

Practising Law Institute
Nuts and Bolts of Financial Products

COMPARING AND CONTRASTING
EXCHANGE TRADED FUNDS AND
EXCHANGE TRADED NOTES

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Legal and Operational

- **Organizational form of issuer**
 - ETF: corporation or business trust (UITs are trusts)
 - ETN: corporation
- **Character of security**
 - ETF: equity – an undivided interest in a pool of assets
 - ETN: debt – senior, unsecured
- **Term of security**
 - ETF: if a corporation, perpetual; if a trust, long term
 - ETN: typically 30 years

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Legal and Operational (continued)

- **Registration**
 - ETF: ETF shares – 1933 Act, 1934 Act; ETF issuer – 1940 Act
 - ETN: 1933 Act, 1934 Act
- **Disclosure document**
 - ETF: prospectus (part of registration statement, usually on Form N-1A)
 - ETN: prospectus supplement (to MTN prospectus supplement and debt shelf prospectus, part of shelf registration statement on Form S-3)

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Legal and Operational (continued)

■ Regulation

- ETF: substantial regulation under 1940 Act
- ETN: not regulated under 1940 Act

■ Regulatory relief necessary

- ETF: exemptive order under 1940 Act; no-action relief under 1934 Act
- ETN: no-action relief under 1934 Act

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Legal and Operational (continued)

■ Exchange listing

- ETF: pursuant to generic listing criteria (or one-off 19b-4 order)
- ETN: pursuant to generic listing criteria (or one-off 19b-4 order)

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Legal and Operational (continued)

■ Principal service providers

- ETF: sponsor (typically investment advisor), administrator, distributor, custodian, independent accountant, legal, index provider/ calculator, exchange, market participants (authorized participants, other broker-dealers)
- ETN: indenture trustee, underwriter, independent accountant, legal, index provider/ calculator, exchange, market participants

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Legal and Operational (continued)

■ **Portfolio management**

- **ETF:** index-based – limited to achieving index performance;
- **actively managed** – pursuant to stated investment objectives
- **ETN:** none, although issuer may hedge exposure

■ **Issuance of securities**

- **ETF:** continuous, in creation units, generally for in-kind deposit at NAV
- **ETN:** from time to time (and sometimes reopened), at negotiated prices

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Legal and Operational (continued)

■ **Redemption of securities**

- **ETF:** daily, in creation units, generally for in-kind proceeds at NAV
- **ETN:** at least once weekly, in large aggregations, for cash, based on current value of index factor and less applicable fees

■ **Clearance and settlement**

- **ETF:** book-entry through facilities of DTC
- **ETN:** book-entry through facilities of DTC

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Legal and Operational (continued)

■ **Voting rights**

- **ETF:** if open-end form, yes; if UIT form, generally none
- **ETN:** none

■ **Taxation**

- **ETF:** taxation as a RIC
- **ETN:** with certain exceptions, treatment as a cash-settled prepaid contract (although subject to change by IRS and U.S. Treasury)

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Economic

■ Liquidity

- **ETF:** intraday over exchange or OTC at market prices; redemption of creation units at least once daily at NAV
- **ETN:** intraday over exchange or OTC at market prices; redemption of large blocks at least once weekly based on index factor

■ Recourse

- **ETF:** assets in portfolio
- **ETN:** credit of the issuer

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Economic (continued)

■ Principal risk

- **ETF:** market risk only
- **ETN:** market risk and issuer credit risk

■ Arbitrage

- **ETF:** NAV purchase/redemption mechanism, secondary market
- **ETN:** redemption mechanism, purchases out of inventory, secondary market

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Economic (continued)

■ Price transparency

- **ETF:** intraday published indicative value; published index/basket information
- **ETN:** intraday published indicative value; published index/basket information

■ Distributions

- **ETF:** yes; received or reinvested
- **ETN:** none

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Economic (continued)

■ Fees and expenses

- ETF: asset-based expense ratio; issuance/redemption fees; brokerage
- ETN: investor fee; redemption fees; brokerage

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