The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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March 24, 2008

SEC proposed Rules to Permit Certain ETFs to Operate Without Exemptive Relief from the Investment Company Act of 1940; Conference Call March 31 at 2:00 p.m.

[22365]

March 24, 2008

TO: ETF ADVISORY COMMITTEE No. 4-08SEC RULES COMMITTEE No. 24-08SMALL FUNDS COMMITTEE No. 11-08UNIT INVESTMENT TRUST COMMITTEE No. 6-08 RE: SEC PROPOSED RULES TO PERMIT CERTAIN ETFS TO OPERATE WITHOUT EXEMPTIVE RELIEF FROM THE INVESTMENT COMPANY ACT OF 1940; CONFERENCE CALL MARCH 31 AT 2:00 P.M.

The Securities and Exchange Commission has proposed Rule 6c-11 under the Investment Company Act of 1940, which would permit certain exchange-traded funds to begin operating without obtaining exemptive relief from the Commission.[1] In conjunction with this proposed rule, the SEC has proposed amendments to its disclosure form for open-end investment companies, Form N-1A, to provide more useful information for ETF investors. The Commission also has proposed Rule 12d1-4 to permit investment companies to invest in ETFs to a greater extent than is currently permitted under the Investment Company Act. Exemptive relief from those restrictions has been granted to ETFs in the past. Finally, the Commission has proposed to amend Rule 12d1-2 to permit affiliated funds of funds to invest in assets other than securities. The proposed rules and form amendments are summarized below.

Comments on the proposed rules are due no later than May 19, 2008. We will hold a conference call on Monday, March 31 at 2:00 EDT to discuss the proposal. The dial-in number is 800/857-1754 and the passcode is 33148. If you plan to participate on the call,

please r.s.v.p. to Maureen Maher at mmaher@ici.org or 202/326-5823. If you are unable to participate on the call, you may provide your comments to Mara Shreck at mshreck@ici.org or 202/326-5923.

Proposed Rule 6c-11

Scope of Proposed Rule – Index-Based and Actively Managed ETFs

To organize and operate, ETFs require exemptive relief from a number of provisions of the Investment Company Act and the rules thereunder.[2] Since 1992, the SEC has granted 61 exemptive orders to ETFs and their sponsors. Historically, the ETFs that have been granted such relief have had a stated investment objective of maintaining returns that correspond to the returns of a securities index whose provider discloses on its web site the identities and weightings of the component assets of the index daily. Recently, the Commission issued exemptive orders to several actively managed ETFs and their sponsors. These orders require the actively managed ETF to disclose on its web site the identities and weightings of the assets held by the ETF.

As the Proposing Release explains, in 2001 the Commission sought comment on the concept of actively managed ETFs.[3] Commenters agreed that actively managed ETFs, like index-based ETFs, should have an arbitrage mechanism intended to minimize the potential deviation between the ETF's market price and the NAV of an ETF share. There was less agreement, however, on whether the Commission should be concerned with the extent of premiums or discounts – i.e., with the efficiency of the arbitrage mechanism. Full portfolio transparency is believed to promote the efficiency of an arbitrage mechanism.

Proposed Rule 6c-11 would codify the exemptive relief provided to both index-corresponding and actively managed ETFs that disclose their portfolio holdings daily, or that correspond to an index that discloses its holdings daily. The Proposing Release solicits comment on whether the Commission should allow fully transparent actively managed ETFs to rely on the proposed rule, and on whether it should consider exemptions for other types of actively managed ETFs.

Conditions

Proposed Rule 6c-11 would provide ETFs organized as open-end funds[4] with exemptions from several provisions of the Investment Company Act and the rules thereunder, subject to certain conditions. The conditions generally mirror the conditions of the exemptive relief previously provided to ETFs. The Proposing Release requests comment on each condition.

Transparency: To rely on the proposed rule, an ETF must either (1) disclose on its web site each business day the identities and weightings of the component securities and other assets held by the fund, or (2) have a stated investment objective of obtaining returns that correspond to the returns of a securities index whose provider discloses daily on its web site the identities and weightings of the component securities and other assets of the index.

The Proposing Release seeks comment on these conditions, including whether: (1) the second alternative is necessary; (2) ETFs should also be required to disclose their liabilities,

to permit investors to evaluate the impact of leverage on the portfolio; and (3) the rule should require disclosure of portfolio changes more than once per day.

Listing on a National Securities Exchange and Dissemination of Intraday Value: For an ETF to rely on the proposed rule, its shares must be approved for listing and trading on a national securities exchange, and a national securities exchange must disseminate the Intraday Value at regular intervals during the day.[5]

Marketing: The proposed rule would require an ETF relying on the rule to identify itself in any sales literature as an ETF that does not sell or redeem individual shares, and to explain that investors may buy or sell shares in secondary market transactions.

Conflicts of Interest: The Proposing Release explains that the operation of an ETF – specifically, the process of purchasing a creation unit – could give rise to conflicts of interest for the ETF's investment adviser, which has discretion to specify securities contained in the basket of assets. This conflict would be minimized for index-based ETFs, because the universe of securities that may be included in those funds' portfolios is limited. With respect to actively managed ETFs, however, these conflicts do not seem different from those that currently exist for actively managed mutual funds.

The proposed rule does not include conditions designed to address this type of conflict. The Proposing Release explains that advisers to ETFs are subject to Section 48(a) of the Investment Company Act, which prohibits a person from doing indirectly, through another person, what that person is prohibited by the Act from doing directly. The Proposing Release solicits comment on whether it would be useful to include a condition in the proposed rule reminding ETFs of these prohibitions.

Affiliated Index Providers: Previously granted exemptive relief for ETFs with affiliated index providers imposed a number of specific requirements designed to prevent the misuse of non-public information.[6] The Proposing Release explains that federal securities laws and the rules of national securities exchanges already require funds and their advisers to adopt measures reasonably designed to accomplish this purpose. Thus, the proposed rule does not include the conditions from existing exemptive orders.

Exemptive Relief

Subject to the conditions described above, which are designed to address the concerns underlying the relevant sections of the Investment Company Act, proposed Rule 6c-11 would permit ETFs to operate without individual exemptive relief from the following requirements. The Proposing Release requests comment on each element of the proposed relief.

Issuance of "Redeemable Securities": Because ETFs issue shares that are redeemable only in creation units, they require exemptive relief from sections 2(a)(32)[7] and 5(a)(1).[8] As explained in previous ETF exemptive applications, this relief is appropriate because the market price of ETF shares is disciplined by arbitrage opportunities, so that investors in ETFs generally should be able to sell shares in the secondary market at approximately their NAV.

Proposed Rule 6c-11 would deem an equity security issued by an ETF to be a "redeemable security" under Section 2(a)(32). To promote the arbitrage function necessary for this relief, the rule would require that an ETF establish creation unit sizes containing a number of shares "reasonably designed to facilitate arbitrage." The Proposing Release requests comment on the proposed requirement for creation unit size, including whether: (1) the proposed requirement provides sufficient guidance to the ETF sponsor in setting appropriate thresholds; (2) it should contain minimum or maximum numerical thresholds; and (3) it should instead require the board of directors to make a finding that the ETF is structured in a manner reasonably intended to facilitate arbitrage.

The Proposing Release explains that creation units are exchanged for the deposit or delivery of a basket of securities and other assets. The proposed rule defines "basket assets" to mean the securities or other assets specified each business day by the ETF for which it will issue or redeem ETF shares. The rule would not require the basket to mirror the portfolio of the ETF, because in some circumstances it may not be practicable, convenient or operationally possible for the ETF to operate on an in-kind basis. This is consistent with previously granted exemptive orders.

Trading of ETF Shares at Negotiated Prices: Because their shares are traded on the secondary market at negotiated prices, ETFs require exemptive relief from Section 22(d) of the Investment Company Act and Rule 22c-1. Together, these provisions essentially prohibit the sale of a redeemable security by a dealer except at a current offering price described in the prospectus, and based on its NAV. The Proposing Release explains that these provisions are designed to prevent dilution and preferential treatment among investors.

The proposed rule would exempt a dealer in ETFs from these provisions with regard to transactions related to ETF shares in the secondary market at current market prices. This relief was previously granted in exemptive orders because the arbitrage function appears to address the potential concerns that these provisions were designed to address. Additionally, secondary market trading should not cause dilution for ETF shareholders because those transactions do not involve ETF portfolio assets and therefore have no direct impact on the NAV of ETF shares held by other investors.

In-Kind Transactions Between ETFs and Certain Affiliates: Section 17(a) of the Investment Company Act generally prohibits an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security to or purchasing any security from the company. Persons may be deemed affiliates of an ETF because they own 5 percent or more, or in some cases more than 25 percent, of an ETF's outstanding securities ("first-tier affiliates"), or because they are affiliated with such persons ("second-tier affiliates").

The proposed rule would grant exemptions from Sections 17(a)(1) and (2) to permit such affiliates to purchase and redeem creation units. This relief has been granted previously in exemptive orders because first- and second-tier affiliates are not treated differently from non-affiliates when engaging in purchase and redemption of creation units, and thus there is no opportunity for these affiliated persons to effect a transaction detrimental to the other ETF shareholders.

Additional Time for Delivering Redemption Proceeds: Section 22(e) of the Investment Company Act generally prohibits a registered open-end investment company from suspending the right of redemption, or postponing the date of satisfaction of redemption

requests for more than seven days after the tender of a security for redemption. Some ETFs that track foreign indexes have received relief from this provision, because local market delivery cycles for transferring securities to redeeming investors, together with local market holiday schedules, require a delivery process in excess of seven days.

The proposed rule would grant similar relief for ETFs with foreign securities in their basket assets. To rely on this exemption, the ETF would be required to disclose in its SAI the foreign holidays it expects to prevent timely delivery of the foreign securities, and the maximum number of days it anticipates it would need to deliver the foreign securities. The delivery would be required to take place no more than 12 calendar days after the tender of ETF shares.

The Proposing Release requests comment on several aspects of this provision, including: (1) whether it should apply when an ETF has a foreign security in its portfolio, but not its basket assets; (2) the definition of "foreign security" as "any security issued by a government or any political subdivision of a foreign country, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign country, and for which there is no established United States public trading market as that term is used in Item 201 of Regulation S-K under the Securities Exchange Act of 1934."

Disclosure Amendments

Proposed Rule 6c-11 would eliminate certain disclosure provisions currently available to ETFs under existing exemptive orders. In addition, the Commission has proposed certain changes to Form N-1A to improve disclosure to investors who purchase ETFs in the secondary market. The Proposing Release requests comment on each aspect of the proposal.

Delivery of Prospectus to Investors

Previously granted exemptive orders have exempted broker-dealers selling ETF shares from the obligation to deliver prospectuses in most secondary market transactions.[9] The applicants receiving this relief represented that broker-dealers would instead deliver a "product description" containing basic information about the ETF and its shares. Proposed Rule 6c-11 would not include a similar exemption, so broker-dealers would be required to deliver a prospectus meeting the requirements of Section 10(a) of the Securities Act of 1933 to investors purchasing ETF shares.

The Proposing Release explains that most broker-dealers currently do not take advantage of the existing relief, and send statutory prospectuses. Additionally, such relief may no longer be necessary in light of the Commission's pending proposal regarding summary prospectus disclosure.[10] If adopted, that proposal would require certain key information to appear in plain English in a standardized order in the front of a fund's prospectus (the "summary section"), and would permit funds to satisfy their delivery obligations by providing investors with a summary prospectus and making additional information available on the Internet. In that event, broker-dealers selling ETF shares could deliver a summary prospectus, rendering the product description relief unnecessary. The Proposing Release explains that if Rule 6c-11 were adopted before the summary prospectus proposal, ETFs would be permitted to deliver a product description in lieu of a prospectus until the resolution of that proposal.

Amendments to Form N-1A (and Summary Prospectus)

The proposed changes to Form N-1A are intended to accommodate the use of the form by ETFs and to better meet the needs of investors who purchase shares in secondary market transactions, rather than financial institutions purchasing creation units directly from the ETF. The Proposing Release solicits comment on this approach, and on whether the form should include information directed at both categories of investor, rather than eliminating certain disclosures relevant only to creation unit purchasers.

Purchasing and Redeeming Shares: The Commission proposes to amend Item 6 of Form N-1A to eliminate the requirement that ETFs disclose information on how to buy and redeem shares of the ETF, because such disclosure is not relevant to secondary market purchasers. Instead, ETF prospectuses would be required to state the number of shares contained in a creation unit, and that individual shares may only be purchased and sold on the secondary market through a broker-dealer. In addition, Item 3 would be amended to exclude from the fee table fees and expenses for purchases or sales of creation units. Instead, the ETF would be required to modify the narrative explanation preceding the example in the fee table to state that individual ETF shares are sold on the secondary market, and that investors may be required to pay brokerage commissions that are not reflected in the fee table. These amendments would not apply to ETFs with creation units of less than 25,000 shares, because more retail investors would be able to transact directly with an ETF that has smaller creation units.

Total Return: The proposed amendments would modify instructions to several items that require the use of the ETF's NAV to determine its return.[11] The instructions would require ETFs to also calculate returns based on the market price of fund shares. The market price would be defined as the last price at which ETF shares trade on their principal U.S. trading market during a regular trading session (i.e., closing price).

Premium/Discount Information: As in current exemptive orders, proposed Rule 6c-11 would require ETFs to disclose to investors, on their web sites and in their prospectuses, information about the extent and frequency with which market prices of fund shares have tracked the fund's NAV. ETFs would also be required to disclose on their web site the prior business day's last determined NAV, the market closing price of its shares, and the premium/discount of the closing price to NAV. Additionally, proposed Item 6(h)(4) of Form N-1A would require ETFs to disclose in their prospectuses the number of trading days, during the most recently completed calendar year and quarters since that year, on which the market price of the ETF shares was greater than the Fund's NAV and the number of days it was less than the fund's NAV. Unlike the exemptive orders, the rule would not require such information to be included on ETFs' web sites.

Periodic Report Information: The proposed amendments would also require ETFs to use the market price of fund shares in addition to NAV to determine their returns, and include a table with premium/discount information for the five recently completed fiscal years, in their annual reports.

Benchmark Index: The proposed amendments would require index-based ETFs to compare their performance to their underlying indices, rather than a benchmark index as currently required in the prospectus and annual report.

Summary Section/Summary Prospectus: As noted above, if the Commission adopts the pending summary prospectus proposal, a broker-dealer selling ETFs would be permitted to

satisfy prospectus delivery obligations by providing purchasers on the secondary market with a summary prospectus. The full prospectus would also contain a summary section at the front with the same information contained in the summary prospectus.

The Proposing Release summarizes the elements proposed to be contained in the summary section and the summary prospectus,[12] and indicates that the additional proposed disclosures discussed above would also be required in an ETF's summary prospectus. The Proposing Release requests comment on whether: (1) ETFs should be exempt from disclosing certain of the required items in the summary prospectus, such as the top ten portfolio holdings; and (2) for ETFs, any of the additional disclosures proposed in the Proposing Release or the summary prospectus disclosure should be located outside of the summary section or summary prospectus.

Amendment of Previously Issued Exemptive Orders

As noted above, unlike previously granted exemptive orders, proposed Rule 6c-11 would not exempt broker-dealers from the requirement to deliver a statutory prospectus.[13] The proposed rule would also amend exemptive relief previously granted to ETFs that are open-end funds to eliminate this exemption, and to require ETFs to satisfy their statutory prospectus delivery requirements.

Exemption for Investment Companies Investing in ETFs

Background – Previously Granted Relief under Section 12(d)(1)

Institutional investors, including registered investment companies, invest in ETFs for a variety of reasons. A fund's ability to invest in ETFs, however, is limited by Section 12(d)(1) of the Investment Company Act, which limits funds' investments in other funds. As the Proposing Release explains, this Section was enacted in response to concerns about "pyramiding," whereby investors in a fund acquire enough assets of another fund to gain control, and use the assets of the acquired fund to enrich themselves; Congress was also concerned about excessive fees and the formation of overly complicated structures.

The Commission's and Congress' views with respect to these concerns have changed over the years, as fund of funds arrangements have been created that serve legitimate purposes. In 1996, Congress granted the Commission specific authority to provide exemptions from this Section, and the Commission has done so, both by adopting rules and granting exemptive relief. In particular, the Commission has granted relief allowing the sale of shares issued by ETFs to unaffiliated funds in excess of the statutory limits, subject to certain conditions. The Proposing Release explains that ETF sponsors informed the SEC staff that certain of these conditions are cumbersome, and suggested that the staff reconsider the conditions in light of the concerns surrounding fund investments in ETFs.

Proposed Rule 12d1-4 Conditions

Proposed Rule 12d1-4 would permit acquiring funds to invest in ETFs in excess of the limits imposed by Section 12(d)(1), subject to four conditions that are designed to address the concerns regarding pyramiding and the threat of large-scale redemptions. Unlike the exemptive orders, the proposed rule would limit an acquiring fund's ability to

redeem ETF shares. The Proposing Release seeks comment on each of the conditions.

Control: The proposed rule would limit the exemption to an acquiring fund that does not "control" an ETF, as defined in Section 2(a)(9) of the Investment Company Act. The effect of the proposed rule would be that an acquiring fund's beneficial ownership of up to 25 percent of the voting securities of an ETF would not, by itself, constitute control over the ETF. If, however an acquiring fund used its ownership interest to exercise a controlling influence over the ETF, even if it owned less than 25 percent of the voting securities, it would not be able to rely on the proposed rule.

The rule would also require that if, as a result of a decrease in the outstanding voting securities of the ETF, the acquiring fund becomes an owner of more than 25 percent of the voting securities, it must vote its shares in the manner prescribed by Section 12(d)(1)(E) (i.e., in the same proportion as the vote of all other holders of the security).

Redemptions: Unlike the exemptive orders, the proposed rule would prohibit a fund from redeeming shares it acquired in reliance on the proposed rule. That is, shares acquired in excess of the three percent limit established by Section 12(d)(1)(a)(i) could not be redeemed directly with the ETF, but could only be sold on the secondary market. Thus, funds would not be able to threaten large-scale redemptions as a means of coercing an ETF.

The proposed rule would also prohibit an ETF, its underwriter, and a broker or dealer that relies on the rule to sell ETF shares in excess of Section 12(d)(1)(B) limits from redeeming those shares acquired by another fund that exceed the limits in 12(d)(1)(A)(i). Because these entities may not always know whether a redemption order is submitted by an acquiring fund that relied on the rule to acquire shares in excess of the three percent limit (and therefore in reliance on the rule), the proposed rule would include a safe harbor for these entities if they have: (1) received a representation from the acquiring fund that none of the shares it is redeeming were acquired in reliance on the rule; and (2) no reason to believe that the acquiring fund is redeeming shares it acquired in reliance on the rule.

Complex Structures: To avoid the creation of overly complex structures, the proposed rule would prohibit an acquired ETF from itself being a fund of funds. An acquiring fund could not rely on the rule to acquire an ETF unless the ETF has a disclosed policy that prohibits it from investing more than 10 percent of its assets in other investment companies or companies that would be investment companies under Section 3(a) of the Investment Company Act but for the exceptions provided by Sections 3(c)(1) and 3(c)(7).

Layering of Fees: To prevent duplicative fees, the proposed rule would limit sales charges and service fees charged by the acquiring fund to those set forth in the FINRA sales charge rule. In addition, acquiring funds would be subject to the disclosure rules regarding acquired funds.[14]

Scope of Proposed Rule 12d1-4

Acquiring Funds Eligible for Relief: Subject to the conditions set forth above, the proposed rule would permit open-end and closed-end management companies, including business development companies, and UITs to invest in ETFs beyond the limits of Section 12(d)(1).

Investments in Affiliated ETFs Outside the Fund Complex: The proposed rule would provide exemptions from Sections 17(a)(1), 17(a)(2), 57(a)(1) and 57(a)(2) of the Investment

Company Act. These provisions restrict a fund's ability to enter into transactions with affiliated persons. Because investors may be deemed affiliated persons by virtue of owning five percent or 25 percent of outstanding voting securities, this relief is necessary to permit acquiring funds owning five percent or more to make additional purchases and to deposit securities with the ETF using a creation basket.

Use of Affiliated Broker to Effect Sales: The proposed rule would also provide relief from Section 17(e)(2) of the Investment Company Act. This provision, and the rules thereunder, impose conditions on a fund transacting with an affiliated broker-dealer. A broker-dealer affiliated with an ETF may become a second-tier affiliate of an acquiring fund that owns more than five percent of the ETF. The proposed rule would permit an acquiring fund to pay commissions, fees or other remuneration to a second-tier affiliated broker-dealer without complying with the requirements set forth in the rules, so long as the affiliation is solely as a result of the acquiring fund's investment in the ETF.

Exemption for Affiliated Fund of Funds Investments

Affiliated Fund of Funds Investments in ETFs

Rule 12d1-2 currently permits affiliated funds of funds to invest in (1) securities issued by unaffiliated investment companies, subject to the investment limits in Sections 12(d)(1)(A) and (F) of the Investment Company Act; (2) securities not issued by an investment company; and (3) unaffiliated money market funds, in reliance on Rule 12d1-1. The Commission proposes to amend Rule 12d1-2 to permit acquiring funds that invest in affiliated funds in reliance on Section 12(d)(1)(G) to invest in unaffiliated ETFs beyond the statutory limitation (and the limitations established by (1) above), subject to the conditions of proposed Rule 12d1-4.

Affiliated Fund of Funds Investments in Other Assets

The Commission also proposes to amend Rule 12d1-2 to permit affiliated funds of funds to invest in "other assets" (i.e., assets other than securities). As explained in the Proposing Release, some funds relying on 12d1-2 wish to invest in assets that may not be securities under the Investment Company Act, including futures and other financial instruments. The Commission has previously granted exemptive orders to permit such investments.

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[1] See Exchange-Traded Funds, SEC Release Nos. 33-8901 and IC-28193 (March 11, 2008) ("Proposing Release"), available at http://www.sec.gov/rules/proposed/2008/33-8901.pdf.

[2] An ETF must have exemptive relief to redeem shares in creation unit aggregations, to trade at current market prices, to engage in in-kind transactions with certain affiliates and,

in certain circumstances, to pay the proceeds from the redemption of shares in more than seven days. As discussed below, the proposed relief would permit these activities subject to certain conditions.

[3] See Actively Managed Exchange-Traded Funds, SEC Release No. IC-25258 (Nov. 8, 2001) ("Concept Release").

[4] The proposed rule would not apply to ETFs organized as unit investment trusts. The Proposing Release requests comment on whether such ETFs should be included in the rule and, if so, whether they should be subject to the same conditions.

[5] The Intraday Value is an approximation of the current value of a share of the ETF. See Proposing Release at 11.

[6] See Proposing Release at note 106.

[7] Section 2(a)(32) defines "redeemable security" as any security the terms of which permit the holder upon presentation to receive the holder's proportionate share of the issuer's current net assets, or the cash equivalent.

[8] Section 5(a)(1) defines an "open-end company" as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer." As discussed above, the proposed rule would apply only to ETFs structured as open-end companies. See supra note 4.

[9] These orders have granted exemptions from Section 24(d) of the Investment Company Act, which makes the dealer exception in Section 4(3) of the Securities Act inapplicable to transactions in redeemable securities issued by an open-end fund.

[10] See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Release Nos. 33-8861 and IC-28064 (Nov. 21, 2007) ("Proposing Release"), available at http://www.sec.gov/rules/proposed/2007/33-8861.pdf.

[11] Proposed Instruction 5(a) to Item 2(c)(2); Proposed Instruction 3(f) to Item 8(a).

[12] See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Release Nos. 33-8861and IC-28064 (Nov. 21, 2007), available at http://www.sec.gov/rules/proposed/2007/33-8861.pdf.

[13] See supra note 9 and accompanying text.

[14] See Item 3(f) to Form N-1A (disclosure of acquired fund fees and expenses).
