

## SEC issues notices for actively managed ETFs

In early February 2008, the Securities and Exchange Commission issued notices relating to exemptive relief requests filed by two investment management firms, [PowerShares Capital Management](#) and [Bear Stearns Asset Management](#), seeking to operate actively managed exchange traded funds (“ETFs”). These actively managed ETFs will use an active management strategy to achieve their investment objectives instead of tracking the performance of a benchmark index.

### Relief Requested

The relief requested mirrors the relief typically sought to operate index-based ETFs. Both applications request relief permitting:

- (a) ETFs covered by the order to issue shares redeemable in large aggregations only (“Creation Units”); and
- (b) secondary market transactions in shares to occur at negotiated market price.

Unlike the Bear Stearns application, the PowerShares application seeks additional relief permitting:

- (a) certain affiliated persons to deposit securities into and receive securities from the PowerShares actively managed ETFs in connection with the purchase and redemption of Creation Units (Bear Stearns actively managed ETFs will issue and redeem Creation Units for cash only, so this relief was not necessary); and
- (b) certain externally registered funds and UITs to acquire shares in excess of the limits imposed by Section 12(d)(1) of the Investment Company Act of 1940, as amended.

Neither application requests relief from Section 24(d) of the Investment Company Act. Absent this relief, a statutory prospectus must accompany each secondary market trade of shares.

### New Conditions

The conditions imposed on this relief will be substantially the same as the conditions imposed on index-based ETFs. Both applications, however, provide that the order will expire on the effective date an Investment Company Act rule is created that provides relief permitting the operation of actively managed ETFs.

The PowerShares relief has a further condition that prevents PowerShares or the ETFs’ subadvisers, directly or indirectly, from causing any institutional investor, or any investor on whose behalf an institutional investor may transact with the ETF, to acquire any deposit security for the ETF through a transaction in which the ETF could not engage directly. This condition ensures that neither PowerShares nor the ETFs’ subadvisers can use the in-kind creation process to circumvent applicable restrictions under the Investment Company Act.

## SEC Concerns About Actively Managed ETFs

The SEC's Actively Managed Exchange-Traded Funds Concept Release (Investment Company Act Release No. 25258, November 8, 2001) highlighted several issues that could have affected the SEC's willingness to authorize the operation of actively managed ETFs, including:

- (a) the effectiveness of arbitrage opportunities, which the SEC related to the transparency and liquidity of the ETF's portfolio holdings; and
- (b) the potential for discrimination among shareholders due to significant differences between secondary market prices and the net asset value; and
- (c) the potential for conflicts of interest for the ETF's investment adviser.

Each application argues that fully transparent portfolios, liquid portfolio securities and dissemination of the ETF's intra-day indicative value permits arbitrage opportunities for actively managed ETFs to the same extent as index-based ETFs, and should minimize differences between secondary market prices and the net asset value. PowerShares will use firewalls and physical separation of personnel, as well as other conflict of interest procedures discussed below. Bear Stearns took the position that its actively managed ETFs do not present a greater potential for conflicts-of-interest than any actively managed mutual fund.

### Initial PowerShares ETFs

Two of the initial actively managed ETFs will be subadvised by AER Advisors, Inc., which will use its proprietary stock screening methodology to manage the AER ETFs. The AER ETFs' portfolio holdings may be changed only once per week on the last business day of each week, and AER may only eliminate and replace up to three stocks each week. To prevent others from front running the stock selection for the AER ETFs, AER will not provide certain details concerning its stock screening methodology to Alpha Equity Research, Inc., AER's affiliate and a stock research provider, or Alpha Equity's clients until the business day following the public announcement of changes in the AER ETFs' holdings.

The other two initial actively managed ETFs will be subadvised by Invesco Institutional, Inc., which will seek to outperform an appropriate benchmark index. The requested relief would also apply to future actively managed ETFs advised by PowerShares or its affiliates that invest in equity or fixed income securities.

### Initial Bear Stearns ETF

The Bear Stearns Current Yield Fund, the initial series of a new trust, intends to invest primarily in short-term debt obligations, but will not be a "money market fund" and will not maintain a target share price. The requested relief would also apply to future actively managed ETFs advised by Bear Stearns or its affiliates that invest primarily in investment grade fixed income securities.

### Contact Information

If you have any questions concerning the contents of this alert, please contact your usual legal adviser at Ropes & Gray or [Robert J. Borzone, Jr.](#)

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