuitable sales of reverse convertibles)*

ETFs - Anti-Manipulation Considerations

Reg. M

- Rule 101 prohibits any "distribution participant" from bidding for, purchasing, or attempting to induce any person to bid for or purchase any security which is the subject of a distribution until after the applicable restricted period
 - SEC relief allows for creations and redemptions and secondary market trading
- Rule 102 prohibits issuers, selling security holders, or any affiliated purchaser from bidding for, purchasing, or attempting to induce any person to bid for or purchase a covered security during the applicable restricted period in connection with a distribution
 - SEC relief allows for redemptions

Sections 9(a)(2) and 10(b) and Rule 10b-5

- “It shall be unlawful for any person, directly or indirectly... to effect, alone or with one or more other persons, a series of transactions in any security ... with respect to such security creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.”

Short Sales

- Stock shorting only permitted when last price movement is positive (Uptick Rule – formerly Rule 10a-1)
 - ETFs were exempt on case-by-case basis, allowing shorts even if price of an ETF's shares was decreasing – theory that ETFs have sufficient liquidity and enough buyers that could take long position
- June 2010 Pilot Program
- As of February 28, 2011, short sale circuit breaker Rule 201 under Reg. SHO does not exempt ETFs
 - However “the circuit breaker approach of Rule 201 will generally result in the majority of ETFs not being subject to its short sale price test restrictions because ETFs are generally diversified” (see Release 34-61595 (Feb. 26, 2010))

Sales of Foreign ETFs in U.S. Market

- Limited to accredited investors and qualified purchasers
- Section 12(d)(1) ownership limits - How to measure?
- Measures would be required to minimize characterization as public offering in violation of §5
- ERISA implications

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- Ms. Bullitt represents both registered and unregistered investment advisers in connection with a broad range of regulatory issues, including compliance issues under the Investment Advisers Act of 1940, fiduciary issues, and trading and market practices. Her clients include traditional money managers, pension plan advisers, and mutual fund advisers, as well alternative managers.
- Prior to joining Morgan Lewis, Ms. Bullitt was an executive director and counsel at Morgan Stanley. While there, she advised the Institutional Equity Division, the Private Wealth Management Division, and the Retail Division, and developed training and policies and procedures addressing a number of different areas of the federal securities laws.
- Ms. Bullitt received her J.D., cum laude, from the University of Michigan Law School in 1987, where she was a member of the *University of Michigan International Law Journal*. She received her B.A. in East Asian studies from Yale University in 1982.

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- Prior to joining Morgan Lewis, Mr. Donohue was the director of the Division of Investment Management at the U.S. Securities and Exchange Commission (SEC) from May 2006 to November 2010, where he was responsible for developing regulatory policy and administering the federal securities laws applicable to mutual funds, ETFs, closed-end funds, variable insurance products, UITs, and investment advisers.
- Before joining the SEC staff, Mr. Donohue served as global general counsel for Merrill Lynch Investment Managers and as executive vice president, general counsel, director, and member of the executive committee for OppenheimerFunds, Inc.

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- From 2005 through 2010, Mr. McGuire was named one of the leading U.S. lawyers for investment management by Chambers USA, based on the views of clients, peers, and other industry professionals. Mr. McGuire was also selected by Ignites, one of the pre-eminent sources for news about the mutual fund industry, as the 2008 "Fund Titan" in the category of "Outside Counsel."

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- Mr. Pershkov counsels clients on a wide variety of regulatory and transactional matters, including investment adviser and broker-dealer advertising; the development of new products and services; federal and state registration and compliance issues; SEC, FINRA, and state investigations and enforcement actions; mergers and acquisitions involving investment companies and investment advisers; interpretive and "no action" letter requests; and SEC exemptive orders.
- From 2006 through 2010, Mr. Pershkov was vice president and counsel at ProFund Advisors LLC.

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