

MEMO# 14132

November 13, 2001

SEC ISSUES CONCEPT RELEASE ON ACTIVELY MANAGED EXCHANGE TRADED FUNDS; CONFERENCE CALL SCHEDULED FOR DEC. 4TH TO DISCUSS RELEASE

[14132] November 13, 2001 TO: SEC RULES COMMITTEE No. 89-01 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 19-01 UNIT INVESTMENT TRUST COMMITTEE No. 24-01 RE: SEC ISSUES CONCEPT RELEASE ON ACTIVELY MANAGED EXCHANGE TRADED FUNDS; CONFERENCE CALL SCHEDULED FOR DEC. 4 TO DISCUSS RELEASE The Securities and Exchange Commission recently issued a concept release seeking comment on various issues relating to actively managed exchange traded funds (ETFs). * The SEC is interested in public comment on the concept of actively managed ETFs to help it in its consideration of any proposals for these products. The Commission's Release is summarized below. Comments are due to the SEC on the Release on or before 60 days after date of publication in the Federal Register. The Institute has scheduled a conference call on Tuesday, December 4, 2001 at 4 p.m. (EST) to discuss the issues raised in the SEC's Release. We will provide more details about the call shortly. If you are interested in participating on the call, contact Deborah Washington at 202-326-5818 no later than Wednesday, November 28th. If you do not plan to participate on the December 4th conference call, please provide your comments on the Release to the undersigned by phone (202) 326-5825 or e-mail (tamara@ici.org) no later than Monday, December 3rd. After discussing how current ETFs operate and their reported benefits and uses, the Release notes that, though actively managed ETFs may share some general similarities with index-based ETFs, there may be significant structural and operational differences between the two types of products. For example, the potential for less transparency in the portfolio of an actively managed ETF may make the process of creating and redeeming creation units more difficult or present greater investment risk for arbitrageurs, which could result in a less efficient arbitrage mechanism and lead to more significant premiums or discounts in the market price for the ETF's shares. The issues of interest to the SEC in reviewing this new product and determining what, if any, exemptive relief to accord it are summarized below. * See Release No. IC-25258 (November 8, 2001). The Release is available on the SEC's website at www.sec.gov/rules/concept/ic-25258.htm. 2 I. DEFINITION OF ACTIVELY MANAGED ETFs As a preliminary matter, the Release states that the Commission assumes that any ETF that would not seek to track the performance of a market index by either replicating or sampling the index securities in its portfolio would be an actively managed ETF. The Commission seeks comment on whether this is an appropriate way to distinguish between index-based and actively managed ETFs. It also questions whether there are reasons to distinguish between different types of actively managed ETFs and, if so, are there reasons to regulate

the various types differently? II. OPERATIONAL ISSUES RELATING TO ACTIVELY MANAGED ETFS After noting that index-based ETFs are, in part, designed to ensure that arbitrage opportunities would reduce any deviations between the NAV and the market price, the Release notes that two factors contribute significantly to the effectiveness of arbitrage in the structure of existing ETFs – the transparency of an ETF’s portfolio and the liquidity of the securities in the ETF’s portfolio. This being the case, the Release raises the following issues relating to actively managed ETFs: • What level of transparency in portfolio holdings is necessary to allow for effective arbitrage activity in the shares of an actively managed ETF? • Should an actively managed ETF be required to disclose the full contents of its portfolio or would disclosure of a sample or its general characteristics suffice? • Can effective arbitrage occur without disclosing specific securities in the portfolio? • How frequently should such disclosure be required; would intra-day changes need to be disclosed? • Would frequent disclosure lead to “front running” or “free riding”? • Would the fund’s investment adviser face a conflict between maximizing performance and facilitating arbitrage by informing the marketplace of the fund’s investment strategies? • Should there be restrictions on the types of securities in which an actively managed ETF can invest? (For example, should an actively managed ETF be prohibited from investing in securities other than equities? What about illiquid securities?) • Is it necessary for an actively managed ETF to create and redeem creation units through in-kind transactions (rather than cash transactions)? • Would significant deviations between the market price of shares of an actively managed ETF and the NAV of the ETF shares compromise the operations of the ETF? III. USES, BENEFITS AND RISKS OF ACTIVELY MANAGED ETFS The Commission seeks comment on ways in which investors may use actively managed ETFs and the potential benefits and risks of this product. Along these lines, the Release solicits comments on the following questions: • Does trading in ETF shares have any relation to market volatility and, if so, in what ways? Could actively managed ETFs lead to greater market volatility? 3 • Has the introduction of ETFs generally led to any undesirable consequences for investors? Would the introduction of actively managed ETFs be detrimental to investors? • Would closed-end funds seek to convert into actively managed ETFs as a possible means of addressing discounts in share price? • Why would an actively managed ETF be a desirable alternative to a mutual fund or closed-end fund that pursues the same investment objective or strategies? • What would be the principal benefits of actively managed ETFs? • Would actively managed ETFs possess the low expenses and tax efficiency associated with existing ETFs? • Would investors be confused about the nature of actively managed ETFs? IV. EXEMPTIVE RELIEF FOR ACTIVELY MANAGED ETFS The Release notes that because actively managed ETFs necessarily would be organized as open-end funds (rather than as UITs with fixed portfolios), these ETFs likely would seek exemptive relief from the same provisions of the Investment Company Act of 1940 as existing ETFs organized as open-end funds. The Release discusses the relief provided to existing ETFs organized as open-end funds and solicits comment on the issues that such relief may raise in connection with actively managed ETFs. A. Relief to Permit Redemptions in Large Aggregations Only Existing ETFs, which issue shares that are redeemable in creation units only, have been provided relief from Sections 5(a)(1) and 2(a)(32) of the Act to permit them to issue shares that are only redeemable as creation units. As a condition of obtaining such relief, ETFs organized as open-end funds have agreed not to advertise or market their shares as an open-end fund or mutual fund. With respect granting similar relief to actively managed ETFs, the Release raises the following issues: • Would actively managed ETFs present any issues with respect to these exemptions that do not exist with respect to index-based ETFs? • Should the potential for more significant deviations between the market price of actively managed ETF shares and the NAV of the shares affect any relief requested from the definition of “redeemable security”? • Are greater disclosure efforts necessary to address

any potential investor confusion regarding the nature of actively managed ETFs and their shares? B. Relief for ETF Shares to Trade at Negotiated Prices Existing ETFs have obtained exemptions from Section 22(d) of the Act and Rule 22c-1 thereunder to permit secondary market trading in ETF shares at negotiated prices rather than at a current offering price described in the prospectus or based on NAV. This relief has been granted, in part, based on representations by the ETFs that secondary market trading in such shares does not cause dilution for shareholders, result in unjust discrimination or preferential treatment among buyers, or disrupt the orderly distribution of shares. With respect to providing similar exemptions to actively managed ETFs, the Release solicits comment on the following:

- 4 • Would actively managed ETFs present any issues with respect to these exemptions that do not exist with respect to index-based ETFs?
- Would the potential for more significant deviations between the market price of actively managed ETF shares and the NAV of the shares: (i) create any potential for discrimination or preferential treatment among investors purchasing and selling shares in the secondary market and those purchasing and redeeming creation units?; or (ii) lead to a less orderly distribution system for actively managed ETF shares?

C. Relief for In-Kind Transactions Between an ETF and Certain Affiliates Index-based ETFs have been provided relief from Section 17(a) of the Act to permit 5% affiliates and 25% affiliates to purchase and redeem creation units through in-kind purchases. The SEC's Release seeks comment on whether actively managed ETFs present any issues with respect to this exemption that do not exist with respect to index-based ETFs. In particular, the Release seeks input on the following:

- If an actively managed ETF proposed to alter the contents of its portfolio deposit or redemption basket during the day to reflect changes in its portfolio, would this process introduce the potential to favor affiliated persons of the ETF? If so, how should this be addressed?
- Could a 5% or 25% affiliate influence decisions by the investment adviser to the fund regarding the securities in the portfolio deposit or redemption basket on a given day?
- Would the structure of an actively managed ETF present greater concerns with respect to potential advance communications about portfolio changes to affiliates?

D. Relief for Certain ETFs to Redeem Shares in More than Seven Days Some existing index-based ETFs that track foreign indices have obtained relief from Section 22(e) to permit them to satisfy redemption requests more than seven days after the tender of a security for redemption. This relief has been sought to accommodate local market delivery cycles for transferring securities, including local market holiday schedules. With regard to actively managed ETFs, the Commission solicits comment on whether (i) actively managed ETFs present any issues with respect to this exemption that do not exist with respect to index-based ETFs and (ii) an investment adviser to an actively managed ETF could manage the ETF so as to comply with Section 22(e).

V. POTENTIAL NEW REGULATORY ISSUES The Commission seeks comment on the following topics it has identified in connection with its consideration of actively managed ETFs and the potential regulatory issues they raise:

- Potential Discrimination Among Shareholders – Would the operation of an actively managed ETF place investors who have the financial resources to purchase or redeem a creation unit at NAV in a different position than most retail investors who may buy and sell ETF shares only at market price? Would the operation of an actively managed ETF give rise to a type of discriminatory treatment of shareholders?
- Potential Conflicts of Interest for an ETF's Investment Adviser – What potential conflicts of interest would exist for the investment adviser to an actively managed ETF?

5 Would the adviser to an actively managed ETF be in a position to create supply or demand for the securities that would favor an affiliate by designating those securities for inclusion in the daily portfolio deposit or redemption basket? Would the increased value of the information regarding the identity of future deposit or redemption securities create additional conflicts and potential for abuse? What measures should be taken to address any potential conflicts?

- Prospectus Delivery in Connection with Secondary Market Purchases – Would providing

actively managed ETFs relief from the prospectus delivery requirements of the Securities Act of 1933 be consistent with the public interest and the protection of investors? Are there any aspects of an actively managed ETF that would make such relief inappropriate (e.g., should the fund be required to deliver its prospectus to communicate its investment strategy or fundamental policies)? If, as with index-based ETFs, relief is granted on the condition that the fund provides investors with a product description, what information about the fund is particularly important to include or highlight in the product description?

VI. THE CONCEPT OF AN ACTIVELY MANAGED ETF AS CLASS OF A MUTUAL FUND The Release notes that in December 2000, the Commission issued the first order to permit certain existing index funds to create a class of shares that would be listed on a national securities exchange and traded in the secondary market at negotiated prices in the same manner as shares of ETFs. The index funds sought to create this new ETF class of shares to provide short-term investors and market timers with an attractive means of purchasing shares that could be bought and sold continuously throughout the day at market prices without increasing the fund's realization of capital gains or fund expenses or hindering its ability to achieve its investment objective of tracking its index. Creation of this class necessitated relief from Sections 18(f)(1) and 18(i) of the Investment Company Act because, among other things, the conventional shares and exchange-traded shares would have certain different rights (e.g., fund shares could be redeemed through the fund; the ETF class shares could only be redeemed as creation units). In light of this relief, the Release solicits comment on the following issues: • Would ETF classes of actively managed funds present any issues with respect to exemptions from Section 18 that do not exist with respect to ETF classes of index funds? • Would the portfolio disclosure required to make fund operations transparent for purposes of the ETF class prove detrimental to the performance of the conventional shares? • Would significant redemptions of conventional shares create undesirable tax consequences for ETF class shareholders? • Would the existence of an ETF class add volatility to an actively managed fund? • Is there any additional potential for conflicts of interest in connection with an ETF class of an actively managed fund? Tamara K. Reed Associate Counsel