**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 270**

**[Release No. IC–25258; File No. S7–20–01]**

**RIN 3235–AI35**

## Actively Managed Exchange-Traded Funds

**AGENCY:** Securities and Exchange Commission (''Commission'').

**ACTION:** Concept release; request for comments.

**SUMMARY:** The Commission is seeking comment on various issues relating to actively managed exchange-traded funds (''ETFs''). All existing ETFs are based on various equity market indices. An actively managed ETF would not track an index. This type of ETF currently does not exist, and the Commission is interested in public comments on this concept to help inform the Commission's consideration of any proposals for actively managed ETFs.

**DATES:** Comments must be submitted on or before January 14, 2002.

**ADDRESSES:** Persons wishing to submit written comments should send three copies of the comment letter to Jonathan G. Katz, Secretary, Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Comments also may be submitted electronically at the following E-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–20–01, and comments submitted by E-mail should include this file number in the subject line. Comment letters received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site *(http://www.sec.gov).* The Commission does not edit personal identifying information, such as names or E-mail addresses, from electronic submissions. Submit only the information you wish to make publicly available.

**FOR FURTHER INFORMATION CONTACT:** Michael W. Mundt, Senior Special Counsel, or Nadya B. Roytblat, Assistant Director, at (202) 942–0564 (Office of Investment Company Regulation, Division of Investment Management, Commission, 450 Fifth Street, NW., Washington, DC 20549–0506).

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## I. Introduction

### *A. The Popularity of ETFs*

The growing interest in exchange-traded funds (''ETFs'') is one of the notable developments in the area of investment management over the past few years. During the year 2000, the number of ETFs increased from 30 to 80, and the amount of assets held by ETFs nearly doubled from $34 billion to $66 billion.[1] While the total amount of ETF assets at the end of 2000 was still relatively small when compared to the approximately $4 trillion of assets in equity open-end investment companies (''open-end funds'' or ''mutual funds''), ETF assets were much closer to the $89 billion of total assets invested in unit investment trusts (''UITs'') and the $135 billion of total assets invested in closed-end investment companies (''closed-end funds'').[2] Moreover, during the first three quarters of 2001, net new investment in ETFs amounted to approximately $24 billion, as compared to approximately $13 billion for equity mutual funds.[3] By the end of September 2001, shareholders had invested more than $64 billion in a total of 92 ETFs.[4] Trading in ETF shares reportedly has accounted for as much as two-thirds of the daily volume on the American Stock Exchange (''AMEX'').[5]

### *B. What Are ETFs?*

ETFs are investment companies that are registered under the Investment Company Act of 1940 (''Act'') as open-end funds or UITs.[6] Unlike typical open-end funds or UITs, ETFs do not sell or redeem their individual shares (''ETF shares'') at net asset value (''NAV'').[7] Instead, ETFs sell and redeem ETF shares at NAV only in large blocks (such as 50,000 ETF shares). In addition, national securities exchanges list ETF shares for trading, which allows investors to purchase and sell individual ETF shares among themselves at market prices throughout the day. ETFs therefore possess

[1] Investment Company Institute (''ICI''), *Exchange-Traded Funds Statistical Collection,* Feb. 8, 2001. Except for this ICI release, the ICI statistical releases cited in this concept release may be found under ''Current Statistical Releases'' or ''Additional Statistical Releases'' at http://www.ici.org/facts_figures/.

[2] ICI, *Trends in Mutual Fund Investing July 2001,* Aug. 30, 2001 (for year-end 2000 mutual fund assets); *Unit Investment Trust Data July 2001,* Aug. 21, 2001 (for year-end 2000 UIT assets); *Closed-End Fund Assets, 1990–2000* (for year-end 2000 closed-end fund assets).

[3] ICI, *Exchange-Traded Fund Assets,* Oct. 19, 2001 (for third quarter 2001 net investment in ETFs); ICI, *Exchange-Traded Fund Assets June 2001,* July 24, 2001 (for second quarter 2001 net investment in ETFs); ICI, *Exchange-Traded Fund Assets March 2001,* Apr. 26, 2001 (for first quarter 2001 net investment in ETFs); and ICI, *Trends in Mutual Fund Investing September 2001,* Oct. 29, 2001 (for year-to-date net investment in mutual funds through third quarter 2001).

[4] ICI, *Exchange-Traded Fund Assets,* Oct. 19, 2001.

[5] Aaron Lucchetti and Ken Brown, *Spiders and WEBS: Amex Is Back, Thanks To a Tradable Variety of Index Mutual Funds,* Wall St. J., Feb. 22, 2000, at A1.

[6] Section 5(a)(1) of the Act defines an open-end fund as an investment company that is a management company which offers or has outstanding any redeemable security of which it is the issuer. 15 U.S.C. 80a–5(a)(1). Section 4(2) of the Act defines a UIT as an investment company that is organized under a trust indenture or similar instrument, that does not have a board of directors, and that issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities. 15 U.S.C. 80a–4(2).

[7] The NAV of a share of an investment company is equal to the value of the investment company's total assets, minus liabilities, divided by the number of outstanding shares.

characteristics of traditional open-end funds and UITs, which issue redeemable shares, and of closed-end funds, which generally issue shares that trade at negotiated prices on national securities exchanges and are not redeemable.[8] A fundamental characteristic of all existing ETFs traded in the United States is that they are based on specific domestic and foreign market indices. An ''index-based ETF'' seeks to track the performance of an index by holding in its portfolio either the contents of the index or a representative sample of the securities in the index.

*C. The Purpose of the Concept Release*

Recently, the concept of an ''actively managed ETF'' has attracted significant attention, even though many of the details regarding the potential operations of actively managed ETFs are apparently still in development.[9] Unlike an index-based ETF, an actively managed ETF would not seek to track the return of a particular index by replicating or sampling index securities. Instead, an actively managed ETF's investment adviser could select securities consistent with the ETF's investment objectives and policies without reference to the composition of an index.

Because of their unique operations, index-based ETFs first must apply to the Commission to obtain exemptive relief from certain provisions of the Act. For example, exemptive relief is necessary for index-based ETFs to redeem ETF shares only in large aggregations and for ETF shares to trade at negotiated prices in the secondary market. An actively managed ETF also would be required to obtain exemptive relief from the Act.

Before we can grant the exemptions necessary to permit the introduction of actively managed ETFs, we must conclude that the exemptions are in the public interest and consistent with the protection of investors and the purposes of the Act.[10] As part of this process, we are issuing this release to seek comment from the public regarding the concept of actively managed ETFs. We expect that this concept release will generate comments and ideas from a wide range of parties, including individual and institutional investors, shareholder organizations, financial planners, investment advisers, fund organizations, market makers, arbitrageurs, ETF sponsors, and national securities exchanges. Our goal is to gain a better understanding of the various perspectives on the concept of actively managed ETFs. We then will be able to evaluate better any proposals for these types of products as they are presented to us through the exemptive process on a case-by-case basis.

## II. Background

*A. The Development of Existing ETFs*

1. ETFs Organized as UITs

In January 1993, a subsidiary of the AMEX introduced the first ETF ''the SPDR Trust. The SPDR Trust, which issues ETF shares referred to as SPDRs (pronounced ''spiders''), is a UIT that tracks the Standard & Poor's 500 Composite Stock Price Index (''S&P 500 Index'') by holding substantially all of the securities in the S&P 500 Index in substantially the same weightings as in the S&P 500 Index. The trustee adjusts the portfolio of the SPDR Trust only to reflect changes in the composition of the S&P 500 Index.[11]

In order to offer SPDRs, the SPDR Trust obtained exemptions from various provisions of the Act.[12] Among other things, the exemptions allow the SPDR Trust to redeem SPDRs in large aggregations only, SPDRs to trade at negotiated prices in the secondary market, dealers to sell SPDRs to purchasers in the secondary market unaccompanied by a prospectus (when prospectus delivery is not required by the Securities Act of 1933 (''Securities Act'')), and certain affiliated persons of the SPDR Trust to deposit securities into, and receive securities from, the SPDR Trust in connection with the purchase and redemption of large aggregations of SPDRs. Since the introduction of SPDRs, ETF sponsors have launched three additional ETFs organized as UITs. The MID CAP SPDR Trust tracks the Standard & Poor's (''S&P'') MidCap 400 Index; the Diamonds Trust (which issues units known as ''Diamonds'') tracks the Dow Jones Industrial Average; and the Nasdaq-100 Trust (which issues units known as ''Cubes'') tracks the Nasdaq-100 Index. Each of these ETFs obtained exemptive relief similar to the relief granted to the SPDR Trust.

2. ETFs Organized as Open-End Funds

In March 1996, ETF sponsors introduced the first two ETFs organized as open-end funds. The CountryBaskets Index Fund, Inc., advised by Deutsche Morgan Grenfell/C. J. Lawrence Inc., consisted of different portfolios (''series'') that tracked various country indices of the Financial Times/S&P Actuaries World Indices.[13] The Foreign Fund, Inc., advised by BZW Barclays Global Fund Advisers (''Barclays''), offers series that track various Morgan Stanley Capital International (''MSCI'') country indices.[14] These ETFs obtained exemptions from various provisions of the Act that were generally analogous to the exemptions obtained by the ETFs organized as UITs.[15]

Many ETFs organized as open-end funds replicate the holdings of their corresponding indices to track the performance of the indices. However, because ETFs organized as open-end funds employ investment advisers, some of these ETFs instead may use ''sampling strategies'' to track the performance of an index. Using a sampling strategy, an investment adviser can construct a portfolio that is a subset of the component securities in the corresponding index, rather than a replication of the index. The investment adviser also may acquire securities for the ETF portfolio that are not included in the corresponding index. While these ETFs still seek to track the performance of their respective indices, they have greater flexibility in accomplishing that goal. In addition, ETFs that are open-end funds are not prohibited from participating in securities lending

[8] Section 5(a)(2) of the Act defines a closed-end fund as any management company other than an open-end company. 15 U.S.C. 80a–5(a)(2)

[9] *See, e.g.,* Anthony Ragozino and Charlie J. Gambino, *Actively-Managed Exchange Traded Funds: Coming Soon to a Market Near You?,* 8 Investment Lawyer, No. 5, May 2001, at 3 (''market professionals on Wall Street [are] scrambling to make [actively managed ETFs] available in the United States''); Dan Weil, *Exchange-traded Funds Boosts AMEX Growth,* The Palm Beach Post, Mar. 9, 2001, at 2D (reporting that AMEX president says AMEX will probably begin trading actively managed ETFs within 12 to 18 months); Yuka Hayashi, *New Generation of ETFs on Horizon,* Wall St. J. Europe, Sept. 26, 2000, at 16 (reporting that fund companies are ''pouring money into development'' of actively managed ETFs); Aaron Lucchetti, *Firms May Explore Funds that Trade on Stock Markets,* Wall St. J., May 16, 2000, at C21 (reporting that AMEX official says about six mutual-fund companies are interested in launching actively managed ETFs).

[10] 15 U.S.C. 80a–6(c).

[11] Because the structure of a UIT does not include the means of providing management, the UIT portfolio is relatively fixed, and elimination and substitution of securities only takes place under unusual circumstances. However, a UIT that tracks an index (like the SPDR Trust) may make adjustments to its portfolio to ensure that the portfolio continues to replicate the index.

[12] SPDR Trust, Series 1, Investment Company Act Rel. Nos. 18959 (Sept. 17, 1992) (notice) and 19055 (Oct. 26, 1992) (order) (''SPDR Order'').

[13] The CountryBaskets Index Fund, Inc. ceased operations in March 1997 and deregistered as an investment company in 1998.

[14] The shares issued by The Foreign Fund were known as ''World Equity Benchmark Shares'' or ''WEBs.'' The ETF recently was renamed iShares Inc., and the shares are now known as ''iShares.''

[15] The CountryBaskets Index Fund, Inc., Investment Company Act Rel. Nos. 21736 (Feb. 6, 1996) (notice) and 21802 (Mar. 5, 1996) (order); The Foreign Fund, Inc., Investment Company Act Rel. Nos. 21737 (Feb. 6, 1996) (notice) and 21803 (Mar. 5, 1996) (order).

programs or from using futures and options in achieving their investment objectives. The revenue generated by these activities may help the ETF to offset expenses that otherwise could cause the performance of the ETF to lag behind the performance of its index (because an index does not have any expenses). Eighty-eight of the 92 ETFs in existence at the end of September 2001 were organized as open-end funds.[16]

*B. How Existing ETFs Operate*

Regardless of the organizational structure of an ETF, all existing ETFs operate in essentially the same manner. Unlike typical open-end funds or UITs, ETFs issue shares only in large aggregations or blocks (such as 50,000 ETF shares) called ''Creation Units.'' An investor, usually a brokerage house or large institutional investor, may purchase a Creation Unit with a ''Portfolio Deposit'' equal in value to the aggregate NAV of the ETF Shares in the Creation Unit. The investment adviser or sponsor of the ETF announces the contents of the Portfolio Deposit at the beginning of each business day. The Portfolio Deposit generally consists of a basket of securities that mirrors the composition of the ETF's portfolio. Because the purchase price of the Creation Unit must equal the NAV of the underlying ETF shares, the required Portfolio Deposit generally also includes a small amount of cash to account for the difference between the value of the basket of securities and the NAV of the ETF shares. The value of a Creation Unit typically exceeds several million dollars. After purchasing a Creation Unit, the investor may hold the ETF shares, or sell some or all of the ETF shares to investors in the secondary market.

1. Secondary Market Trading

Like operating companies or closed-end funds, ETFs register offers and sales of shares under the Securities Act and list their ETF shares for trading on a national securities exchange under the Securities Exchange Act of 1934 (''Exchange Act''). As with any listed security, investors also may trade ETF shares in off-exchange transactions. In either case, ETF shares trade at negotiated prices. The development of the secondary market in ETF shares depends upon the activities of the exchange specialist assigned to make a market in the ETF shares and upon the willingness of Creation Unit purchasers to sell ETF shares in the secondary market.

ETF shares purchased in the secondary market are not redeemable from the ETF except in Creation Unit aggregations. If an investor presents a Creation Unit to the ETF for redemption, the redeeming investor receives a ''Redemption Basket,'' the contents of which are identified by the ETF investment adviser or sponsor at the beginning of the day. The Redemption Basket (usually the same as the Portfolio Deposit) consists of securities and a small amount of cash. As with purchases from the ETF, redemptions from the ETF are priced at NAV (*i.e.*, the value of the Redemption Basket is equal to the NAV of the ETF shares in the Creation Unit). An investor holding fewer ETF shares than the amount needed to constitute a Creation Unit may dispose of those ETF shares only by selling them in the secondary market. The investor receives market price for the ETF shares, which may be higher or lower than the NAV of the ETF shares. The investor also pays customary brokerage commissions on the sale.

2. Arbitrage Opportunities

Because of arbitrage opportunities inherent in the ETF structure, ETF shares generally have not traded in the secondary market at a significant premium or discount in relation to NAV. If ETF shares begin to trade at a discount (*i.e.*, a price less than NAV), arbitrageurs may purchase ETF shares in the secondary market and, after accumulating enough shares to equal a Creation Unit, redeem them from the ETF at NAV, and thereby acquire the more-valuable securities in the Redemption Basket. In purchasing the ETF shares, arbitrageurs create greater market demand for the shares, which may raise the market price to a level closer to NAV. If ETF shares trade at a premium (*i.e.*, a price greater than NAV), arbitrageurs may purchase the securities in the Portfolio Deposit, use them to obtain the more-valuable Creation Units from the ETF and then sell the individual ETF shares in the secondary market to realize their profit. As the supply of individual ETF shares available in the secondary market increases, the price of the ETF shares may fall to levels closer to NAV. An exchange specialist designated to maintain a market in the ETF shares also works to provide appropriate amounts of shares in the secondary market in response to supply and demand.

In addition, because the ETF investment adviser or sponsor announces the identities of the securities in the Portfolio Deposit and Redemption Basket each day, arbitrageurs also may decide to engage in arbitrage transactions based on their need for particular securities (for example, to replace borrowed securities that the arbitrageur previously sold ''short'') or on their own assessment of the relative value of the Portfolio Deposit or Redemption Basket in comparison to the price of the ETF shares. As an apparent result of this arbitrage discipline, ETF sponsors and market participants report that the average deviation between the daily closing price and the daily NAV of ETFs that track domestic indices is generally less than 2%.[17] With respect to ETFs that track certain foreign indices, the deviations may be more significant.[18]

*C. Reported Uses and Benefits of Existing ETFs*

In exemptive applications to permit the operations of ETFs, applicants have argued that ETFs provide investors and the markets with a number of benefits. First, applicants have argued that ETFs provide investors with the opportunity to invest in a diversified basket of securities through the purchase of a

[16] ETFs organized as open-end funds include the Select Sector SPDR Trust, consisting of series that track various S&P sector indices; iShares Inc. and iShares Trust, consisting of series that domestic and foreign equity indices compiled by S&P, Dow Jones & Company, Inc. (''Dow Jones''), Frank Russell & Co., and MSCI, and streetTRACKS Series Trust, consisting of series that track indices compiled by Dow Jones, Morgan Stanley Dean Witter, and FORTUNE.

[17] *See, e.g,* Second Amended and Restated Application of Barclays Global Fund Advisors, File No. 812–11600, filed May 11, 2001 (''Barclays Application'') at 57–58 (stating that average deviations between the daily closing price and the daily NAV of ETF shares of ETFs tracking domestic indices range from a premium of .05% to a discount of .02%). Persons may obtain copies of applications cited in this concept release for a fee from the Commission's Public Reference Branch, 450 5th Street, NW., Washington, DC 20549–0102 (telephone 202/942–8090).

*See also* John Spence, *Salomon Releases ETF Premium/Discount Study,* indexfunds.com, Oct. 23, 2000 (reporting that a Salomon Smith Barney study of the trading of ETF shares found that shares of ETFs tracking domestic indices had an average bid price that was a .17% discount to the ETFs' respective estimated intra-day NAVs, as recorded at random points during the trading days in September 2000), at http://www.indexfunds.com/Pfarticles/20001023_SSMBstudy_iss_etf_JS.htm.

[18] *See. e.g.,* Barclays Application at 36 (stating that the Malaysia (Free) WEBs Index Fund traded at wider spreads to NAV following the imposition of capital controls by the Malaysian government in 1998).

*See also* Memorandum in Support of Hearing Request filed by Fund Democracy, LLC, and the Consumer Federation of America with respect to the Barclays Application (arguing that arbitrage opportunities do not ensure that the difference between the market price and NAV of ETF shares will remain narrow, and citing in particular the experience of ETFs tracking various foreign indices), available at http://www.funddemocracy.com/hearing_request_docs.htm.

single exchange-traded security.[19] As a result, investors can have the diversification benefits of an investment company with the trading flexibility of a stock. In addition, ETF applicants have stated that unlike closed-end funds (the traditional type of investment company that issues exchange-traded shares), ETFs can avoid the discounts and premiums in market price often associated with closed-end fund shares by continually issuing and redeeming ETF shares in Creation Units, and thereby creating an arbitrage mechanism.[20]

1. ETFs as a Tool for Individual Investors

As the ETF marketplace has developed, individual investors apparently have accepted ETFs as an index investment with trading flexibility.[21] Certain individual investors reportedly invest in ETF shares as a long-term investment for asset allocation purposes, while other individual investors apparently trade ETF shares frequently as part of market timing investment strategies.[22] For those investors who trade more frequently, ETFs offer the ability to purchase and sell ETF shares in the secondary market at a known price anytime during the trading day, to purchase ETF shares on margin, and to sell ETF shares short.

2. The Uses of ETFs for Institutional Investors

Institutions also may purchase ETF shares in the secondary market for a variety of reasons. For example, certain pension funds whose investment restrictions preclude investment in index derivatives may instead invest in ETF shares.[23] Other institutions reportedly prefer to hold ETF shares instead of index futures because ETF shares do not have the margin requirements or expiration dates of futures.[24] Some private investment companies (such as hedge funds) reportedly employ ETF shares in hedging strategies by taking certain short or long positions in individual securities of a certain market sector, while taking opposite positions in ETF shares tracking that sector.[25] Other institutional money managers and mutual funds may use ETFs as a temporary means of keeping cash invested in a broad market segment during transitions in investment strategy or management.[26]

3. The Efficiency of ETFs

ETFs also appear to attract investors as a low-cost and tax efficient investment vehicle.[27] Like index-based mutual funds (''index funds''), index-based ETFs are passively managed to track an index and do not have significant turnover in portfolio securities. As a result, ETF expenses are typically lower than the expenses of actively managed mutual funds, which generally have higher management fees and brokerage expenses due to portfolio trading. In addition, ETF expenses are often lower than the expenses of index funds. Because most ETF shareholders purchase and sell ETF shares through secondary market transactions rather than through transactions with the ETF, ETFs do not have the same degree of shareholder recordkeeping and service expenses as index funds.[28] However, investors who purchase and sell ETF shares in secondary market transactions pay brokerage commissions in connection with those transactions, which can represent an additional cost to investors that is not reflected in the expense ratio of an ETF.

With respect to tax efficiency, ETFs reportedly offer advantages over many mutual funds. When a mutual fund sells portfolio securities to pursue its investment strategies or to generate cash for shareholder redemptions, the mutual fund may realize capital gains if the value of the securities increased while they were in the fund portfolio. A mutual fund distributes accumulated capital gains to its shareholders, and shareholders generally must pay taxes on those distributions. An ETF also may accumulate and distribute capital gains to investors. However, like index funds, an ETF may be more tax efficient than many mutual funds because of the low turnover in its portfolio securities. In addition, the ETF structure may allow an ETF to avoid capital gains to an even greater extent than index funds. Because an ETF typically redeems Creation Units of ETF shares by delivering securities in the Redemption Basket, an ETF does not have to sell securities (and possibly realize capital gains) in order to pay redemptions in cash.[29] The Redemption

[19] *See, e.g.*, Fourth Amended and Restated Application of SPDR Trust, Series 1, File No. 812–7545, filed Aug. 7, 1992 (''SPDR Application''), at 42–43. In the SPDR Application, applicants stated that SPDRs were developed in response to the suspension of trading in ''index participants'' (''IPs''), contracts of indefinite duration based on the value of a basket (index) of securities. *See* SPDR Application at p. 45. Trading in IPs was suspended after the U.S. Court of Appeals for the Seventh Circuit found that IPs represented a futures contract within the exclusive jurisdiction of the Commodity Futures Trading Commission. *Chicago Mercantile Exchange, et al. v. Securities and Exchange Commission, et al.*, 883 F.2d 537 (7th Cir. 1989), *cert. denied* 496 U.S. 936, 110 S. Ct. 3214 (1990). Because SPDRs represented an interest in an actual portfolio of securities, SPDRs did not present the futurity issues of IPs.

[20] *See, e.g.*, Fifth Amended and Restated Application of The CountyBaskets Index Fund, Inc., File No. 812–9188, filed June 30, 1995, at 11.

[21] *See, e.g.*, Lee Barney, *Exchange-Traded Funds Continue to Grow in 2001,* TheStreet.com, May 16, 2001 (''The first and foremost reason investors like ETFs is because, like index funds, they offer exposure to a variety of sectors. * * *.''), at http://www.thestreet.com/funds/funds,1430991.html; Lee Clifford, *All Your Stocks in One Basket,* Fortune, Mar. 5, 2001, at 200 (explaining how ETFs can be useful of tracking an index, balancing a portfolio, or gaining exposure to a market segment); Barbara Eisner Bayer, *The Latest Indexing Craze,* Fool.com, June 27, 2000 (''Perhaps the greatest benefit of ETFs is that investors will now have instant exposure to a diversified portfolio of stocks.''), at http://www.fool.com/Server/FoolPrint.asp?File+/ddow/2000/ddow000627.htm.

[22] *See, e.g.*, Aaron Lucchetti, *Tradable Shares Bring Some Buzz to Mutuals,* Wall St. J., June 5, 2000, at R1 (profiling different types of ETF investors); Jerry Morgan, *ETFs, An Alternative to Index Funds,* Newsday, Jan. 29, 2000, at F05; John Spence, *FRC Study Examines Future of ETFs,* indexfunds.com, Nov. 6, 2000 (reporting on a survey conducted by Financial Research Corporation that found that 75% of retail investors surveyed who either owned or had inquired about ETFs intended to use ETFs primarily for buy-and-hold strategies, while 25% intended to use ETFs for a mix of long-term and trading strategies), at http://www.indexfunds.com/Pfarticles/20001106_FRCstudy_iss__etf_JShtm.

[23] *See, e.g.*, Elgin, Peggie R., *SPDR Web Ensnares Both Active, Passive Fund Managers,* 14 Corporate Cashflow Magazine, No. 13, Dec. 1993, at 5.

[24] *See, e.g.*, Barney, *supra* note 21.

[25] *See, e.g.*, Allison Bisbey Colter, *Exchange-Traded Funds Are Booming,* Wall St. July 12, 2001, at C19 (noting also that some hedge funds use ETF shares instead of index futures to avoid licensing requirements of the Commodity Futures Trading Commission).

[26] *See, e.g.*, Fred Williams, *Interest Accelerates: ETFs: Market up 82% to Nearly $76 Billion,* Pensions and Investments, Mar. 5, 2001, at 25.

[27] *See, e.g.*, John Spence, *Retail Investor Perception of Exchange-Traded Funds*, indexfunds.com, Feb. 22, 2001 (reporting on survey conducted by Financial Research Corporation that found ''tax efficiency,'' ''trading and tax flexbility,'' and ''lower expense ratios'' to be the three most commonly cited reasons for potential interest in ETFs among retail investors), at http://www.indexfunds.com/Pfarticles/20010223_ETFperception_iss-etf-JS.htm; Theo Francis, *Navigating the New World of ETFs*, Wall St. J., May 11, 2001, at C1; Sara Robinson, *A Mutual Fund Rival on the Trading Floor,* N.Y. Times, Nov. 7, 1999, at 8.

[28] *See, e.g.*, Frederick P. Gabriel Jr., *ETFs, May Be Losing Pricing Edge: Some to Have Fees that Match Top Funds*, Investment News, Aug. 27, 2001, at 3 (reporting that an analysis by Lipper Inc. found only a few examples of index funds that are less expensive than ETFs with the same investment objective); Aldo Svaldi, *ETFs Take Aim at Ailing Mutual Funds*, The Denver Post, Mar. 4, 2001, at J–03 (reporting that ETFs that track the larger U.S. indices have an average annual expense ratio of .34%, compared to .50% for an index fund, and 1 to 1.5% for an actively managed mutual fund); Aaron Lucchetti, *Index Mutual Funds Have a Price War*, Wall St. J., at C–1, May 12, 2000 (noting that ETFs may have expense advantages over index funds because they do not deal directly with individual investors through expensive telephone centers and retail offices).

[29] Because an ETF does not have to maintain cash reserves to pay redemptions, an ETF also may be able to remain more fully invested in the securities of its corresponding index, which could help an

Continued

Basket also may include securities from the ETF portfolio that have the highest unrealized capital gains (*i.e.*, securities that have appreciated in value the most while in the ETF portfolio). Because the ETF may be able to eliminate securities with significant unrealized capital gains from its portfolio through the redemption process, the ETF may avoid realizing some capital gains if the ETF needs to sell securities at a later date to track its index.[30]

## III. The Concept of an Actively Managed ETF

As noted above, market participants are interested in developing an ''actively managed ETF''—an ETF with an actively managed portfolio that does not seek to replicate the performance of any particular market index. Like existing ETFs, an actively managed ETF would be registered under the Act (as an open-end fund rather than a UIT, because a UIT cannot be managed) and would issue and redeem its shares only in Creation Units. The ETF would list its shares on a national securities exchange, and investors would trade the ETF shares throughout the day at market prices in the secondary market. As with index-based ETFs, the ability to buy and redeem Creation Units at NAV would present arbitrage opportunities if the market price of the individual ETF shares deviated from NAV.

Despite these general similarities, there may be significant structural and operational differences between the two types of products.[31] For example, it is not clear whether an actively managed ETF would propose to inform investors of the contents of its portfolio in the same manner as index-based ETFs (through the daily announcement of the Portfolio Deposit and Redemption Basket).[32] Because the portfolio of an actively managed ETF likely would change more frequently and in less foreseeable ways than the portfolio of an index-based ETF, it is not clear how or whether an actively managed ETF would propose to communicate intra-day changes to investors.[33] This potential for less transparency in the portfolio holdings of an actively managed ETF may make the process of creating and redeeming Creation Units more difficult or present greater investment risk for arbitrageurs. As a result, an actively managed ETF could have a less efficient arbitrage mechanism than index-based ETFs, which could lead to more significant premiums or discounts in the market price of its shares.

In addition to potential operational differences, an actively managed ETF may not have the same uses and benefits as those associated with index-based ETFs. As described above, many of the uses of existing ETFs, particularly for institutional investors, relate to the fact that ETF shares serve as a proxy for an index, which would not be the case for ETF shares of actively managed ETFs. In addition, an actively managed ETF may have greater turnover in its portfolio securities, which could result in higher expenses and less tax efficiency than index-based ETFs.[34]

We need to consider carefully whether actively managed ETFs are in the public interest and consistent with the protection of investors and the purposes of the Act before we grant the relief necessary to allow for the introduction of these products. To facilitate this process, we are seeking public comment on a wide range of issues posed by the possible introduction of actively managed ETFs. In addition to the specific questions outlined in the following sections, we seek comment on these broad issues:

- How are actively managed ETFs likely to be structured, managed and operated?
- How will investors use, and benefit from, actively managed ETFs?
- Would the exemptive relief that the Commission has granted to index-based ETFs be appropriate for actively managed ETFs?
- Are there any new regulatory concerns that might arise in connection with actively managed ETFs?

## IV. Areas for Comment

### *A. Index-Based ETFs vs. Actively Managed ETFs*

For purposes of this release, we have assumed 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. Thus, actively managed ETFs would include, for example, an ETF that seeks to achieve a multiple (or the reverse) of the performance of a market index. Actively managed ETFs also would include any ETF that, although it may be using a market index as a benchmark for measuring its performance, pursues an investment objective that is not tied to the index.

Is this an appropriate way to distinguish between index-based and actively managed ETFs? Are there any reasons to distinguish between different types of actively managed ETFs? If there are different types of actively managed ETFs, are there any reasons to regulate the various types differently?

### *B. Operational Issues Relating to Actively Managed ETFs*

The unique structure of an ETF—in which investors can buy and redeem Creation Units at NAV, and can sell and purchase individual ETF shares in the secondary market at market price—is designed, among other things, to ensure arbitrage opportunities that would reduce any deviations between the NAV and the market price of ETF shares. The expectation that the market price of ETF shares would track NAV (and the performance of an index) is important to many of the uses of ETF shares as index-based securities. An ETF also is thought to offer advantages over a closed-end fund structure in which discounts from NAV are common. The existing ETFs, as a general matter, have not experienced significant deviations between the NAV and the market price of their ETF shares.[35]

Is it important that ETFs be designed to enable arbitrage and thereby

ETF track its index more effectively than some index funds. *See, e.g.*, Albert B. Crenshaw, *Funds that Trade Like Stocks; ETFs Offer Some Advantages over Traditional Mutuals*, Wash. Post, July 9, 2000, at H02.

[30] *See, e.g.*, Karen Damato, *Tax Advantages Are Promised by Fund Rivals,* Wall St. J., Sept. 1, 2000, at C1; Dagen McDowell, *Exchange-Traded Funds Are Tax-Efficient, but Not Tax Perfect*, TheStreet.com, Aug. 22, 2000, at http://www.thestreet.com/funds/deardagen/1049339.html.

[31] As noted above, many of the details regarding the potential operations of an actively managed ETF are apparently in development. *See, e.g.*, Andrew Greene, *AMEX Plans Active Exchange-Traded Fund*, *Mutual Fund Market News*, Aug. 14, 2000 (quoting a fund industry observer who describes the development of an actively managed ETF as ''the financial industry's equivalent of the space program back in the 1960's'' and states that fund companies and exchanges are scrambling to develop something without knowing what it will look like).

[32] *See, e.g.*, Dagen McDowell, *Non-Index Exchange-Traded Funds on the Horizon*, TheStreet.com, May 16, 2000 (''a stumbling block to creating an actively managed [ETF] is the transparency of the underlying portfolio * * *. No fund company or fund manager would want to reveal everything that's in a fund on a regular basis.'') at http://www.thestreet.com/funds/deardagen/940643.html.

[33] *See, e.g.*, Lucchetti and Brown, *supra* note 5 (reporting that for an actively managed ETF to be priced continuously throughout the day, the ETF manager would have to disclose what the ETF was buying and selling during the day, which most active managers would not wish to do).

[34] *See, e.g.*, Michael Santoli, *Great Pretenders: New-fashioned ''Funds'' No Threat to Old Ones,* Barron's, Apr. 9, 2001, at F18 (noting that some observers do not believe that actively managed ETFs, will offer the cost and tax benefits of index-based ETFs); Scott Cooley, *The Time Isn't Right for Actively Managed ETFs*, Morningstar.com (noting that unless managers reduce portfolio trading, an actively managed ETF would not be a tax-efficient vehicle) at http://news.morningstar.com/doc/article/01,1,3073,00.html.

[35] *See supra* note 17.

minimize the probability that ETF shares will trade at a large premium or discount? In considering whether to grant the exemptive relief necessary to permit actively managed ETFs, should we be concerned about whether their shares will trade at a significant premium or discount?

It appears that two factors may contribute significantly to the effectiveness of arbitrage in the ETF structure—the transparency of an ETF's portfolio and the liquidity of the securities in the ETF's portfolio.

1. Transparency of an ETF's Portfolio

Existing ETFs generally create and redeem Creation Units through in-kind transactions. At the beginning of each day, the investment adviser or sponsor of the ETF makes available the identities of the securities in the Portfolio Deposit and the Redemption Basket (generally through the National Securities Clearing Corporation, a clearing agency that effects the sales and redemptions of Creation Units for many ETFs). These baskets generally reflect the contents of the portfolio of the ETF on that day and do not change during the day.[36] In addition, the listing exchange makes available the current value of the Portfolio Deposit on a per ETF share basis at 15 second intervals throughout the day and disseminates intra-day values of the relevant index. This high degree of transparency in the investment operations of an ETF helps arbitrageurs determine whether to purchase or redeem Creation Units based on the relative values of the ETF shares in the secondary market and the securities contained in the ETF's portfolio.

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? Is it sufficient for an actively managed ETF to disclose only a sample of its portfolio or the general characteristics of its portfolio? Can effective arbitrage occur without any disclosure of the specific securities in an ETF's portfolio (*i.e.*, arbitrage that is based strictly on the NAV and market price of ETF shares)?

How frequently would the investment adviser of an actively managed ETF need to disclose the portfolio securities or characteristics of the ETF portfolio? Would an investment adviser need to disclose intra-day changes in the portfolio of an actively managed ETF? Would there be a need to permit or require the specified Portfolio Deposit or Redemption Basket to change during the day to reflect changes in the ETF's portfolio? If so, what type of notice would be necessary to inform investors of any changes to the Portfolio Deposit or Redemption Basket in the course of a day? Are intra-day values of the Portfolio Deposit meaningful to investors if investors do not know the contents of the ETF portfolio?

Would frequent disclosure of portfolio holdings lead to ''front running'' of the ETF portfolio, where other investors would trade ahead of the ETF and the Creation Unit purchasers who must assemble Portfolio Deposits?[37] Would frequent disclosure of portfolio holdings lead to ''free riding,'' where other investors would mirror the investment strategies of an actively managed ETF while the ETF investors pay the advisory fees? Would an investment adviser to an actively managed ETF face a conflict between maximizing performance and facilitating arbitrage by informing the marketplace of the adviser's investment strategies (*e.g.*, would there be a reluctance on the part of a portfolio manager to make frequent adjustments in the portfolio because of the possible impact on the arbitrage mechanism)?

2. Liquidity of Securities in an ETF's Portfolio

Existing ETFs track various equity indices including foreign and domestic indices, broad-based indices, and sector indices. All of the indices have specified methodologies for selecting their component securities. The methodologies generally ensure that an index consists of a certain number of component securities, and that those securities will have significant market capitalization and will be actively traded. Because ETFs either replicate or sample the indices, their portfolio securities also should possess these characteristics. Effective arbitrage depends in part upon the ability of investors to readily assemble the Portfolio Deposit for purchases of Creation Units and to sell securities received upon redemption of Creation Units. The liquidity of portfolio securities is an important factor in this process.

Should actively managed ETFs be limited to certain investment objectives or policies that are designed to ensure that the portfolio securities are sufficiently liquid to permit effective arbitrage? If so, what types of parameters are necessary to ensure that an ETF invests in securities that can be readily purchased or sold by arbitrageurs? Should an actively managed ETF be permitted to invest in securities other than equity securities? Should an actively managed ETF be permitted to invest in any illiquid securities or securities that could not be included in a Portfolio Deposit or Redemption Basket? Should an actively managed ETF be prohibited from investing in securities that are not registered under section 12 of the Exchange Act?[38] Should an actively managed ETF be prohibited from investing in securities that are part of an ''unsold allotment'' within the meaning of section 4(3)(C) of the Securities Act?[39]

Is it necessary for an actively managed ETF to create and redeem Creation Units through in-kind transactions (rather than cash transactions)?[40] Would there be any consequences to permitting cash purchases and redemptions of Creation Units for an actively managed ETF? Could the cash component of a Portfolio Deposit or Redemption Basket be used to account for portfolio securities that could not be included in a Portfolio Deposit or Redemption Basket?[41]

3. Other Operational Issues

What other issues could cause an actively managed ETF to operate differently than an index-based ETF? Would the clearance and settlement procedures for Creation Unit transactions for actively managed ETFs be the same as for index-based ETFs? Are there other operational issues that could affect the willingness of investors to purchase shares of an actively managed ETF either on the secondary market or in Creation Units from the ETF? Would significant deviations

[36] Because an index-based ETF seeks to track the performance of an index, often by replicating the component securities of the index, the ETF investment adviser or sponsor has no reservations about informing the marketplace of the contents of the ETF's portolio.

[37] *See, e.g.*, Hayashi, *supra* note 9 (stating that disclosure of the portfolio of an actively managed ETF could lead to front running and create unwanted demand for the stocks identified by the ETF for inclusion in its portfolio).

[38] 15 U.S.C. 78*l*.

[39] 15 U.S.C. 77d(3)(C).

[40] Though existing ETFs primarily transact in-kind, they generally reserve the possibility of cash purchases and redemptions under certain circumstances, such as on days when a substantial rebalancing of an ETF's portfolio is required. *See, e.g.*, Barclays Application at 23–24. Certain iShares ETFs that invest in certain foreign markets currently effect creations and redemptions through cash transactions.

[41] Most ETFs currently reserve the possibility that cash may be substituted for certain securities in a Portfolio Deposit or Redemption Basket under unusual circumstances, such as when an investor who purchases or redeems a Creation Unit is not permitted to transact in particular securities. *See, e.g.*, Barclays Application at 28–29.

between the market price of shares of an actively managed ETF and the NAV of the ETF shares compromise the operations of the ETF?

*C. Uses, Benefits and Risks of Actively Managed ETFs*

As noted, in granting exemptions under section 6(c), the Commission must find that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.[42] The Commission is interested in learning about the ways in which investors may use actively managed ETFs and the benefits that this new investment product may be expected to bring. The Commission also is seeking comment generally on any aspects of actively managed ETFs that may be relevant to the determination that the Commission would be making under section 6(c).

In determining whether the relief we have granted to permit ETFs should be expanded to permit actively managed ETFs, we think it is appropriate to consider the uses and benefits of existing index-based ETFs, as well as any concerns regarding ETFs generally. What are the most important uses and benefits of index-based ETFs? Have index-based ETFs encountered any problems of which the Commission should be aware in evaluating future ETF proposals? [43] Are investors confused about the differences between ETFs and mutual funds? What measures could be taken to address any potential investor confusion? Does trading in ETF shares have any relation to market volatility, and if so, in what ways? [44] Has the introduction of ETFs generally led to any undesirable consequences for investors?

With respect to the potential for actively managed ETFs, should investors expect that any mutual fund could be transformed into an ETF, or would only certain types of actively managed portfolios lend themselves to the ETF structure? Would closed-end funds seek to convert into actively managed ETFs as a possible means of addressing discounts in share price? [45] Why would an actively managed ETF be a desirable alternative to a mutual fund or closed-end fund that pursues the same investment objectives or strategies?

What would be the principal uses of actively managed ETFs by investors? Would an actively managed ETF serve primarily as a short-term trading vehicle? Could an actively managed ETF be used to gain exposure to an asset category in a manner similar to index-based ETFs? Would an actively managed ETF have any role in hedging strategies? Would an actively managed ETF appeal more to individual investors or institutional investors?

What would be the principal benefits of actively managed ETFs? Would an actively managed ETF possess the low expenses and tax efficiency associated with existing ETFs? Would the introduction of actively managed ETFs be detrimental to investors, and if so, how? Would investors be confused about the nature of actively managed ETFs? Could actively managed ETFs lead to greater market volatility? [46] Is the development of actively managed ETFs important for U.S. financial institutions to maintain a competitive position in global securities markets? [47]

*D. Exemptive Relief From the Investment Company Act for Actively Managed ETFs*

Because of their unique structure, ETFs must obtain exemptive relief from certain provisions of the Act. An ETF organized as an open-end fund generally requests an order (i) under section 6(c) of the Act granting relief from sections 2(a)(32) and 5(a)(1) of the Act so that the ETF may register under the Act as an open-end fund and issue shares that are redeemable in Creation Units only; (ii) under section 6(c) granting relief from section 22(d) of the Act and rule 22c–1 under the Act to permit the purchase and sale of individual ETF shares in the secondary market at negotiated prices; and (iii) under sections 6(c) and 17(b) of the Act granting relief from sections 17(a)(1) and (a)(2) of the Act to permit in-kind purchases and redemptions of Creation Units by persons who may be affiliated with the ETF by reason of owning more than 5%, and in some cases more than 25%, of its outstanding securities. Certain ETFs that track foreign indices also have obtained relief under section 6(c) from section 22(e) of the Act so that they may satisfy redemption requests more than seven days after the tender of a Creation Unit for redemption due to delivery cycles for securities in the local markets.

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 Act as existing ETFs that are organized as open-end funds. In considering whether to grant relief from each of the sections outlined above pursuant to section 6(c), the Commission must find that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.[48] Under section 17(b), the Commission may exempt a proposed transaction from section 17(a) if evidence establishes that the terms of the transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching, and the proposed transaction is consistent with the policies of the registered investment company and the general provisions of the Act.[49] In evaluating any exemptive applications to permit actively managed ETFs, we would assess whether these exemptive standards are met.

1. Relief for ETFs To Redeem Shares in Large Aggregations Only

Section 5(a)(1) defines an ''open-end company'' as a management investment company that is offering for sale or has outstanding any redeemable security of which it is the issuer.[50] Section 2(a)(32) defines a redeemable security as any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer, is

[42] *See supra* note 10.

[43] *See, e.g.*, Karen Damato and Aaron Lucchetti, *Critics Worry About Risks of Exchange-Traded Funds*, Wall St. J., July 7, 2000, at C1 (reporting on criticism that ETFs may not disclose adequate information about the potential for ETF shares to trade at a premium or discount to NAV).

[44] *See* Carol Vinzant, *NASDAQQQ: Trading in ''Cubes'' is Skyrocketing, and Some Critics Fear the Nasdaq 100-Based vehicles Are Contributing to Volatility*;, Wash. Post, May 10, 2001, at E1 (reporting that some critics believe trading in cubes has increased market volatility).

*But see* The October 1987 Market Break, A Report by the Division of Market Regulation, U.S. Securities and Exchange Commission, Feb. 1988, at 3–18 (suggesting that market basket trading could provide an additional layer of liquidity in the market that could reduce volatility).

[45] *See, e.g.*, Aaron Lucchetti, *In Closed-ends, a Possible Way to Get Rid of Discounts to NAV*, Wall St. J., Apr. 10, 2000, at R14 (reporting on idea to convert closed-end funds to ETFs to eliminate discounts in share prices).

[46] *See, e.g.*, Andrew Brent, *SEC Guidance Expected for Exchange Funds*, Mutual Fund Market News, May 28, 2001 (reporting that some analysts believe there are several scenarios in which an actively managed ETF could cause increased market volatility).

[47] A type of actively managed exchange-traded investment company was introduced by Deutsche Bank in Germany in November 2000 and has reportedly experienced some success among retail investors in Germany. *See, e.g.*, Stephan Kueffner, *Exchange-Traded Funds Make Their Mark in German Market*, Capital Markets Report, April 23, 2001. As a general matter, investment companies that are not organized or created under the laws of the United States cannot offer, sell, or deliver shares to investors in the United States unless they obtain an order of the Commission. 15 U.S.C. 80a–7(d).

[48] *See supra* note 10.

[49] 15 U.S.C. 80a–17(b)

[50] *See supra* note 6.

entitled to receive approximately the holder's proportionate share of the issuer's current net assets, or the cash equivalent.[51] Because ETF shares are not individually redeemable, an ETF requests relief to permit the ETF to register and operate as an open-end fund and to issue shares that are redeemable in Creation Units only.

In support of the relief, ETFs have noted that investors may redeem ETF shares in Creation Units from each ETF. ETFs also have noted that because the market price of Creation Units is disciplined by arbitrage opportunities, investors in ETF shares generally should be able to sell ETF shares in the secondary market at approximately their NAV. ETFs organized as open-end funds have agreed as a condition to the exemptive relief that the ETF will not be advertised or marketed as an open-end fund or mutual fund. The prospectuses and advertising materials for ETFs prominently disclose that ETF shares are not individually redeemable and that shareholders may acquire shares from an ETF and tender those shares for redemption to the ETF in Creation Units only.[52]

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?

2. Relief for ETF Shares To Trade at Negotiated Prices

Section 22(d), among other things, prohibits a dealer from selling a redeemable security that is being currently offered to the public by or through an underwriter, except at a current public offering price described in the prospectus.[53] Rule 22c–1 generally requires that a dealer selling, redeeming, or repurchasing a redeemable security do so only at a price based on its NAV.[54] Because secondary market trading in ETF shares takes place at negotiated prices, and not at a current offering price described in the prospectus or based on NAV, existing ETFs have obtained exemptions from section 22(d) and rule 22c–1.

In support of their requests for relief, ETFs generally have noted that the provisions of section 22(d), as well as rule 22c–1, appear to be designed to prevent dilution caused by certain riskless-trading schemes by principal underwriters and contract dealers, to prevent unjust discrimination or preferential treatment among buyers resulting from sales at different prices, and to assure an orderly distribution of investment company shares by eliminating price competition from dealers offering shares at less than the published sales price and repurchasing shares at more than the published redemption price. The ETFs submit that secondary market trading in ETF shares does not cause dilution for ETF shareholders because the secondary market transactions do not directly involve ETF portfolio assets (the transactions are with other investors, not the ETF), and thus have no impact on the NAV of ETF shares held by other investors. In addition, ETFs have stated that to the extent that different prices for ETF shares exist during a given trading day, or from day to day, these variances occur as a result of third-party market forces, such as supply and demand, and not as a result of discrimination or preferential treatment among purchasers. With respect to the orderly distribution of ETF shares, ETFs have noted that anyone may acquire Creation Units from the ETF, and that no dealer should have an advantage over any other dealer in the sale of ETF shares. ETFs also have argued that the distribution system for ETF shares should be orderly because arbitrage activity ensures that the difference between the market price of shares and their NAV remains narrow.[55]

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 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? Would more significant deviations lead to a less orderly distribution system for actively managed ETF shares? Are greater disclosure efforts necessary to address potential investor confusion regarding the fact that individual shares of actively managed ETFs would be sold at market price while Creation Unit aggregations of ETF shares would be redeemable at NAV?

3. Relief for In-Kind Transactions Between an ETF and Certain Affiliates

Section 17(a) of the 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.[56] Because purchases and redemptions of Creation Units may be in-kind rather than cash transactions, section 17(a) may prohibit affiliated persons of an ETF from purchasing or redeeming Creation Units. Section 2(a)(3)(A) of the Act defines ''affiliated person'' as any person owning 5% or more of an issuer's outstanding voting securities. ETFs indicate that certain large investors may be affiliated persons of an ETF under section 2(a)(3)(A) of the Act (''5% Affiliates''). In addition, some investors may own more than 25% of an ETF's outstanding voting securities and therefore may be deemed an affiliated person of the ETF under section 2(a)(3)(C) of the Act (''25% Affiliates'').[57] ETFs have obtained exemptions from section 17(a) to permit 5% Affiliates and 25% Affiliates to purchase and redeem Creation Units through in-kind transactions.

In seeking this relief, ETFs have submitted that because 5% Affiliates and 25% Affiliates are not treated differently from non-affiliates when engaging in purchases and redemptions of Creation Units, there is no opportunity for these affiliated persons to effect a transaction detrimental to the other ETF shareholders. The securities to be deposited for purchases of Creation Units and to be delivered for redemptions of Creation Units are announced at the beginning of each day and are equally applicable to all investors. All purchases and redemptions of Creation Units are at an ETF's next calculated NAV, and the securities deposited or received upon redemption are valued in the same manner, using the same standards, as those securities are valued for purposes of calculating the ETF's NAV.[58]

Would actively managed ETFs present any issues with respect to this exemption that do not exist with respect to index-based ETFs? 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

[51] 15 U.S.C. 80a–2(a)(32).

[52] *See, e.g.*, Barclays Application at 63–70, 81.

[53] 15 U.S.C. 80a–22(d).

[54] 17 CFR 270.22c–1

[55] *See, e.g.*, Barclays Application at 70–74.

[56] 15 U.S.C. 80a–17(a).

[57] 15 U.S.C. 80a–2(a)(3).

[58] *See, e.g.*, Barclays Application at 74–79.

favor affiliated persons of the ETF? If so, how should this be addressed? Could a 5% Affiliate or 25% Affiliate influence decisions by the investment adviser to an actively managed ETF 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 communication of information about portfolio changes to affiliates?

4. Relief for Certain ETFs To Redeem Shares in More Than Seven Days

Section 22(e) of the Act generally prohibits a registered open-end investment company from suspending the right of redemption, or postponing the date of payment or satisfaction of redemption requests more than seven days after the tender of a security for redemption.[59] Some ETFs that track foreign indices have stated that 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. These ETFs request relief from section 22(e) so that they may satisfy redemptions up to a specified maximum number of calendar days depending upon specific circumstances in the local markets, as disclosed in the ETF's prospectus or statement of additional information (''SAI''). Other than in the disclosed situations, these ETFs satisfy redemptions within seven days.[60]

These ETFs state in their exemptive applications that section 22(e) of the Act is designed to prevent unreasonable, undisclosed, and unforeseen delays in the payment of redemption proceeds and assert that the requested relief will not lead to the problems that section 22(e) was designed to prevent. The anticipated delays in the payment of redemption proceeds would occur principally due to local holidays in the foreign markets. The ETFs state that the SAI will disclose those local holidays (over the period of at least one year following the date of the SAI) that are expected to prevent the delivery of redemption proceeds in seven days and the maximum number of days needed to deliver redemption proceeds.[61]

Would actively managed ETFs present any issues with respect to this exemption that do not exist with respect to index-based ETFs? Could the investment adviser to an actively managed ETF manage the ETF so as to comply with section 22(e)?

*E. Potential New Regulatory Issues*

In evaluating any specific proposal for an actively managed ETF, the Commission will be considering whether the proposal presents any new regulatory concerns. In this regard, we are interested in public comment on the issues raised below, as well as any additional issues that might be identified by the commenters.

1. Potential Discrimination Among Shareholders

Section 1(b)(3) of the Act states that the public interest and the interest of investors are adversely affected when investment companies issue securities containing inequitable or discriminatory provisions.[62] One potential difference between the existing ETFs and an actively managed ETF is that, in the latter case, significant deviations could develop between the market price and the NAV of the ETF shares. It might also be possible that, during any particular time, the NAV of an actively managed ETF could be increasing while the market price of its shares could be falling, and vice versa.

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 that section 1(b)(3) of the Act was designed to prevent? Commenters who believe that this concern might be raised by an actively managed ETF are encouraged also to discuss the ways in which they believe the Commission should address it.

2. Potential Conflicts of Interest for an ETF's Investment Adviser

Section 1(b)(2) of the Act states that the public interest and the interest of investors are adversely affected when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of persons other than shareholders, including directors, officers, investment advisers, or other affiliated persons, and underwriters, brokers, or dealers.[63] The operation of an ETF—specifically, the process in which a Creation Unit is purchased by delivering a basket of securities to the ETF, and redeemed in exchange for a basket of securities—may lend itself to certain conflicts for the ETF's investment adviser, who has discretion to specify the securities included in the baskets. These conflicts would appear to be minimized in the case of an index-based ETF because the universe of securities that may be included in the ETF's portfolio generally is restricted by the composition of its corresponding index. The same would not appear to be the case for an actively managed ETF. The increased investment discretion of the adviser to an actively managed ETF would seem to increase the potential for conflicts of interest. For example, an adviser to an index-based ETF would have little ability to create a market for certain securities in a way that would favor an affiliate. Because the adviser to an actively managed ETF would have greater discretion to designate securities to be included in the Portfolio Deposit or Redemption Basket, a greater potential for conflicts appears to exist.

What potential conflicts of interest would exist for the investment adviser to an actively managed ETF? Would the adviser to an actively managed ETF be in a position to create supply or demand for 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?

3. Prospectus Delivery in Connection With Secondary Market Purchases

Open-end funds and UITs are required to deliver a prospectus in connection with a sale of their shares. Specifically, section 24(d) of the Act provides, in relevant part, that the prospectus delivery exemption provided to dealer transactions by section 4(3) of the Securities Act does not apply to any transaction in a redeemable security issued by an open-end fund or UIT.[64] For transactions in ETF shares in the secondary market, the Commission has granted exemptions under section 6(c) of the Act from section 24(d) to permit

[59] 15 U.S.C. 80a–22(e).

[60] In their applications, ETFs acknowledge that no relief obtained from the requirements of section 22(e) will affect any obligations that they may otherwise have under rule 15c6–1 under the Exchange Act. *See, e.g.,* Second Amended and Restated Application of Barclays Global Fund Advisors, File No. 812–11598, filed May 11, 2001 (''Barclays Foreign Application'') at 76. Rule 15c6–1 requires that most securities transactions be settled within three business days of the trade date. 17 CFR 240.15c6–1

[61] *See, e.g.,* Barclays Foreign Application at 76–84.

[62] 15 U.S.C. 80a–1(b)(3).

[63] 15 U.S.C. 80a–1(b)(2).

[64] 15 U.S.C. 80a–24(d); 15 U.S.C. 77d(3).

dealers selling shares of certain ETFs to rely on the prospectus delivery exemption provided by section 4(3) of the Securities Act.[65] ETFs that have received this relief continue to be subject to prospectus delivery requirements in connection with sales of Creation Units and transactions involving an underwriter.

In support of the relief, applicants have noted that the ETF shares would be listed on a national securities exchange and would be traded in a manner similar to shares of closed-end funds, for which dealers selling shares in the secondary market generally are not required to deliver a prospectus. These ETFs also have agreed that dealers selling their shares will provide investors with a ''product description'' describing the ETF and its shares.[66] While not intended as a substitute for a prospectus, the product description contains information about the ETF shares that is tailored to meet the needs of investors purchasing the shares in the secondary market. The product description provides a plain English description of the salient features of the ETF shares, including the fact that the shares are index-based securities, the manner in which the ETF shares trade on the secondary market, and the manner in which Creation Units are purchased and redeemed. The product description discloses that the ETF shares are not redeemable individually, and that an investor selling the shares in the secondary market may receive less than the NAV of the ETF shares.[67]

To the extent that actively managed ETFs would seek similar relief from prospectus delivery requirements, would the relief be consistent with the public interest and the protection of investors? Are there any aspects of an actively managed ETF that would make this relief inappropriate? For example, should an actively managed ETF be required to deliver its prospectus in order to communicate its investment strategy or fundamental policies? If the relief is granted on the condition that actively managed ETFs provide investors with a product description, what information about an actively managed ETF is particularly important to include or highlight in the product description?

### *F. The Concept of an Actively Managed ETF as a Class of a Mutual Fund*

#### 1. Multiple Class Open-End Funds

Open-end funds often offer multiple classes of shares representing interests in the same portfolio of securities. An open-end fund may establish a multiple class arrangement generally to offer investors a choice of methods for paying distribution costs or to allow the fund to use alternative distribution channels more efficiently. For example, a fund may offer a class of shares that carries only a front-end sales load, and another class that carries a deferred sales load and an asset-based distribution fee (known as a ''rule 12b–1 fee'' because it is permitted by rule 12b–1 under the Act) [68].

A multiple class arrangement requires an exemption from sections 18(f)(1) and 18(i) of the Act.[69] Rule 18f–3 under the Act provides that exemption and establishes a framework governing the multiple class arrangements of open-end funds.[70] Rule 18f–3 addresses issues that may create various conflicts among the different classes of shares of a fund. One requirement of rule 18f–3 is that, other than certain differences allowed by the rule, each class must have the same rights and obligations as each other class.

#### 2. An Index-Based ETF as a Class of an Existing Open-End Fund

In December 2000, the Commission issued the first order to permit certain existing index funds to create a class of shares (''ETF class'') 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 (''ETF Class Order'').[71] By creating an ETF class, the index funds hope to provide short-term investors and market timers with an attractive means of purchasing shares that can be bought and sold continuously throughout the day at market prices.[72] In their exemptive application, the index funds stated that the purchase and redemption requests by short-term investors in the conventional classes increase a fund's realization of capital gains, increase fund expenses, and hinder a fund's ability to achieve its investment objective of tracking its index. Because transactions in the individual shares of the ETF class would occur in the secondary market, these transactions would not involve the funds, and as a result, would not disrupt the funds' portfolio management or increase the funds' transaction costs.[73]

In the ETF Class Order, exemptive relief from sections 18(f)(1) and 18(i) of the Act was required because, among other reasons, the index funds stated that the conventional shares and exchange-traded shares would have certain different rights.[74] For example, the conventional shares would be individually redeemable from the fund, while exchange-traded shares would be redeemable only in Creation Units. In addition, the exchange-traded shares would be traded in the secondary market, while conventional shares would not. The funds asserted that these different rights were necessary for the proposal to have the desired benefits, and that the different rights did not implicate the concerns underlying section 18 of the Act, including conflicts of interest and investor confusion. With respect to the potential for investor confusion, the funds agreed to take a variety of steps to ensure that investors understand the key differences between the classes of exchange-traded shares and conventional shares.[75]

#### 3. ETF Class of an Actively Managed Open-End Fund

Would actively managed mutual funds seek to introduce exchange-traded classes? Do short-term investors such as market timers and day traders use actively managed funds in the same way that they use index funds? If not, are there different reasons to permit existing actively managed mutual funds to establish ETF classes?

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

[65] *See, e.g.,* SPDR Order.

[66] ETFs that possess relief from section 24(d) are listed on the American Stock Exchange, which has adopted rules requiring the delivery of product descriptions. *See* American Stock Exchange Constitution and Rules & Arbitration Awards, Rules 1000 and 1000A.

[67] *See, e.g.,* SPDR Applicaiton at 82–98.

[68] 17 CFR 270.12b–1.

[69] Section 18(f)(1) of the Act, in relevant part, prohibits an open-end fund from issuing any class of ''senior security,'' which includes any stock of a class having a priority over any other class as to the distribution of assets or the payment of dividends. 15 U.S.C. 80a–18(f)(1). Section 18(i) of the Act requires that every share of stock issued by an open-end fund be voting stock, with the same voting rights as every other outstanding voting stock. 15 U.S.C. 80a–18(i).

[70] 17 CFR 270.18f–3.

[71] Vanguard Index Funds, Investment Company Act Rel. Nos. 24680 (Oct. 6, 2000) (notice) and 24789 (Dec. 12, 2000) (order).

[72] Transactions in an index fund's conventional shares would continue to be priced at that day's NAV. The purchase and redemption of Creation Units also would be priced at NAV.

[73] Application and Vanguard Index Funds, File No. 812–12094, filed July 12, 2000 (''Vanguard Application''), at 6–8.

[74] In addition to relief from section 18, the ETF Class Order also granted the exemptive relief typically obtained by index-based ETFs organized as open-end funds and prospectus delivery relief.

[75] Vanguard Application at 36–47.

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?

Is there additional potential for investor confusion about the nature of the ETF class shares? How would potential investor confusion be addressed? Would prospectus delivery relief be appropriate in connection with ETF classes of actively managed funds, and if so, what information should be included in the product description?

## V. Solicitation of Additional Comments

In addition to the areas for comment identified above, we are interested in any other issues that commenters may wish to address relating to actively managed ETFs. Please be as specific as possible in your discussion and analysis of any additional issues.

By the Commission.

Dated: November 8, 2001.

**Margaret H. McFarland,**

*Deputy Secretary.*

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