

EVOLUTION OF EXCHANGE TRADED PRODUCTS:
HOW NEW SEC RULES MAY TIP THE COMPETITIVE
BALANCE

Nuts & Bolts of Financial Products 2010
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What we will cover in this presentation:

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- Registering and launching exchange-traded funds
 - Conventional Exchange-Traded Funds ("ETFs")
 - Commodities-Based and Other Exchange-Traded Vehicles ("ETVs")
 - (Exchange-Traded Notes, or "ETNs," will be covered by a subsequent panelist)
- Understanding how unique regulatory requirements impact the current competitive balance between ETFs and ETVs
- How will new SEC rules change the current competitive landscape?

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Typical Operation of an ETF

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- Most ETFs are index funds.
- Investment objective = tracking the performance of a specified securities index.
- American Stock Exchange pioneered the concept of a tradeable basket of stocks with the "SPDRs" in 1993, which invests in stocks comprising the S&P 500 Composite Stock Price Index.
- AMEX remained the center of ETF development and innovation until its merger into New York Stock Exchange.

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Typical Operation of an ETF (continued)

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- Many ETFs track broad market indices, but there are also sector-specific ETFs that track a variety of other market indices ranging from industrials to health care and medical development, as well as recently-introduced "actively-managed" ETFs.
- Large ETF sponsors include Barclays Global Investors (iShares), State Street Global Advisors (SPDRs), Vanguard, and PowerShares.
- Innovative nature of ETFs has also attracted relative newcomers to the mutual fund industry, like Wisdom Tree.

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Typical Operation of an ETF (continued)

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- Unlike index and other mutual funds, ETFs do not sell shares to, or redeem shares from, individual investors at net asset value ("NAV").
- Instead, ETFs sell and redeem their shares at NAV only in large blocks called "creation units" (such as 100,000 shares).
- Brokerage firms and institutional investors that purchase or redeem ETF shares in creation units (referred to as "Authorized Purchasers" or "APs") typically do so through "in-kind" transactions involving a "portfolio deposit" equal in value to the aggregate NAV of the ETF shares in the respective creation unit.
- Contents of portfolio deposit announced at beginning of each business day.
- Portfolio deposit generally consists of a basket of securities that mirrors the composition of the ETF's portfolio.

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Typical Operation of an ETF (continued)

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- After purchasing a creation basket, an AP may hold the ETF's shares, or sell some or all of the shares to other brokerage firms, institutional investors, or individual investors.
- Shares are listed on a national stock exchange (such as the NYSE Arca) and trade through purchase and sale transactions in the secondary market, just like shares of stock of any public company, until APs purchase shares in the secondary market to sell them back to the ETF in a creation unit called a "redemption basket."
- ETFs possess characteristics of "closed-end" funds, which generally issue shares that trade at negotiated prices on national securities exchanges and are not redeemable, but ETFs generally avoid discounts common to closed-end funds.

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Overview of Regulation of ETFs under the Federal Securities Laws

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- Like index and other types of mutual funds, ETFs are captured by definition of an "investment company" under the Investment Company Act of 1940 (the "1940 Act"), so they must register with SEC under the 1940 Act as "open-end management investment companies."
- Like mutual funds, ETFs are required to register the offering of their shares with the SEC under the Securities Act of 1933 (the "1933 Act").
- Like mutual funds, ETFs are exempted from the requirement under the Securities Exchange Act of 1934 (the "1934 Act") to file periodic reports such as 10-Ks and 10-Qs.
- Instead, ETFs provide investors with semi-annual and annual shareholder reports like other mutual funds.

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Benefits of Exchange Traded Funds

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- ETFs offer investors several potential benefits:
 - Investment in a diversified basket of securities through the purchase of a single exchange traded security.
 - Diversification benefits of mutual funds while still being able to trade shares of ETF with the flexibility of a listed stock.
 - ETFs may avoid discounts and premiums of closed-end funds by continuously issuing and redeeming ETF shares in creation units and thereby creating arbitrage opportunities.

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Potential Cost Savings Offered by ETFs

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- Like index funds, most ETFs are "passively" managed to track an index and typically have relatively low levels of turnover in portfolio securities.
- ETF expenses may therefore be lower than expenses of actively managed mutual funds, which generally have higher management fees and brokerage expenses due to ongoing purchases and sales of portfolio securities.
- Some ETFs have even lower expense ratios than comparable index funds, because ETFs have lower level of shareholder recordkeeping and service expenses than index funds offered and sold to individual investors.
- Individual investor information for ETFs is kept at retail broker-dealer level, while ETF transfer agent keeps only information on APs.

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Potential Tax Advantages Offered by ETFs

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- Mutual funds that sell portfolio securities to pursue investment strategies or generate cash for shareholder redemptions may realize capital gains.
- Tax law requires fund to distribute capital gains to its shareholders, who are taxed on gain.
- Significant market downturns can lead to tax anomalies.
- ETFs must also distribute capital gains, but may be more tax efficient because of low portfolio turnover.
- ETFs typically redeem shares in kind, so they may not have to sell securities and generate capital gains.

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Commodity-Based and Other Exchange Traded Vehicles: A New Generation of ETFs

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- Witnessing the success of conventional ETFs, several years ago creative fund sponsors began to explore whether the ETF structure could be used to "equitize" non-security asset classes such as gold, silver, crude oil or other types of commodities not generally available to individual investors.

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Precious Metals Exchange Traded Vehicles

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- The first ETV to be offered in US was the "Equity Gold Trust," now called "StreetTracks."
- Gold Trust made investing in gold available to a broader investor base by permitting individual investors to *beneficially* own gold bullion in the form of a listed equity security.
- Gold Trust holds gold bullion transferred to it in exchange for Trust shares issued in creation units and delivers gold for redemption baskets.
- Other precious metal ETVs followed on the heels of the Gold Trust.

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Oil-Based Exchange Traded Vehicles

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- Around the same time, similar interest developed in creating an exchange traded vehicle that would provide individual investors with a direct means of investing in and/or hedging their exposure to the spot price of crude oil and other petroleum-based products.
- Notwithstanding certain similarities to the precious metals funds, there were fundamental differences in the two types of funds' respective underlying commodity-based investments that had to be taken into account from a regulatory perspective.

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Oil-Based Exchange Traded Vehicles (continued)

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- Transporting and storing crude oil is exponentially more expensive than transporting gold or other precious metals.
- Investing directly in crude oil was therefore unworkable; selling and redeeming creation units in in-kind transactions would also have been fundamentally unworkable.
- This left crude oil-based *derivative* instruments as the only viable alternative.
- Crude oil futures contracts are traded in well-developed commodities markets, including the New York Mercantile Exchange ("NYMEX").

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Oil-Based Exchange Traded Vehicles (continued)

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- However, futures contracts, unlike securities and precious metals, cannot be transferred in in-kind transactions — futures contracts are agreements between two parties, and the corresponding obligation between the parties is fundamentally different from a legal standpoint than property such as securities or precious metals.
- The first oil-based ETV, United States Commodities Funds' U.S. Oil Fund ("USOF"), required creation units to be purchased and redeemed through cash transactions, with the cash then being used to purchase futures contracts.

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Other Commodity-Based Exchange Traded Vehicles



- ETVs that invest in commodities *other than* gold and oil have been developed and successfully brought to market.
- These ETVs include broad-based commodity ETFs like GreenHaven Continuous Commodity Index, iShares GSCI Commodity-Indexed Trust and PowerShares DB Commodity Index Tracking Fund.
- There are also sector-specific commodity ETVs like PowerShares DB Agriculture Fund, PowerShares Base Metals Fund and MLCS Grains Index Elements ETF.
- Currency ETVs track specified currencies.

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Overview of Regulation of Commodity-Based Exchange Traded Vehicles



- Commodity-based ETVs are not regulated as investment companies under the 1940 Act, because they have generally not been viewed as investing in "securities."
 - *N.B.:* Commodity futures contracts, unlike underlying commodities, have been the subject of an ongoing jurisdictional debate between SEC and CFTC; commodity pools have for years registered their shares under the 1933 Act, but the treatment of commodity pools for purposes of the 1940 Act has at times been less clear.
- Commodity-based ETVs are required to register offering of shares under 1933 Act.
- May also need "no-action" relief under the 1934 Act.

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Overview of Regulation of Commodity-Based Exchange Traded Vehicles (continued)



- Commodity futures contracts are regulated by United States Commodity Futures Trading Commission ("CFTC").
- Collective investment vehicles that invest in commodity futures contracts are regulated by CFTC and National Futures Association ("NFA") as "commodity pools."
- Tax issues, basic corporate structuring questions, and other legal questions must be addressed to successfully negotiate the maze of regulations that apply to ETVs.
- Voyage is not for the weak-of-heart, and ETVs have been under a microscope recently at the federal level, which may result in new investment restrictions.

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Nuts and Bolts: Registration Requirements for ETFs Under the 1933 Act and the 1940 Act

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- Absent an applicable exemption, securities issued by general corporate issuers are required to be registered under the 1933 Act by filing a registration statement on the prescribed form.
- Mutual funds and other investment companies such as ETFs are no different, but the mechanics of registering and paying registration fees can be significantly more streamlined than for corporate and other non-investment company issuers.
- Absent an available exemption, mutual funds and other investment companies also are required to register under 1940 Act on the prescribed registration form.
- Both registrations can be accomplished through the same "integrated" registration form – Form N-1A .

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ETF Prospectus Delivery Requirements

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- Like conventional mutual funds, ETFs are required to deliver prospectuses to APs that purchase shares.
- There is a twist, however, to the prospectus delivery requirements for ETFs regarding *secondary market* purchasers.
- Until recently, ETFs obtained an exemption from the prospectus delivery requirements to secondary market purchasers; instead, broker-dealers were required to deliver summary "Product Descriptions."
- New SEC rules now require prospectuses to be delivered to secondary market purchasers.

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Nuts and Bolts: Registration Requirements for ETVs under the 1933 Act

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- ETVs, like ETFs, must register their shares under the 1933 Act.
- The "catchall" form, Form S-1, is used by most ETVs.
- The *mechanics* of registering and paying the registration fees on ETV shares as opposed to ETF shares can be significantly more complex.
- Why? Because ETVs are not investment companies, they generally are not permitted to sell an unlimited number of shares; instead, they must register a definite amount of securities, and when those securities are sold, a new registration statement must be filed.
- Moreover, unlike ETFs and mutual funds, redemptions cannot be netted against sales.
- Therefore, while there are certain "shelf" registration procedures that can potentially be used by an ETV to streamline registration requirements, generally a new Form S-1 must be filed when an ETV has sold all of the shares it has registered.

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Registration Requirements for ETVs under the 1933 Act (continued)

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- This requirement effectively obligates ETVs (at least, the successful ones) to pay significant amounts of ongoing SEC registration fees that ETFs do not have to pay.
- The ETV also incurs significant associated legal, accounting, and other expenses.
- At the same time, ETVs are not required to register under the 1940 Act because they are not investment companies.

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ETFs Versus ETVs: Application of Substantive Regulatory Requirements of the 1940 Act

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- Because of their unique structure, ETFs must obtain exemptive relief from certain provisions of the 1940 Act by filing an application with the SEC.

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ETFs Versus ETVs: Application of Substantive Regulatory Requirements of the 1940 Act (continued)

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- Obtaining an exemptive order may take an extended period of time and require a significant commitment of legal and other resources.
- Preparing the exemptive application requires a significant commitment of time and resources and a careful analysis of multiple legal and technical operational issues.
- The SEC staff has made a concerted effort to streamline this process, and as a result, the process may now take six to twelve months as opposed to one to two years or more.
- However, innovative new ETFs are constantly being developed, and the application process for a new type of ETF may take considerably longer – sometimes a period of years.

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Exemptive Relief from the 1940 Act Not Required for ETVs

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- Because they are not investment companies and are therefore not regulated under the 1940 Act, ETVs are not required to obtain exemptive relief from provisions of the 1940 Act.
- This may give ETVs a "speed to market" advantage over ETFs because obtaining an exemptive order can be a protracted process.

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ETFs Versus ETVs: Exemptive Relief Under the Securities Exchange Act of 1934

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- ETF shares are listed on national exchanges and trade in the secondary market.
- This aspect of ETFs has been viewed as potentially triggering the application of certain provisions of the 1934 Act and the rules thereunder.
- ETVs that have analyzed potential applicability of these 1934 Act provisions and rules in some cases have concluded that certain provisions and rules do not apply.
- Other provisions and rules may apply.

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ETFs Versus ETVs: Application of Exchange Listing Standards

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- Another significant regulatory component of ETF secondary market trading and exchange listing is the triggering of exchange listing requirements.
- Authority must be requested and obtained by the listing exchange submitting an exemptive application to the SEC's Division of Trading and Markets under Rule 19b-4 of the 1934 Act.

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ETFs Versus ETVs: Application of Exchange Listing Standards (continued)

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- Applicable rules require a 19b-4 application to be submitted for each new ETV.
- The 19b-4 process can be time consuming, and it may be particularly important to assess the need to submit a 19b-4 application early on in the process of forming and registering an ETV.

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ETFs VERSUS ETVs: Structural Considerations

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- ETFs enjoy a very significant competitive advantage as a result of being organized and regulated as investment companies under the 1940 Act – availability of “Subchapter M” treatment under Internal Revenue Code (“IRC”).
- Mutual funds, ETFs, and other types of registered investment companies (“RICs”) receive pass-through tax treatment from special provisions under IRC contained in Subchapter M of the Code.
- ETVs must search for other sources of pass-through tax treatment under the IRC.
- One avenue has been to organize as “master limited partnerships” since limited partnerships generally receive pass-through tax treatment under IRC.

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ETFs VERSUS ETVs: Structural Considerations (continued)

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- Importantly, however, alternative structures such as master limited partnerships may present certain disadvantages from varying perspectives, including under the federal securities laws.

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**ETFs VERSUS ETVs: Structural Considerations
(continued)**

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- Another practical implication of choosing a tax structure for an ETV is tax reporting.
- Limited partnerships, for example, are required to report earnings to investors on "K-1s," which some fund sponsors may have viewed as unattractive from a marketing standpoint.
- In this regard, Treasury Department recently issued guidance on appropriate tax reporting for certain types of fund structures that may be employed by ETVs.

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ETFs Versus ETVs: Other Regulatory Considerations

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- Potential applicability of the Commodities Exchange Act
 - Regulation of commodity pools
 - Registration and record keeping
 - Disclosure
 - Commodity Pool Operators ("CPOs") are generally required to deliver to each prospective investor, and file with the NFA and the CFTC, a "disclosure document" setting forth information about the commodity pool and the CPO
 - For ETVs, this document can be the ETV's prospectus.

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FINRA "Direct Participation Program" Requirements

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- Under FINRA rules, a "direct participation program" includes a program that provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution.
- Under FINRA Conduct Rule 2810 ("Rule 2810"), no member or person associated with a member may participate in any manner in any public offering of securities of a "direct participation program" unless documents and information as specified therein related to the offering have been filed with and reviewed by FINRA .

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New SEC Rules Would Enhance Speed to Market for ETFs

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- Proposed Rule 6c-11 would provide exemptions to an ETF that complies with the Rule's conditions so that the ETF would not need to file an individual exemptive application and obtain exemptive relief before commencing operations.
- If adopted, Rule 6c-11 would make it substantially more practicable to establish new ETFs by eliminating the costs and other burdens associated with preparing and filing exemptive applications and reducing the time it takes to bring a new ETF to market.
- Although the SEC has not adopted Rule 6c-11, the agency did recently adopt the proposed "Summary Prospectus" rule which went ahead and incorporated certain of the disclosure principles from proposed 6c-11.

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New SEC Rules Would Enhance Speed to Market for ETFs (continued)

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- To rely on Rule 6c-11, an ETF would be required to:
 - Be approved for listing and trading on a national securities exchange under Section 12 of the 1934 Act.
 - Issue and redeem creation units in exchange for basket assets, the current value of which is disseminated on a per share basis by the exchange at regular intervals during the trading day.
 - In any sales literature, ETF must identify itself as an ETF that does not sell or redeem individual shares and explain that investors may purchase or sell individual shares only on an exchange.

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New SEC Rules Would Enhance Speed to Market for ETFs (continued)

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- The SEC also proposed a new rule, Rule 12d1-4 under the 1940 Act, that would provide necessary exemptions for other mutual funds to invest in ETFs without any limits, with conditions substantially less burdensome than those that have heretofore been included in Section 12(d)(1) exemptive orders for both funds-of-funds and funds-of-ETFs.

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New SEC Rules Would Enhance Speed to Market for ETFs (continued)

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- Competitive Impact on ETFs versus ETVs:
 - ETVs currently enjoy a competitive cost and "speed-to-market" advantage over ETFs because they are not required to obtain exemptive orders under the 1940 Act.
 - On the other, the fact that ETVs are not regulated investment companies or "RICs" has subjected product sponsors to a unique set of regulatory challenges under 1933 Act registration procedures, including applicable "shelf registration" rules, and potentially "ineligible issuer" rules, as well as under federal tax laws.
 - This competitive calculus would change if the proposed ETF exemptive rules are adopted – ETVs would no longer enjoy a competitive advantage over ETFs resulting from ETFs having to obtain exemptive relief; at the same time, ETVs would continue to be subject to the unique regulatory issues resulting from not being regulated under the 1940 Act.

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Prognosis

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- However, not clear that the SEC staff considers the ETF exemptive rules ready to be adopted by the SEC.
- The rules enjoy widespread industry support, but the SEC continues to apply new requirements to certain new ETFs that may ultimately result in re-proposing the rule or holding up its adoption indefinitely.
- Stay tuned!

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