

## SEC Proposes New Rules for ETFs

The Securities and Exchange Commission (“SEC”) recently proposed a new rule under the Investment Company Act of 1940, as amended (“1940 Act”), that would permit certain exchange traded funds (“ETFs”) to organize and operate without obtaining an exemptive order from the SEC. The SEC also proposed amendments to Form N-1A designed to provide more useful information to investors who purchase and sell ETF shares in the secondary markets. In addition, the SEC proposed a new rule under the 1940 Act to permit investment companies to invest in ETFs to a greater extent than currently permitted under the 1940 Act. The proposing release is available [here](#).

### Proposed Rule 6c-11: The “ETF Rule”

The SEC’s approach to ETF rulemaking focuses on portfolio transparency and disclosure. Proposed Rule 6c-11, which only applies to open-end funds and not unit investment trusts, permits index-based ETFs and fully transparent, actively managed ETFs to organize and operate without obtaining an exemptive order from the SEC. The proposed rule codifies most of the exemptive relief granted to-date to ETFs, including the relief granted in late February 2008 to WisdomTree, Barclays, Bear Stearns and PowerShares to organize and operate the first fully transparent actively managed ETFs (collectively, the “Actively Managed ETF Orders”).

### Conditions

*Transparency.* The proposed rule does not limit the types of indexes that an ETF may track or the types of securities that comprise any index. Under the proposed rule, an ETF must either disclose its portfolio holdings on a daily basis, or, if the ETF seeks to track an index, the index provider must disclose the index components on an internet website. Note: An actively managed ETF whose portfolio holdings are not fully transparent cannot rely on the proposed rule and must apply for exemptive relief before commencing operations.

*Exchange Listing: Intraday Value Dissemination.* The ETF’s shares must be listed and traded on a national securities exchange. The listing exchange must disseminate an approximation of the current value of the ETF’s portfolio holdings on a per-share basis (Intraday Value) at regular intervals during the trading day.

*Creation Unit Size, “Basket Assets,” and Marketing.* The ETF must establish creation unit sizes the number of shares of which are reasonably designed to facilitate arbitrage. ETFs may require or permit a creation unit purchaser to substitute cash for some or all of the securities delivered to the ETF in exchange for a creation unit. The ETF must not market or advertise itself as an open-end fund or mutual fund, and must explain that investors purchase and sell ETF shares in secondary market transactions that do not involve the ETF.

### Conditions in ETF Orders But Not in Contained in the Proposed ETF Rule

*Conflicts of Interest.* While the Actively Managed ETF Orders contain a condition prohibiting an adviser from causing a creation unit purchaser to acquire a security for the ETF through a transaction in which the ETF could not engage directly, the proposed rule does not contain this condition. Section 48(a) of the 1940 Act prohibits an adviser from any such activity.

*Affiliated Index Providers.* Conditions in orders issued to ETFs with an affiliated index provider, such as firewalls between index creators and portfolio managers, limits on changes to the index methodology, and component securities and independent calculation agents (so-called “WisdomTree Conditions”), which are designed to prevent the communication of material non-public information between the ETF and the affiliated index provider, are not included in the proposed rule.

*Prospectus Delivery.* While index-based ETF orders have included relief from section 24(d) of the 1940 Act, which relieves dealers from delivering ETF prospectuses to investors in secondary market transactions, the Actively Managed ETF Orders do not contain this relief and neither does the proposed rule. If the SEC's summary prospectus proposal is adopted, broker-dealers could deliver a summary prospectus in secondary market transactions. The SEC expects to amend previously issued ETF orders to remove the section 24(d) exemptions and, thus, require all ETFs to satisfy their statutory prospectus delivery requirements.

## Exemptions Provided by the Proposed ETF Rule

The proposed rule provides relief from sections 2(a)(32), 22(d), 22(e), 17(a)(1) and 17(a)(2) of the 1940 Act, and rule 22c-1(a) under the 1940 Act, which is consistent with the exemptive relief granted to-date to ETFs.

## Proposed Amendments to Form N-1A

New disclosures in an ETF's prospectus and annual reports would include (a) returns based on share market price; (b) the number of trading days that shares trade at a premium or discount; and (c) performance comparison to the ETF's underlying index rather than a benchmark index, for index-based ETFs. ETFs with creation units of 25,000 or more shares could omit certain disclosures, such as information on how to buy and redeem shares from the ETF, and fees and expenses for purchases or sales of creation units (currently included in the prospectus fee table and periodic reports). Open-end ETFs would have to comply with the prospectus summary section disclosures proposed by the SEC in its [Enhanced Disclosure Proposing Release](#), if adopted.

## Proposed Rule 12d1-4: The "ETF Fund of Funds Rule"

Proposed rule 12d1-4 permits fund investments in ETFs beyond the limits of section 12(d)(1) if: (a) the acquiring fund (and any entity in a control relationship with the acquiring fund) does not control the ETF; (b) the acquiring fund does not redeem certain shares acquired in reliance on the proposed rule (the shares must be sold in secondary market transactions); (c) the fees charged by the acquiring fund do not exceed the FINRA sales charge limits; and (d) the acquired ETF is not itself a fund of funds (three-tier fund structures are prohibited).

## Amendments to Rule 12d1-2

Rule 12d1-2 permits affiliated funds of funds to acquire securities issued by other unaffiliated investment companies, as well as securities (other than securities issued by an investment company). Proposed amendments to rule 12d1-2 would allow acquiring funds that invest in affiliated funds in reliance on section 12(d)(1)(G) to invest in unaffiliated ETFs beyond the statutory limitations as long as the funds comply with the conditions of proposed rule 12d1-4. Other proposed amendments to rule 12d1-2 would permit funds relying on section 12(d)(1)(G) to invest in, among other things, real estate, futures contracts, and other financial instruments that do not qualify as a security under the 1940 Act.

## Comment Period

Comments on the proposed rules and amendments should be provided on or before May 19, 2008.

## Contact Information

For further information, please contact your usual Ropes & Gray lawyer or:

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