TRANSACTIONAL & SECURITIES

Legal News Alert[SM]

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Legal News Alert is part of our ongoing commitment to providing up-to-the minute information about pressing concerns or industry issues affecting our transactional and securities clients and colleagues.

If you have any questions about this newsletter or would like to discuss this topic further, please contact your Foley attorney or the following individuals:

Patrick D. Daugherty
New York, New York
212.838.3547
pdaugherty@foley.com

George T. Simon
Chicago, Illinois
312.832.4554
gsimon@foley.com

SEC Proposes Rules for Exchange-Traded Funds

The U.S. Securities and Exchange Commission (SEC) has proposed new rules regulating exchange-traded funds (ETFs) that will simplify the process for bringing ETFs to market and will permit institutions to invest in ETFs to a greater extent than is now allowed.[1] The rules, which codify exemptive orders the SEC has issued to ETFs, are designed to eliminate unnecessary regulatory burdens and to facilitate greater competition and innovation among ETFs and other investment funds. The most sweeping change in the proposed rules would allow ETFs, including fully transparent, actively managed ETFs, to begin operating without obtaining individual exemptive orders from the SEC. The SEC notes that the new rules should allow more ETFs to come to market, particularly smaller ETFs. With these new rules, ETFs may significantly challenge mutual funds for primacy among investors.

Description of ETFs

ETFs are similar to mutual funds in that they offer investors an interest in a pool of securities and other assets. Unlike a mutual fund, however, shares of an ETF are bought and sold throughout the day on a stock exchange, not directly from the fund. Only "Authorized Participants," large institutional investors that enter into an agreement with the fund's distributor, are permitted to purchase and redeem shares directly from the fund and only in large aggregations called "Creation Units" that are worth several million dollars. Authorized Participants may hold the Creation Units they purchase or sell the ETF shares in the secondary market, enabling individual investors to then buy and sell ETF shares on an exchange.

Like shares of stock of other types of issuers, ETF shares are bought and sold on a stock exchange based on a bid-offer market. Creation Units purchased or redeemed directly from the fund are priced at the aggregate net asset value of the shares in the Creation Unit. Shares trading on an exchange usually track their underlying net asset value closely because Authorized Participants arbitrage price differences between trading prices and net asset value by purchasing or redeeming Creation Units from the fund. To facilitate arbitrage, exchanges that list ETFs disclose the approximate value of a Creation Unit based on the ETF's holdings every 15 seconds,

[1] *Exchange-Traded Funds*, Release Nos. 33-8910 and IC-28193 (March 11, 2008) — http://www.sec.gov/rules/proposed/2008/33-8901.pdf. Comments on the proposal are due on May 19, 2008.

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which is referred to as the "Intraday Indicative Value." Further, the portfolio of securities held by ETFs is fully transparent in that ETFs disclose their entire holdings on a daily basis. Portfolio transparency is one method of ensuring that Authorized Participants will be able to accurately estimate the value of a Creation Unit.

Initially, all ETFs were "index-based" and tracked a broad index. Eventually, narrow indexes designed specifically for ETFs were created, some of which were maintained by an affiliate of the ETF's advisor. In February 2008, the SEC approved four exemptive applications for the operation of "actively managed ETFs" that do not track an index but instead have portfolio managers who select securities consistent with the investment policies and objectives of the ETF.

Relief From the Requirement to Obtain Exemptive Order

Presently, all ETFs are required to obtain exemptive relief from the SEC's Division of Investment Management from various rules and provisions of the Investment Company Act of 1940 (Investment Company Act). The process of obtaining exemptive relief involves significant expense and typically takes several months. Proposed Rule 6c-11 under the Investment Company Act will enable most ETFs, including fully transparent, actively managed ETFs, to begin operations without obtaining individual exemptive relief from the SEC.

Proposed Rule 6c-11 codifies the following conditions that the SEC has imposed on ETFs through the exemptive application process:

- **Transparency of the ETF portfolio:** The ETF must disclose the following information on its Web site each business day: (1) the prior business day's net asset value, (2) the closing market price of the ETF's shares, (3) the premium or discount of the closing market price against the net asset value of the ETF's shares as a percentage of net asset value, and (4) either (a) the identities and weightings of the component securities and other assets of the ETF's underlying index (in the case of an index-based ETF) or (b) the identities and weighting of component securities and other assets held by the ETF (in the case of an actively managed ETF).
- **Listing on a national securities exchange and disclosure of the ETF's Intraday Indicative Value:** ETF shares must be approved for listing and trading on a national securities exchange under Section 12(d) of the Securities Exchange Act of 1934. Further, the ETF must issue Creation Units in exchange for a deposit of assets, the current value of which is disseminated on a per-share basis by a national securities exchange at regular intervals during the trading day.
- Marketing: An ETF's sales literature must clearly state that the ETF does not sell or redeem individual shares and explain that investors may purchase or sell individual shares on a national securities exchange. This is to prevent investors from confusing ETFs and mutual funds.

Proposed Rule 6c-11 does not limit the types of indices that an ETF may track or dictate the type of securities that must comprise an index followed by an ETF. The rule also does not restrict an ETF sponsor from maintaining its own index.

Registration Statement Disclosure

The SEC also proposes changes to Form N-1A, the registration statement used to register shares of an ETF. These changes are designed to improve the information provided to individual investors who purchase and sell ETF shares in the secondary market and to eliminate information not relevant to individual investors. The proposed changes would require ETFs to include in their prospectuses returns based upon the market price of their shares, which will more closely reflect an investor's actual return, as well as returns based upon the shares' net asset value. Also, an ETF would be required to disclose on its Web site and in its prospectus information regarding how closely the market price of the ETF's shares tracks the fund's net asset value. This premium/discount information must also disclose historical information regarding how often the market price and net asset value have deviated. The SEC is also proposing changes to ETF annual reports, which would require ETFs to report their investment returns using both market prices and net asset value, and to include a table with premium/discount information. Additionally, the SEC is proposing to amend the prospectus and annual report requirements of Form N-1A to require all index-based ETFs to compare their performance to their underlying indices instead of a different benchmark index. This will enable investors to evaluate whether the ETF is meeting its performance objectives.

In another release, the SEC has proposed prospectus delivery reforms for ETFs and mutual funds.[2] If adopted, ETFs and mutual funds will be able to satisfy prospectus delivery obligations by providing a short summary prospectus and posting the full prospectus to a Web site. Previously, the

[2] *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies,* Investment Company Act Release No. 28064 (Nov. 21, 2007).

SEC had allowed some ETFs to deliver brief "product descriptions" in lieu of a full prospectus but the SEC proposes rescinding that relief in conjunction with the new prospectus delivery reforms.

Relaxation of Restrictions on Investing in ETFs

The SEC also proposes new Rule 12d1-4 under the Investment Company Act, which would allow mutual funds and other investment companies to make larger investments in ETFs. Currently, these investment companies may acquire only three percent of an ETF's shares under Section 12(d)(1) of the Investment Company Act. Under the proposed rule, a mutual fund or other investment company may acquire securities of an ETF above the three percent limit, subject to the following conditions:

- **Control:** An acquiring fund may not rely on the rule if it exercises controlling influence over the ETF's management or policies. Under the Investment Company Act, there is a rebuttable presumption that an investor who beneficially owns more than 25 percent of the voting securities of an investment company controls that company.
- **Redemptions:** Proposed Rule 12d1-4 contains two provisions that would prevent an acquiring mutual fund or investment company from redeeming ETF shares it acquired in reliance on the proposed rule. First, the rule prohibits any acquiror that relies on the new rule from redeeming the shares in excess of the three percent limit. Second, the rule prohibits an ETF, its distributor, and a broker-dealer that relies on the rule from redeeming those shares acquired in excess of the three percent limit. These restrictions are designed to prevent a shareholder from coercing or influencing the ETF by threatening a large redemption.
- **Three-tier fund structures:** To avoid overly complex, multi-tiered fund structures, the proposed rule prohibits an ETF whose shares are acquired from itself from being a fund of funds. Without this restriction, an acquiring fund has the potential to become a complicated structure and investors may not be able to determine the nature and value of the holdings ultimately underlying an investment.
- **Fees:** To prevent duplicative or layered fees, the proposed rule limits sales charges and service fees charged by the acquiring mutual fund or investment company to those set forth in the Financial Industry Regulatory Authority's sales charge rule, which takes into consideration fees charged at both levels of a fund of funds structure.

Foley is a leading law firm serving the ETF industry and has a history of innovation in the ETF area. The firm counsels the entire range of industry participants – from index providers and fund sponsors to stock exchanges, specialists, investment advisors and sub-advisors, banks and institutional investors. The firm was instrumental in bringing StreetTracks Gold, the first commodity-based ETF, to market and serves as lead counsel to the CurrencyShares/M7 Ventures products, the first ETFs that track foreign currencies. The CurrencyShares/M7 Ventures products cover eight foreign currencies and have attracted over $3.25 billion in total assets. Foley also serves as special regulatory counsel to Bear Stearns Current Yield Fund, which is the first actively managed ETF to obtain approval from the SEC to trade on a U.S. stock exchange.

ABOUT FOLEY

The attorneys of Foley's Transactional & Securities Practice provide sophisticated legal advice on the issues most important to public and private companies, including all aspects of merger and acquisition transactions, capital markets transactions, securities matters, investment company matters, corporate governance and counseling, and other matters. We are a significant resource for organizations worldwide in need of insightful and innovative legal and business counsel.

Jay O. Rothman
Milwaukee, Wisconsin
414.297.5644
jrothman@foley.com

Foley.com