SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 270, and 274

[Release Nos. 33-8901; IC-28193; File No. S7-07-08]

RIN 3235-AJ60

Exchange-Traded Funds

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is proposing a new rule under the Investment Company Act of 1940 that would exempt exchange-traded funds ("ETFs") from certain provisions of that Act and our rules. The rule would permit certain ETFs to begin operating without the expense and delay of obtaining an exemptive order from the Commission. The rule is designed to eliminate unnecessary regulatory burdens, and to facilitate greater competition and innovation among ETFs. The Commission also is proposing amendments to our disclosure form for open-end investment companies, Form N-1A, to provide more useful information to investors who purchase and sell ETF shares on national securities exchanges. In addition, the Commission is proposing a new rule to allow mutual funds (and other types of investment companies) to invest in ETFs to a greater extent than currently permitted under the Investment Company Act.

DATES: Comments should be received on or before May 19, 2008.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-07-08 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-07-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: With respect to proposed rule 6c-11 and amendments to Form N-1A, Dalia Osman Blass, Senior Counsel, or Penelope Saltzman, Acting Assistant Director, (202) 551-6792, with respect to proposed rule 12d1-4 and proposed amendments to rule 12d1-2, Adam Glazer, Senior Counsel, or Penelope Saltzman, Acting Assistant Director, (202) 551-6792, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC

20549-5041.

SUPPLEMENTARY INFORMATION: The Commission is proposing for public comment new rules 6c-11 [17 CFR 270.6c-11] and 12d1-4 [17 CFR 270.12d1-4] and amendments to rule 12d1-2 [17 CFR 270.12d1-2] under the Investment Company Act of 1940 ("Investment Company Act" or "Act"),[1] and amendments to Form N-1A[2] under the Investment Company Act and the Securities Act of 1933 (the "Securities Act").[3]

TABLE OF CONTENTS

1 15 U.S.C. 80a. Unless otherwise noted, all references to rules under the Investment Company Act will be to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270], and all references to statutory sections are to the Investment Company Act.

2 17 CFR 239.15A, 17 CFR 274.11A.

3 15 U.S.C. 77a.

I. INTRODUCTION

Exchange-traded funds are an increasingly popular investment vehicle.[4] Last year, the number of ETFs traded in U.S. markets increased by 67 percent, from 357 to 601, and the assets held by ETFs increased by about 42 percent, to approximately $580 billion.[5] Although aggregate ETF assets are less than seven percent of assets held by traditional mutual funds (*i.e.*, open-end investment companies),[6] they are growing more rapidly.[7]

ETFs offer public investors an undivided interest in a pool of securities and other assets

---

[4] When we refer to an ETF in this release, we refer to an ETF that meets the definition of "investment company" and is registered under the Investment Company Act generally because it issues securities and is primarily engaged or proposes to primarily engage in the business of investing in securities. Some other types of exchange-traded funds, which we will not discuss in this release, invest primarily in commodities or commodity-based instruments, such as crude oil and precious metal ("commodity ETFs"). Commodity ETFs are typically organized as trusts, and issue shares that trade on a securities exchange like other ETFs, but they are not "investment companies" under the Investment Company Act. *See* section 3(a)(1) (defining the term "investment company" as a company that "(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."). 15 U.S.C. 80a-3(a)(1).

[5] Investment Company Institute ("ICI"), Outline of Supplemental Tables for Exchange-Traded Fund Report (http://members.ici.org/stats/etfdata.xls ("ICI ETF Statistics 2007")), *Exchange-Traded Fund Assets December 2007*, Jan. 30, 2008 ("*ICI ETF Assets 2007*"). ICI statistics cited in this release may be found at: http://www.ici.org/stats/etf/index.html and exclude commodity ETFs. By comparison, 153 ETFs were introduced in 2006, 50 were introduced in 2005, and 32 ETFs were introduced in 2004. ICI, *2007 Investment Company Fact Book*, May 2007.

[6] In 2007, net new investment in ETFs was approximately $142 billion compared to $212 billion in traditional mutual funds, or 67 percent of net new investment in traditional mutual funds. ICI ETF Statistics 2007, *supra* note 5; ICI, *Trends in Mutual Fund Investing December 2007*, Jan. 30, 2008 ("*ICI Trends December 2007*").

[7] *ICI ETF Assets 2007*, *supra* note 5. As of December 2007, assets held by traditional equity and bond mutual funds were $8.9 trillion. *ICI Trends December 2007*, *supra* note 6. In 2007, ETF assets grew 42 percent (from $407.9 billion to $579.5 billion) while traditional equity and bond mutual fund assets grew 9.7 percent (from $8.06 trillion to $8.9 trillion). *See* ICI ETF Statistics 2007, *supra* note 5; *ICI Trends December 2007*, *supra* note 6.

and thus are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day like stocks on an exchange through a broker-dealer.[8] ETFs therefore possess characteristics of traditional mutual funds, which issue redeemable shares, and of closed-end investment companies, which generally issue shares that trade at negotiated market prices on a national securities exchange and are not redeemable.[9]

Since they were first developed in the early 1990s, ETFs have evolved. The first ETFs held a basket of securities that replicated the component securities of broad-based stock market indexes, such as the S&P 500.[10] Many of the newer ETFs are based on more specialized indexes,[11] including indexes that are designed specifically for a particular ETF,[12] bond indexes,[13]

---

8 ETF shares represent an undivided interest in the portfolio of assets held by the fund. ETFs are registered with the Commission and are organized either as open-end investment companies or unit investment trusts ("UITs"). *See* section 5(a)(1) of the Investment Company Act (defining "open-end company" as a management company that is offering for sale or has outstanding any redeemable security of which it is the issuer); section 4(2) of the Act (defining "unit investment trust" as an investment company that (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust). 15 U.S.C. 80a-5(a)(1).

9 ETFs today have certain characteristics that have made them attractive to investors. Many have lower expense ratios and certain tax efficiencies compared to traditional mutual funds, and they allow investors to buy and sell shares at intra-day market prices. Moreover, investors can sell ETF shares short, write options on them, and set market, limit, and stop-loss orders on them. The shares of many ETFs often trade on the secondary market at prices close to the net asset value ("NAV") of the shares, rather than at discounts or premiums.

10 *See, e.g.*, SPDR Trust, Series 1, Investment Company Act Release Nos. 18959 (Sept. 17, 1992) [57 FR 43996 (Sept. 23, 1992)] (notice) and 19055 (Oct. 26, 1992) (order) ("SPDR Order"); Diamonds Trust, Investment Company Act Release Nos. 22927 (Dec. 5, 1997) [62 FR 65453 (Dec. 12, 1997)] (notice) and 22979 (Dec. 30, 1997) (order). The S&P 500 stands for the Standard & Poor's 500 Composite Stock Price Index.

11 ETF providers offer ETFs that track the performance of indexes related to particular industries or market sectors. In 2007, domestic sector/industry ETFs increased by 62% from 135 to 219. *ICI ETF Assets 2007*, *supra* note 5.

12 Many of these indexes are essentially portfolios of assets that are compiled (and change) on the basis of criteria that the index provider has designed for the particular ETF. Some indexes, for example, are "fundamental" indexes or rules-based indexes, in which the securities are chosen on criteria such as dividends and core earnings. *See, e.g.*, PowerShares Exchange-Traded Fund

(footnote continued)

and international indexes.[14] Originally marketed as opportunities for investors to participate in tradable portfolio or basket products, ETFs are held today in increasing amounts by institutional investors (including mutual funds) and other investors as part of sophisticated trading and hedging strategies.[15] Shares of ETFs can be bought and held (sometimes as a core component of a portfolio),[16] or they can be traded frequently as part of an active trading strategy.[17]

Like money market funds first offered in the 1970s, ETFs represent a new type of

---

Trust, Investment Company Act Release Nos. 25961 (Mar. 4, 2003) [68 FR 11598 (Mar. 11, 2003)] (notice) ("PowerShares 2003 Notice") and 25985 (Mar. 28, 2003) (order) ("PowerShares 2003 Order") (PowerShares offers ETFs that mirror custom-built indexes based on "Intellidexes," which were created by a quantitative unit of the American Stock Exchange). A few of the index providers that compile and revise the indexes are affiliated with the sponsor of the ETF. *See, e.g.*, WisdomTree Investments, Investment Company Act Release Nos. 27324 (May 18, 2006) [71 FR 29995 (May 24, 2006)] (notice) ("WisdomTree Notice") and 27391 (June 12, 2006) (order) ("WisdomTree Order") (WisdomTree's ETFs seek to track the price and yield performance of domestic and international equity securities indexes provided by an affiliate).

13 As of December 2007, 49 ETFs track bond indexes. ICI, *Exchange-Traded Fund Assets December 2007*, Jan. 30, 2008. *See, e.g.*, Ameristock ETF Trust, Investment Company Act Release Nos. 27847 (May 30, 2007) [72 FR 31113 (June 5, 2007)] (notice) ("Ameristock Notice") and 27874 (June 26, 2007) (order); Vanguard Bond Index Funds, Investment Company Act Release Nos. 27750 (Mar. 9, 2007) [72 FR 12227 (Mar. 15, 2007)] (notice) and 27773 (Apr. 2, 2007) (order); Barclays Global Fund Advisors, Investment Company Act Release Nos. 27608 (Dec. 21, 2006) [71 FR 78235 (Dec. 28, 2006)] (notice) ("Barclays High Yield Notice") and 27661 (Jan. 17, 2007) (order).

14 The first international equity ETFs were introduced in 1996. As of December 2007, there were 159 ETFs that provide exposure to international equity markets. ICI, *Exchange-Traded Fund Assets December 2007*, Jan. 30, 2008. International index-based ETFs increased by 87% from 85 in 2006 to 159 in 2007. *Id.*

15 David Hoffman, *Funds' grip loosens as ETFs gain*, InvestmentNews, Apr. 28, 2006 (reporting that in 2004, 44% of 821 advisory firms polled by Financial Research Corp. of Boston said they collectively allocated an average of 12% of total assets under management to ETFs as compared with 2003, in which only 34% used ETFs and collectively allocated an average of 8% of assets under management).

16 *See, e.g.*, iShares Trust, Investment Company Act Release No. 25969 (Mar. 21, 2003) [68 FR 15010 (Mar. 27, 2003)].

17 *See* GARY L. GASTINEAU, EXCHANGE-TRADED FUNDS MANUAL, 2 (2002) ("GASTINEAU") (ascribing the popularity of ETFs among active traders to high trading volume, competitive market makers, and active arbitrage pricing.). Morgan Stanley, *Exchange-Traded Funds Quarterly Report*, Nov. 16, 2006, at 13 ("They can be used by market timers wishing to gain or reduce exposure to entire markets or sectors throughout the trading day.").

registered investment company ("fund"). And like money market funds, they have required exemptions from certain provisions of the Act before they can commence operations.[18] Since 1992, the Commission has issued 61 orders to ETFs and their sponsors.[19]

In this release, we propose a new rule that would codify the exemptive orders we have issued to ETFs. Proposed rule 6c-11 would allow new competitors (*i.e.*, those sponsors who do not already have exemptive orders) to enter the market more easily. We also are proposing amendments to our registration form for open-end funds, Form N-1A, to provide more useful information to individual investors who purchase and sell ETF shares on national securities exchanges. Finally, we are proposing a new rule to allow funds to invest in ETFs to a greater extent than currently permitted under the Act and our rules.

II. OPERATION OF EXCHANGE-TRADED FUNDS

All ETFs trading today operate in a similar way.[20] Unlike traditional mutual funds, ETFs

---

[18] *See* rule 2a-7 under the Act, which codified the standards for granting the applications filed by money market funds for exemptions from the pricing and valuation provisions of the Act. For a discussion of the administrative history of rule 2a-7, *see* Valuation of Debt Instruments and Computation of Current Price per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)].

[19] Since 2000, the Commission has provided ETF sponsors relief for any ETFs created in the future in connection with their exemptive orders so that the sponsors can introduce new ETFs if the ETFs meet the terms and conditions contained in the exemptive orders. *See, e.g.*, Barclays Global Fund Advisors, Investment Company Act Release Nos. 24394 (Apr. 17, 2000) [65 FR 21219 (Apr. 20, 2000)] (notice) and 24451 (May 12, 2000) (order).

[20] Until recently, all ETFs had an investment objective of seeking returns that are correlated to the returns of a securities index, and in this respect operated much like traditional index funds. Recently, we issued orders approving actively managed ETFs. *See* WisdomTree Trust, *et al.*, Investment Company Act Release Nos. 28147 (Feb. 6, 2008) [73 FR 7776 (Feb. 11, 2008)] (notice) ("WisdomTree Actively Managed ETF Notice") and 28174 (Feb. 27, 2008) (order) ("WisdomTree Actively Managed ETF"); Barclays Global Fund Advisors, *et al.*, Investment Company Act Release Nos. 28146 (Feb. 6, 2008) [73 FR 7771 (Feb. 11, 2008)] (notice) and 28173 (Feb. 27, 2008) (order) ("Barclays Actively Managed ETF"); Bear Sterns Asset Management, Inc., *et al.*, Investment Company Act Release Nos. 28143 (Feb. 5, 2008) [73 FR 7768 (Feb. 11, 2008)] (notice) and 28172 (Feb. 27, 2008) (order) ("Bear Sterns Actively Managed ETF"); PowerShares Capital Management LLC, *et al.*, Investment Company Act

(footnote continued)

do not sell or redeem their individual shares ("ETF shares") at net asset value ("NAV"). Instead, financial institutions purchase and redeem ETF shares directly from the ETF, but only in large blocks called "creation units."[21] A financial institution that purchases a creation unit of ETF shares first deposits with the ETF a "purchase basket" of certain securities and other assets identified by the ETF that day, and then receives the creation unit in return for those assets. The basket generally reflects the contents of the ETF's portfolio and is equal in value to the aggregate NAV of the ETF shares in the creation unit. After purchasing a creation unit, the financial institution may hold the ETF shares, or sell some or all in secondary market transactions.[22]

Like operating companies and closed-end funds, ETFs register offerings and sales of ETF shares under the Securities Act and list their shares for trading under the Securities Exchange Act of 1934 ("Exchange Act").[23] As with any listed security, investors may trade ETF shares at market prices. ETF shares purchased in secondary market transactions are not redeemable from the ETF except in creation units.

The redemption process is the reverse of the purchase process. The financial institution acquires (through purchases on national securities exchanges, principal transactions, or private transactions) the number of ETF shares that comprise a creation unit, and redeems the creation

---

Release Nos. 28140 (Feb. 1, 2008) [73 FR 7328 (Feb. 7, 2008)] (notice) ("PowerShares Actively Managed ETF Notice") and 28171 (Feb. 27, 2008) (order) ("PowerShares Actively Managed ETF" and collectively, "Actively Managed ETF Orders").

21 As discussed further below, creation units typically consist of at least 25,000 ETF shares. *See infra* note 113.

22 We note that depending on the facts and circumstances, broker-dealers that purchase a creation unit and sell the shares may be deemed to be participants in a distribution, which could render them statutory underwriters and subject them to the prospectus delivery and liability provisions of the Securities Act. *See* 15 U.S.C. 77b(a)(11).

23 15 U.S.C. 78a.

unit from the ETF in exchange for a "redemption basket" of securities and other assets.[24] An investor holding fewer ETF shares than the amount needed to constitute a creation unit (most retail investors) may dispose of those ETF shares by selling them on the secondary market. The investor receives market price for the ETF shares, which may be higher or lower than the NAV of the shares, and pays customary brokerage commissions on the sale.

The ability of financial institutions to purchase and redeem creation units at each day's NAV creates arbitrage opportunities that may help keep the market price of ETF shares near the NAV per share of the ETF. For example, if ETF shares begin trading on national securities exchanges at a price below the fund's NAV per share, financial institutions can purchase ETF shares in secondary market transactions and, after accumulating enough shares to comprise a creation unit, redeem them from the ETF in exchange for the more valuable securities in the ETF's redemption basket. Those purchases create greater market demand for the ETF shares, and thus tend to drive up the market price of the shares to a level closer to NAV.[25] Conversely, if the market price for ETF shares exceeds the NAV per share of the ETF itself, a financial institution can deposit a basket of securities in exchange for the more valuable creation unit of ETF shares, and then sell the individual shares in the market to realize its profit. These sales would increase the supply of ETF shares in the secondary market, and thus tend to drive down the price of the ETF shares to a level closer to the NAV of the ETF share.[26]

---

[24] ETFs sometimes provide cash-in-lieu payments on some (or all) purchases or redemptions. *See infra* notes 120-121 and accompanying text.

[25] The purchase of the ETF shares on the secondary market combined with the sale of the redemption basket securities also may create upward pressure on the price of ETF shares and/or downward pressure on the price of redemption basket securities, driving the market price and ETF NAV closer together.

[26] The institution's purchase of the purchase basket securities combined with the sale of ETF shares also may create downward pressure on the price of ETF shares and/or upward pressure on the

(footnote continued)

Arbitrage activity in ETF shares is facilitated by the transparency of the ETF's portfolio. Each day, the ETF publishes the identities of the securities in the purchase and redemption baskets, which are representative of the ETF's portfolio.[27] Each exchange on which the ETF shares are listed typically discloses an approximation of the current value of the basket on a per share basis ("Intraday Value")[28] at 15 second intervals throughout the day and, for index-based ETFs, disseminates the current value of the relevant index.[29] This transparency can contribute to the efficiency of the arbitrage mechanism because it helps arbitrageurs determine whether to purchase or redeem creation units based on the relative values of ETF shares in the secondary market and the securities contained in the ETF's portfolio.

Arbitrage activity in ETF shares also appears to be affected by the liquidity of the securities in an ETF's portfolio. Most ETFs represent in their applications for exemptive relief

---

price of purchase basket securities, driving the market price and the ETF's NAV closer together.

ETF sponsors and market participants report that the average deviation between the daily closing price and the daily NAV of ETFs that track domestic indexes is generally less than 2%. *See, e.g.,* Vanguard U.S. Stock ETFs, Prospectus 56-59 (Apr. 27, 2007). ETFs that track foreign indexes may have a more significant deviation. *See, e.g.,* iShares FTSE/Xinhua China 25 Index Fund, Prospectus 19 (Dec. 1, 2006).

27 With respect to index-based ETFs, portfolio transparency is enhanced by the transparency of the underlying index. Index providers publicly announce the components of their indexes. Because an index-based ETF seeks to track the performance of an index, often by replicating the component securities of the index, the transparency of the underlying index results in a high degree of transparency in the ETF's investment operations. Similarly, each of the actively managed ETFs operating under the recent exemptive orders approved by the Commission is required to make public each day the securities and other assets in its portfolio. *See* Actively Managed ETF Orders, *supra* note 20.

28 The Intraday Value also is referred to as the Intraday Indicative Value, Indicative Optimized Portfolio Value, Indicative Fund Value, Indicative Trust Value, or Indicative Partnership Value.

29 National securities exchanges are permitted to disseminate this information at 60 second intervals for ETFs that track non-U.S. indexes. *See, e.g.,* Commentary .01(b)(2) to NYSE Acra Equities Rule 5.2(j)(3); Commentary 0.2(a)(C)(c) to American Stock Exchange Constitution and Rules & Arbitration Awards Rule 1000A.

that they invest in highly liquid securities.[30] Effective arbitrage depends in part on the ability of financial institutions to readily assemble the basket for purchases of creation units and to sell securities received upon redemption of creation units, and liquidity appears to be a factor in this process. An ETF's investment in less liquid securities may reduce arbitrage efficiency and thereby increase both the likelihood that a deviation between ETF share market price and NAV per share may occur and the amount of any deviation that does occur.

III. EXEMPTIONS PERMITTING FUNDS TO FORM AND OPERATE AS ETFS

Today we are proposing for public comment a new rule that would codify much of the relief and many of the conditions of orders that we have issued to index-based ETFs in the past, and more recently to certain actively managed ETFs. The proposed rule is designed to enable most ETFs to begin operations without the need to obtain individual exemptive relief from the Commission.

A. Scope of Proposed Rule 6c-11

1. Index-Based ETFs

Proposed rule 6c-11, like our orders, would provide exemptions for ETFs that have a stated investment objective of maintaining returns that correspond to the returns of a securities

---

[30] Index-based ETFs track indexes that have specified methodologies for selecting their component securities. The methodologies generally ensure that an index consists of securities that will be highly liquid. *See, e.g.,* Barclays High Yield Notice, *supra* note 13 ("The Underlying Index is a rules-based index designed to reflect the 50 most liquid U.S. dollar-denominated high-yield corporate bonds registered for sale in the U.S. or exempt from registration."). Because index-based ETFs either replicate or sample the indexes, their portfolio securities also should possess these characteristics. The actively managed ETFs also appear to invest in highly liquid securities. *See* WisdomTree Actively Managed ETF, *supra* note 20 (investing in U.S. and foreign money market securities); Barclays Actively Managed ETF, *supra* note 20 (investing in foreign money market securities); Bear Sterns Actively Managed ETF, *supra* note 20 (investing primarily in investment-grade fixed income securities); PowerShares Actively Managed ETF, *supra* note 20 (investing in large cap companies or U.S. government and corporate debt securities).

index whose provider discloses on its Internet Web site the identities and weightings[31] of the component securities and other assets of the index.[32] In this respect, the rule would codify our previous exemptive orders. Our experience is that the conditions included in the index-based ETF orders have effectively preserved the statutory purposes of the Act.

The proposed rule would not limit the types of indexes that an ETF may track or the types of securities that comprise any index. Thus, the rule would not limit the exemption to ETFs investing in liquid securities or assets, although existing ETFs generally have represented to us that their portfolios are comprised of highly liquid securities,[33] and, as open-end funds, are required to comply with the liquidity guidelines applicable to all open-end funds.[34]

---

31 Proposed rule 6c-11(e)(9) defines "weighting of the component security" as "the percentage of the index's value represented, or accounted for, by such component security."

32 Proposed rule 6c-11(e)(4)(v)(B) (defining "exchange-traded fund"); *see infra* Section III.B.1 for a discussion of this index transparency requirement. Index-based ETFs obtain returns that correspond to those of an underlying index by replicating or sampling the component securities of the index. An ETF that uses a replicating strategy generally invests in the component securities of the underlying index in the same approximate proportions as in the underlying index. *See, e.g.*, First Trust Exchange-Traded Fund, Investment Company Act Release No. 27051 (Aug. 26, 2005) [70 FR 52450 (Sept. 2, 2005)] ("First Trust Notice") at n.1. If, however, there are practical difficulties or substantial costs involved in holding every security in the underlying index, the ETF may use a representative sampling strategy pursuant to which it will invest in some but not all of the relevant component securities. An ETF that uses a sampling strategy includes in its portfolio securities that are designed, in the aggregate, to reflect the underlying index's capitalization, industry, and fundamental investment characteristics, and to perform like the index. The ETF implements the sampling strategy by acquiring a subset of the component securities of the underlying index, and possibly some securities that are not included in the corresponding index that are designed to help the ETF track the performance of the index. *See, e.g., id*.

33 *See supra* note 30 and accompanying and following text. *See also* WisdomTree Notice, *supra* note 12 at n.8 and accompanying text.

34 Long-standing Commission guidelines have required open-end funds to hold no more than 15% of their net assets in illiquid securities and other illiquid assets. *See* Statement Regarding "Restricted Securities," Investment Company Act Release No. 5847 (Oct. 21, 1969) [35 FR 19989 (Dec. 31, 1970)]; Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992) [57 FR 9828 (Mar. 20, 1992)]. A fund's portfolio security is illiquid if it cannot be disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the ETF. *See* Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release

(footnote continued)

We request comment regarding the effect of portfolio liquidity on the potential for deviation between ETF share market price and NAV and the amount of any deviation. In addition to the liquidity guidelines applicable to all open-end funds, should the Commission include additional liquidity requirements as a condition of the exemptions? If so, what additional requirements and why? Should the chance (or likelihood) that substantial discounts or premiums may occur if an ETF portfolio contains less liquid securities or assets be a regulatory concern for the Commission, or should it be treated as a material risk to be disclosed to prospective investors, permitting them to evaluate whether the risk makes the ETF an appropriate investment in light of the investor's investment objectives?[35] We note that currently there is substantially more market interest in ETFs that track broad-based indexes that are comprised of highly liquid securities than ETFs that track more specialized indexes.[36] How would liquidity or illiquidity of securities or other assets in an ETF's portfolio affect the ability of financial institutions to assemble securities for a purchase basket and thus the arbitrage mechanism and operation of the ETF? Would liquidity requirements preclude the development of specialty ETFs that serve narrow investment purposes but which may satisfy particular investment needs of certain investors?

2. Actively Managed ETFs

We recently issued exemptive orders to several actively managed ETFs and their

---

No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (adopting amendments to rule 2a-7 under the Act); Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)] (adopting Rule 144A under the Securities Act).

35 The Commission is proposing an amendment to Form N-1A that would codify the condition in our orders that ETFs disclose the extent and frequency with which market prices have tracked their NAV. *See infra* notes 169-170 and accompanying text.

36 *See* ICI ETF Statistics 2007, *supra* note 5.

sponsors.[37] Like our orders, proposed rule 6c-11 would provide an exemption for an actively managed ETF that discloses on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the ETF.[38] Unlike index-based ETFs, an actively managed ETF does not seek to track the return of a particular index. Instead, an actively managed ETF's investment adviser, like an adviser to any traditional actively managed mutual fund, generally selects securities consistent with the ETF's investment objectives and policies without regard to a corresponding index.

In 2001, we sought comment on the concept of an actively managed ETF ("2001 Concept Release").[39] We requested comment on a broad number of questions that we felt were important to consider before expanding the scope of the exemptive orders we had issued. We wanted to know how investors would use an actively managed ETF because it seemed that, unlike an investment in an index-based ETF, an investment in an actively managed ETF could not be used, for example, to implement a hedging strategy. We questioned whether an actively managed ETF would provide investors with the same or similar benefits as index-based ETFs, including potential tax efficiencies and low expense ratios.

Our 2001 Concept Release also asked more focused questions about the structural and operational differences between the two types of ETFs and how those differences might affect the market value of ETF shares. We inquired whether as a matter of public policy an ETF must be designed to enable efficient arbitrage and thereby minimize the probability that ETF shares

---

37 *See* Actively Managed ETF Orders, *supra* note 20.

38 Proposed rule 6c-11(e)(4)(v)(A); *see infra* Section III.B.1 for a discussion of this requirement.

39 *See* Actively Managed Exchange-Traded Funds, Investment Company Act Release No. 25258 (Nov. 8, 2001) [66 FR 57614 (Nov. 15, 2001)] ("2001 Concept Release").

would trade at a material premium or discount.[40] We asked, for example, whether actively managed ETFs must have the same degree of portfolio transparency as index-based ETFs, a factor that appeared to contribute significantly to arbitrage efficiency.[41] It was unclear to us at that time whether an adviser to actively managed ETFs would be willing to provide the same degree of transparency as an adviser to index-based ETFs because, for example, disclosure could allow market participants to access the fund's investment strategy.[42] We were concerned that reduced transparency could expose arbitrageurs to greater investment risk and result in a less efficient arbitrage mechanism, which in turn could lead to more significant premiums and discounts than experienced by index-based ETFs.

We received 20 comments from market participants, many of which supported the introduction of actively managed ETFs.[43] Many commenters stated that actively managed ETFs would have the potential to provide investors with uses and benefits similar to index-based ETFs. For example, commenters maintained that, like index-based ETFs, actively managed ETFs could potentially serve as short-term or long-term investment vehicles, allow investors to gain

---

[40] *Id.* at text following n.35.

[41] *See supra* note 27 and accompanying text.

[42] We also noted concerns that full disclosure could permit market participants to "front-run" portfolio trades. *See infra* text accompanying and preceding note 84. In addition, because actively managed portfolios likely would change more frequently and in less foreseeable ways than a portfolio of index-based ETFs, we were unclear how or whether an actively managed ETF would communicate intra-day portfolio changes to investors. *See generally*, Russ Wermers, *The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, Investment Company Institute Perspective, June 2001, Vol. 7, No. 3, at http://www.ici.org/perspective/per07-03.pdf. (examining the potential effects of more frequent portfolio disclosure on the performance of mutual funds and concluding that, with more frequent disclosure, shareholders would likely receive lower total returns on their investments due to, among other things, front-running and free-riding).

[43] The comment letters to the 2001 Concept Release are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 (File No. S7-20-01), and are available on the Commission's Internet Web site (http://www.sec.gov/rules/concept/s72001.shtml).

exposure to an asset category such as value, growth or income, and play a significant role in an investor's hedging strategies.[44] Commenters also asserted that actively managed ETFs have the potential for providing investors benefits similar to index-based ETFs, including low expense ratios and intra-day exchange trading.[45] Other commenters, however, questioned whether some of the investor benefits traditionally associated with index-based ETFs would be present with actively managed ETFs.[46]

Commenters agreed that actively managed ETFs should be designed, like index-based ETFs, with an arbitrage mechanism intended to minimize the potential deviation between market price and NAV of ETF shares.[47] Not all commenters agreed, however, on whether we should be concerned with the extent of premiums or discounts and, therefore, whether we should require full portfolio transparency. Some asserted that the amount of any discount or premium that might develop ought not to be a consideration for us in determining whether to grant exemptive

---

[44] *See, e.g.*, Comment Letter of the American Stock Exchange LLC, File No. S7-20-01 (Mar. 5, 2002) ("For example, an investor may find that a particular actively managed ETF more closely tracks his securities holdings, and therefore may be a more effective hedge."); Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002). One commenter asserted, however, that actively managed ETFs would be of greater interest to retail investors; institutional investors would not use active fund products for hedging, cash equitization or other strategies. Comment Letter of Barclays Global Investors, File No. S7-20-01 (Jan. 11, 2002).

[45] *See, e.g.*, Comment Letter of the American Stock Exchange LLC, File No. S7-20-01 (Mar. 5, 2002)**;** Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002).

[46] One commenter, for example, asserted that an actively managed ETF would likely not experience similar tax efficiency because that is predominantly a function of the low portfolio turnover of index-based ETFs. The commenter also noted that actively managed ETFs are unlikely to have the low expenses associated with index-based ETFs, which result primarily from lower advisory fees associated with the passive management of those funds. Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002).

[47] *See, e.g.*, Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002); Comment Letter of Barclays Global Investors, File No. S7-20-01 (Jan. 11, 2002).

relief.[48] One commenter argued that ETFs with share prices that significantly deviate from NAV would likely not attract the interest of investors and would ultimately fail if they did not provide information necessary for market participants to make knowledgeable investment decisions.[49] Other commenters asserted that it is important to require that ETFs provide all investors with the same information about portfolio holdings[50] and to require clear fund disclosures regarding the risks associated with the level of transparency provided.[51] These commenters stressed the need,

---

48 *See, e.g.*, Comment Letter of the American Bar Association, Committee on Federal Regulation of Securities, File No. S7-20-01 (Feb. 1, 2002) ("We believe that the Commission should not mandate the level of transparency in ETFs' portfolios, but rather should allow fully informed demand in the financial markets to determine the proper levels. Different segments of the market with different needs might demand investment vehicles with different variation. To prevent market demand from determining the structure of investment vehicles would retard efficiency, competition, and capital formation."); Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002) ("…[A] non-transparent actively managed ETF will be no worse off than closed-end funds trading today. In fact, the premium/discount of a non-transparent ETF should be narrower due to the ETF's open-ended qualities."); Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002) ("While [spreads] may be higher for actively managed ETFs than for index ETFs, we do not believe that the discounts between market price and NAV will approach those seen in closed-end funds.").

49 *See* Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002); *see also* Comment Letter of the American Bar Association, Committee on Federal Regulation of Securities, File No. S7-20-01 (Feb. 1, 2002) ("Ultimately it is in the interest of the sponsor and investment adviser to provide for effective arbitrage opportunities. It is unlikely that an actively managed ETF sponsor would be able to convince the critical market participants such as specialists, market makers, arbitragers and other Authorized Participants to support a product that contained illiquid securities to a degree that would affect the liquidity of the ETF, making it difficult to price, trade and hedge, ultimately leading to its failure in the marketplace.").

50 *See, e.g.*, Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002) ("Sponsors of actively managed ETFs should not be permitted to provide more information about portfolio holdings to the exchange specialist and market makers than they provide to other investors. Vanguard believes, as a matter of fundamental fairness, that all investors in a fund must be treated equally. Providing information only to a favored few is inconsistent with the foundation of our capital markets—full and fair disclosure to all investors.").

51 *See, e.g.*, Comment Letter of Morgan Stanley & Co., File No. S7-20-01 (May 3, 2002) ("Even if the Commission were to determine that new forms of ETFs do pose a significant risk of trading at a discount or premium to NAV, we do not believe that the Commission should delay approval of the product for this reason. Instead, we would urge the Commission to address any perceived investor risks by requiring additional risk disclosure."); Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002) ("Investors in an actively managed ETF must receive adequate disclosure about the risks associated with the level of the ETF's transparency (and other risks

(footnote continued)

however, for sufficient market information to value the fund's portfolio.[52] Others argued that portfolio transparency is essential to support effective arbitrage.[53] One commenter asserted that any lack of transparency would negatively impact an ETF's arbitrage mechanism and would likely result in ETF shares trading at secondary market prices that do not reflect the value of the ETF's underlying portfolio.[54] The commenter noted that to the extent an ETF operates with less than full transparency during periods of market volatility, this would likely result in some individual investors buying or selling ETF shares at secondary market prices moving in the opposite direction of the ETF's NAV. The commenter urged us to consider carefully the consequence of granting an exemption that might yield such a result.[55] The Investment Company Institute asserted that to the extent that all or part of an ETF's portfolio is not transparent, it could raise significant investor protection concerns including the potential for disparate treatment

---

unique to actively managed ETFs) ….. if the ETF has limited transparency, the fund's disclosure documents should discuss the possibility that the spreads between bid and asked prices and between the market price and NAV of the fund's exchange-traded shares may be higher than is typically the case of index ETFs.").

52 *See, e.g.*, Comment Letter of the American Stock Exchange LLC, File No. S7-20-01 (Mar. 5, 2002) (asserting that non-transparent actively managed ETFs need not disclose the full contents of their portfolios "so long as there is sufficient market information available to value the portfolio or a creation unit (or if different, the Redemption Basket) on an intra-day basis so as to facilitate secondary market trading and hedging."); Comment Letter of State Street Bank and Trust Co., File No. S7-20-01 ("While the importance of an effective arbitrage mechanism is clear, there are potential ways to achieve an effective arbitrage mechanism with less than full transparency, and, potentially, with no portfolio transparency. This may be accomplished with proper disclosure of an actively managed ETF's investment strategy and portfolio characteristics.").

53 *See, e.g.*, Comment Letter of Barclays Global Investors, File No. S7-20-01 (Jan. 11, 2002) ("It is generally accepted that portfolio transparency is the key to effective arbitrage. Therefore, the most significant issue for the Commission … is whether [actively managed ETFs] would provide the necessary level and frequency of portfolio disclosure to support efficient arbitrage.").

54 *Id.*

55 *Id.*

of investors and the potential for the ETF to trade at significant premiums and discounts.[56]

Today we propose exemptions applicable to both index-based and actively managed ETFs that provide portfolio transparency to market participants. The comments we received, together with subsequent developments, address the principal concerns we raised in the 2001 Concept Release with respect to actively managed ETFs. We have received a number of applications from actively managed ETFs whose sponsors are interested in offering fully transparent, actively managed ETFs, and recently we have issued orders approving several of these ETFs.[57] As described in these applications, an actively managed ETF would operate in the same manner as an index-based ETF.[58] Each would be registered under the Act as an open-end fund and would redeem shares in creation units in exchange for basket assets. Each would be listed on a national securities exchange, and investors would trade the ETF shares throughout the day at market prices in the secondary market.[59] The national securities exchange typically would disseminate the Intraday Value of ETF shares at 15-second intervals throughout the trading day,[60] thereby providing institutional investors and other arbitrageurs the information necessary to engage in ETF share purchases and sales on the secondary market, and purchases and redemptions with the fund, which should help keep ETF share prices from trading at a significant discount or premium.[61] Finally, the actively managed ETFs represent that they would provide

---

56 Comment Letter of the Investment Company Institute, File No. S7-20-01 (Jan. 14, 2002).

57 *See* Actively Managed ETF Orders, *supra* note 20.

58 *See id.*

59 *See infra* notes 88-94 and accompanying text for a discussion of the proposed rule's condition that ETF shares be approved for listing and trading on a national securities exchange.

60 *See infra* notes 92-94 and accompanying text for a discussion of the proposed rule's condition that ETFs be listed on an exchange that disseminates the Intraday Value of ETF shares on a regular basis.

61 *See supra* notes 27-29 and accompanying and following text. *See also* Actively Managed ETF
(footnote continued)

ETF investors with uses and benefits similar to index-based ETFs.[62]

We believe that permitting fully transparent, actively managed ETFs would provide additional investment choices for investors and that exemptions necessary to permit the operation of these ETFs would be in the public interest and consistent with the policies and purposes of the Act. By proposing this rule we are not, however, suggesting that we will not consider applications for exemptive orders for actively managed ETFs that do not satisfy the proposed rule's transparency requirements. Rather, we are at this time proposing to permit fully transparent, actively managed ETFs to be offered without first seeking individual exemptive orders from the Commission.

We request comment on allowing actively managed ETFs with fully transparent portfolios to rely on the exemptions provided by the proposed rule. We only recently approved orders to allow certain actively managed ETFs and have not had the opportunity to observe how they operate in the markets over a significant period of time. Should we wait until we have gained greater experience with the operation of actively managed ETFs before adopting a final rule applicable to them? Is there any concern that a fully transparent actively managed ETF would not facilitate an efficient arbitrage mechanism? Would actively managed ETFs provide investors with uses and benefits similar to or different than their index-based counterparts? Do these or any other concerns regarding the operation of a fully transparent actively managed ETF warrant limiting the rule to index-based ETFs and considering exemptions for actively managed ETFs on a case by case basis through the exemptive applications process? Should we consider

---

Orders *supra* note 20.

62 *See, e.g.*, In re PowerShares Capital Management LLC, *et al.*, Fifth Amendment, File No. 812-13386, filed Jan. 7, 2008 ("PowerShares Actively Managed ETF Application"), at 12-13 (available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549).

exemptions for other types of actively managed ETFs? If so, how would the arbitrage mechanism work in these ETFs? What kinds of conditions should we consider in order to facilitate an arbitrage mechanism?

3. Organization as an Open-end Investment Company

Our proposed rule would be available only to ETFs that are organized as open-end funds.[63] We have provided similar exemptions to unit investment trusts ("UITs") in the past.[64] However, because we have not received an exemptive application for a new ETF to be organized as a UIT since 2002, there does not appear to be a need to include UIT relief in the proposed rule.[65] We understand that ETF sponsors prefer the open-end fund structure because it allows more investment flexibility.[66] In addition, unlike an ETF that is a UIT, an open-end fund ETF may participate in securities lending programs and has greater flexibility in reinvesting dividends received from portfolio securities. Of the 601 ETFs in existence as of December 2007, 593 were organized as open-end funds.[67]

---

63 Proposed rule 6c-11(e)(4).

64 *See, e.g.,* SPDR Order, *supra* note 10. *See supra* note 8 for a definition of UITs.

65 Although two exemptive applications for ETFs organized as UITs were filed in 2007, the applications were occasioned by the transfer of the sponsorship from Nasdaq Financial Products Services, Inc. to PowerShares Capital Management, LLC and did not result in new ETFs. *See* BLDRs Index Funds Trust, Investment Company Act Release No. 27745 (Feb. 28, 2007) [72 FR 9787 (Mar. 5, 2007)] ("BLDRs Notice"); Nasdaq-100 Trust, Series 1, Investment Company Act Release No. 27740 (Feb. 27, 2007) [72 FR 9594 (Mar. 2, 2007)].

66 A UIT portfolio is fixed, and substitution of securities may take place only under certain circumstances. As a result, an ETF organized as a UIT typically replicates the holdings of the index it tracks. By contrast, existing ETFs organized as open-end funds may employ investment advisers and use a "sampling" strategy to track the 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 invest a specific portion of the ETF's portfolio in securities and other financial instruments that are not included in the corresponding index if the adviser believes the investment will help the ETF track its underlying index. *See, e.g.,* First Trust Notice, *supra* note 32, at. n.1.

67 The number of ETFs organized as UITs is based on information in the Commission's database of Form N-SAR filings.

We request comment on whether we should include ETFs organized as UITs in the definition of ETF under the proposed rule. If so, should they be subject to the same conditions set forth in the proposed rule?

B. Conditions

ETF sponsors have sought exemptions from certain provisions of the Act and our rules so that they may register ETFs as open-end funds. The principal distinguishing feature of open-end funds is that they offer for sale redeemable securities.[68] The Act defines "redeemable security" as any security that allows the holder to receive his or her proportionate share of the issuer's current net assets upon presentation to the issuer.[69]

Section 22(d) of the Act prohibits any dealer in redeemable securities from selling open-end fund shares at a price other than a current offering price described in the fund's prospectus.[70] Rule 22c-1 under the Act requires funds, their principal underwriters, and dealers to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem.[71] Together, these provisions are designed to require that fund shareholders are treated equitably when buying and selling their fund shares.[72]

---

68 15 U.S.C. 80a-5(a)(1); *see infra* notes 109-121 and accompanying text.

69 15 U.S.C. 80a-2(a)(32).

70 15 U.S.C. 80a-22(d).

71 17 CFR 270.22c-1(a). The rule requires that funds calculate their NAV at least once daily Monday through Friday (with certain exceptions, including days on which no securities are tendered for redemption and the fund receives no orders to purchase or sell securities). *See* 17 CFR 270.22c-1(b)(1). Today, most funds calculate NAV as of the time the major U.S. stock exchanges close (typically at 4:00 p.m. Eastern Time). Thus, a fund's NAV generally reflects the closing prices of the securities it holds. Under rule 22c-1, an investor who submits an order before the 4:00 p.m. pricing time receives that day's price, and an investor who submits an order after the pricing time receives the next day's price.

72 *See generally*, H.R. REP. NO. 2639, 76th Cong., 3d Sess., 8 (1940). *See also* INVESTMENT TRUSTS AND INVESTMENT COMPANIES, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 279, 76th Cong., 1st Sess., pt. 3, at 860-874 (1939).

ETFs seeking to register as open-end funds under the Act require exemptions from these provisions because certain investors may purchase and sell individual ETF shares on the secondary market at current market prices, *i.e.*, at prices other than those described in the ETF's prospectus or based on NAV. As discussed above, investors (typically financial institutions) can purchase and redeem shares from the ETF at NAV only in creation units.[73] Because these financial institutions can take advantage of disparities between the market price of ETF shares and NAV, they may be in a different position than investors who buy and sell individual ETF shares only on the secondary market.[74] The disparities in market price and NAV, however, provide those institutional investors with opportunities for arbitrage that would tend to drive the market price in the direction of the ETF's NAV to the benefit of retail investors.[75]

Today, we propose a rule with certain conditions that may permit the ETF structure to operate within the scope of the Act without sacrificing appropriate investor protection, and is designed to be consistent with the purposes fairly intended by the policy and provisions of the Act.[76] Our orders have provided exemptions from the definition of "redeemable security" and section 22(d) and rule 22c-1 for ETFs with an arbitrage mechanism that helps maintain the equilibrium between market price and NAV. Our proposed rule would codify these exemptions subject to three conditions that appear to have facilitated the arbitrage mechanism: transparency

---

73 *See supra* Section II for a discussion on the operation of ETFs.

74 *See, e.g.,* Comment Letter of Barclays Global Investors, File No. S7-20-01 (Jan. 11, 2002) ("[D]uring periods of market volatility… it is not unreasonable to assume that some retail investors would buy or sell ETF shares at secondary market prices moving in the opposite direction of a fund's NAV.").

75 *See supra* notes 25-26 and accompanying text.

76 Section 6(c) of the Act permits the Commission, conditionally or unconditionally, to exempt by rule any person, security, or transaction (or classes of persons, securities, or transactions) from any provision of the Act "if and to the extent that such 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. 15 U.S.C. 80a-6(c).

of the ETF's portfolio, disclosure of the ETF's Intraday Value, and listing on a national securities exchange.

1. Transparency of Index and Portfolio Holdings

To take advantage of the proposed exemption, an ETF must either (i) disclose on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the fund, or (ii) have a stated investment objective of obtaining returns that correspond to the returns of a securities index, whose provider discloses on its Internet Web site the identities and weightings of the component securities and other assets of the index.[77] The Web page of the ETF or the index provider, as the case may be, must be publicly accessible at no charge.[78] Thus, the proposed rule would allow for an actively managed ETF provided that the actively managed ETF discloses its portfolio assets each business day.[79]

We seek comment on these transparency conditions. In particular, we request comment on the proposed provision requiring that an ETF that tracks an index and does not disclose its portfolio each business day must track an index whose provider discloses on an Internet Web site the component securities and other assets of the index it tracks.[80] Is it necessary for the rule to include this option instead of simply requiring daily portfolio disclosure by the ETF? What circumstances, if any, would prevent an index-based ETF from disclosing its portfolio

---

77 Proposed rule 6c-11(e)(4)(v).

78 *Id.*

79 *See supra* discussion at Section III.A.2. An index-based ETF that has the investment objective of obtaining returns that correspond to the returns of multiple securities indexes may rely on the proposed rule provided that it discloses its portfolio in the same manner as a fully transparent actively managed ETF.

80 The proposed rule defines an "index provider" to mean the person that determines the securities and other assets that comprise a securities index. *See* proposed rule 6c-11(e)(7).

holdings?[81] Would Internet Web site disclosure of portfolio holdings be sufficient? If not, what other means of disclosure should the ETF or the index provider use?

We also seek comment on whether we should require ETFs to disclose daily on their Internet Web sites liabilities (as well as portfolio holdings) to permit investors, particularly arbitrageurs, to evaluate the impact of leverage from borrowings on the fund's portfolio.[82] Should we limit such a requirement to certain kinds of ETFs that may have significant liabilities? If so, how should we identify the ETFs that would be subject to the condition?

One of the issues we discussed in the 2001 Concept Release was that full portfolio transparency could give market participants an ability to access the fund's market strategies (*i.e.,* "free-riding") and, in some cases, the ability to trade ahead of the ETF (*i.e.,* "front-running").[83] Those commenters who addressed the issue generally agreed that intra-day or advance portfolio disclosure may be detrimental to an actively managed ETF because it could enable third parties to front-run the fund.[84] Therefore, the proposed rule does not require disclosure of intra-day changes in the portfolio of the ETF, because currently, intra-day changes do not affect the composition of the ETF's basket assets until the next trading day.[85] The proposed rule also does not require advance disclosure of portfolio trades.[86]

---

81 *See supra* note 27.

82 For example, if an ETF enters into a written call to hedge the fair value exposure of an equity security in its portfolio, it would sacrifice any unrealized gains caused by the price of the equity security increasing above the price at which the call may be exercised (*i.e.* the strike price). Unless the ETF discloses the presence of these and similar liabilities, investors may not be able to evaluate the impact of leverage on the NAV of the ETF.

83 Market participants could trade ahead of an ETF if it disclosed portfolio assets in advance of the trades, rather than after the assets were acquired.

84 *See, e.g.,* Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002); Comment Letter of the Investment Company Institute, File No. S7-20-01 (Jan. 14, 2002).

85 Applicants seeking exemptions for actively managed ETFs noted that under accounting procedures followed by the funds, portfolio trades made on the prior business day ("T") would be

(footnote continued)

We request comment on these aspects of the proposal. Should the rule require disclosure of portfolio changes more often than once a day? How would more frequent disclosure affect the arbitrage mechanism? Would more frequent disclosure increase the likelihood of free-riding or front-running? The rule does not limit ETFs to tracking specialized indexes that change their assets at or below a specified frequency. How might this affect the transparency of the portfolios of ETFs that would rely on index rather than portfolio disclosure?[87]

Should the proposed rule prohibit advance portfolio disclosure? Would advance portfolio disclosure increase the likelihood of free-riding or front-running? If so, should the risk that participants may engage in these activities be treated as a material risk to be disclosed to prospective investors permitting them to evaluate whether the risk makes the ETF an appropriate investment in light of the particular investor's investment objectives? How would advance disclosure affect the arbitrage mechanism? If the portfolio disclosed in advance differed from the actual portfolio acquired, would that affect the market's ability to price the ETF's shares?

2. Listing on a National Securities Exchange and Dissemination of Intraday Value

An ETF that relies on rule 6c-11 would need to satisfy two additional conditions set forth in the paragraph defining "exchange-traded fund."[88] First, shares issued by the ETF would have

---

booked and reflected in the fund's NAV on the current business day ("T+1"). *See, e.g.*, WisdomTree Actively Managed ETF Notice, *supra* note 20, at n.5. As a result, these funds will not have to announce trades before they are made. In addition, the funds will be able to disclose at the beginning of each trading day the portfolio that will form the basis of the NAV calculation at the end of the day. *Id.*

[86] *See* proposed rule 6c-11(e)(4)(v)(A). Under the proposed rule, an ETF could disclose its portfolio at the end of the day on which relevant portfolio trades occurred (*i.e.*, after the portfolio assets are acquired) or the beginning of the following day, which would eliminate the potential for front-running.

[87] *See supra* note 77 and accompanying text.

[88] Proposed rule 6c-11(e)(4) (defining "exchange-traded fund").

to be approved for listing and trading on a national securities exchange.[89] We have premised our previous exemptive orders on the ETF listing its shares for trading on a national securities exchange.[90] Listing on an exchange would provide an organized and continuous trading market for the ETF shares at negotiated prices. Applicants for exemptive relief have noted that this intra-day trading, combined with the arbitrage mechanism inherent in the ETF structure, should prevent significant premiums and discounts between the market price of ETF shares and the Intraday Value.[91]

Second, an ETF could rely on the rule only if a national securities exchange disseminates the Intraday Value at regular intervals during the trading day.[92] Applications for exemptive relief have noted that exchanges typically disseminate the Intraday Value every 15 seconds during trading hours.[93] They have also asserted that this regular dissemination of the Intraday Value enables market makers to engage in the arbitrage activities that determine the market price for ETF shares.[94]

We request comment on these two conditions. Should the rule require that ETF shares be listed on a national securities exchange? Should the rule make allowance for shares that are delisted for a short time, or for suspensions in listing? If an ETF's shares were not listed for

---

89 Proposed rule 6c-11(e)(4)(iii).

90 *See*, *e.g.*, HealthShares, Inc., Investment Company Act Release No. 27553 (Nov. 16, 2006) [71 FR 67404, 67408 (Nov. 21, 2006)] ("HealthShares Notice").

91 *See*, *e.g.*, Amended and Restated Application of Ziegler Exchange Traded Trust, File No. 812-13224, filed Dec. 19, 2006 ("Ziegler Application"), at 10; PowerShares Actively Managed ETF Notice, *supra* note 20.

92 Proposed rule 6c-11(e)(4)(i).

93 *See, e.g.*, Van Eck, Van Eck Associates Corp., Investment Company Act Release No. 27283 (Apr. 7, 2006) [71 FR 19214 (Apr. 13, 2006)], at n.3; PowerShares Actively Managed ETF Notice, *supra* note 20, at n.2.

94 *See, e.g.*, Ziegler Application, *supra* note 91, at 26-27.

trading on a national securities exchange (even on a temporary basis), would the ETF structure permit the arbitrage mechanism to function appropriately? Should the rule require an ETF to liquidate or take other steps in the event of delisting? Should the proposed rule condition relief on listing exchanges disseminating the Intraday Value? If not, are there other means for market makers to receive the Intraday Value? Are there alternatives to using the basket as the basis for the Intraday Value calculation? For example, should the rule require the entity calculating the Intraday Value to use the ETF's portfolio (as opposed to the basket)? Should the calculation method be prescribed?

The proposed rule does not require the dissemination of an ETF's Intraday Value at specific intervals because the rules of national securities exchanges, as approved by the Commission, establish the frequency of disclosure.[95] Should the rule specify a minimal frequency? For example, should the rule prohibit an ETF from relying on the exemption if it is listed on an exchange that permits dissemination at intervals longer than the current 15 or 60-second intervals?

3. Marketing

Our exemptive orders included a condition requiring each ETF to agree not to market or advertise the ETF as an open-end fund or mutual fund and to explain that ETF shares are not individually redeemable.[96] This condition was designed to help prevent retail investors from confusing ETFs with traditional mutual funds. Similarly, the proposed rule would require each ETF relying on the rule to identify itself in any sales literature as an ETF that does not sell or redeem individual shares, and explain that investors may purchase or sell individual ETF shares

---

95 An ETF's Intraday Value is disseminated every 15 seconds (or 60 seconds in the case of ETFs that track foreign indexes). *See supra* note 29 and accompanying text.

96 *See, e.g.,* WisdomTree Order, *supra* note 12.

in secondary market transactions that do not involve the ETF.[97] This condition, like the prior condition in our orders, is designed to help prevent retail investors from confusing ETFs with traditional mutual funds.

We request comment on whether the proposed condition is likely to provide a benefit for investors with respect to ETF marketing and advertising materials. Are investors confused about the distinction between ETFs and traditional mutual funds? Should any confusion be addressed through rule requirements? Should the rule require ETFs to identify themselves as either index-based or actively managed ETFs?

4. Conflicts of Interest

Section 1(b)(2) of the Investment Company 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 directors, officers, investment advisers, or other affiliated persons, and underwriters, brokers, or dealers rather than in the interest of shareholders.[98] The operation of an ETF—specifically, the process in which a creation unit is purchased by delivering basket assets to the ETF, and redeemed in exchange for basket assets—may lend itself to certain conflicts for the ETF's investment adviser, which has discretion to specify the securities included in the baskets. For example, the adviser could direct creation unit purchasers to purchase securities from affiliates of the adviser for subsequent presentation to the ETF. As we noted in the 2001 Concept Release, these conflicts would appear

---

97 Proposed rule 6c-11(e)(4)(ii). The term sales literature is defined in the proposed rule to mean any advertisement, pamphlet, circular, form letter, or other sales material addressed to or intended for distribution to prospective investors other than a registration statement filed with the Commission under section 8 of the Act. Proposed rule 6c-11(e)(8). An ETF would have to make similar disclosures in its prospectus under the proposed amendments to Form N-1A. *See* proposed Item 6(h)(3) of Form N-1A, and *infra* text accompanying note 159.

98 15 U.S.C. 80a-1(b)(2).

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.[99] We also noted that the same would not appear to be the case for an actively managed ETF. Because the adviser to an actively managed ETF would have greater discretion to designate securities to be included in the basket assets, a greater potential for conflicts appears to exist.

Commenters generally stated that actively managed ETFs would not be faced with conflicts that are different from those that currently exist for actively managed mutual funds.[100] One commenter, however, recommended that the Commission impose any prohibitions or conditions under the Act that would apply to transactions directly effected by the adviser on any transactions effected at the adviser's discretion.[101] The commenter noted that, for example, an ETF that is prohibited from acquiring a security in certain underwritings (under section 10(f) of the Act)[102] should be prohibited from circumventing this prohibition by including the security in the ETF's basket assets. Similarly, an adviser could attempt to circumvent section 17(a) restrictions on principal transactions between a registered fund and its affiliates by designating a security for the basket assets that a creation unit purchaser would have to purchase from an

---

99 *See* 2001 Concept Release, *supra* note 39, at Section IV.E.2.

100 *See, e.g.*, Comment Letter of the American Stock Exchange LLC, File No. S7-20-01 (Mar. 5, 2002); Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002); Comment Letter of Nuveen Investments, File No. S7-20-01 (Jan. 14, 2002).

101 Comment Letter of the Investment Company Institute, File No. S7-20-01 (Jan. 14, 2002).

102 Section 10(f) of the Act prohibits a fund from purchasing any security during an underwriting or selling syndicate if a principal underwriter of the security is an officer, director, member of an advisory board, investment adviser, or employee of the fund or if any of these persons is an affiliate of the principal underwriter. 15 U.S.C. 80a-10(f). This section protects fund shareholders by preventing an affiliated underwriter from placing or "dumping" unmarketable securities in the fund.

affiliate of the adviser.[103]

We have not included a condition in the proposed rule prohibiting an actively managed ETF's adviser, directly or indirectly, from causing a creation unit purchaser to acquire a security for the ETF through a transaction in which the ETF could not engage directly. An adviser to an actively managed ETF already is subject to section 48(a) of the Act, which prohibits a person from doing indirectly, through another person, what that person is prohibited by the Act from doing directly. An adviser, therefore, would be prohibited from causing an institution that transacts directly with the ETF (or any investor on whose behalf the institution may transact with the ETF) to acquire any security for the ETF through a transaction in which the ETF could not engage directly.[104]

We request comment on whether it would be useful to include a condition in the proposed rule reminding ETFs relying on the rule of the prohibitions contained in section 48(a) of the Act. We also request comment on potential conflicts of interest for an ETF's investment adviser. Does an adviser to a fully transparent, actively managed ETF face different conflicts of interest from the conflicts of an adviser to a traditional mutual fund? If so, what are those conflicts and how could the rule address them?

---

103 Section 17(a) generally prohibits affiliated persons of a registered fund ("first-tier affiliates") or affiliated persons of the fund's affiliated persons ("second-tier affiliates") from selling securities or other property to the fund (or any company the fund controls). 15 U.S.C. 80a-17(a).

104 *See Lessler v. Little*, 857 F.2d 866, 873-874 (1st Cir. 1988) (reversing dismissal of a claim that principals of a registered investment company and its adviser had violated sections 17(a)(2) and 48(a) of the Act by purchasing the fund's assets indirectly by arranging for sale of the fund to a third party in conjunction with an arrangement whereby the adviser obtained excessive interest in the transferred assets); *SEC v. Commonwealth Chemical Securities*, 410 F. Supp 1002, 1018 (S.D.N.Y. 1976) (finding violations of sections 17(a) and 48(a) of the Act by directors of a registered investment company who caused a third party to purchase shares in an offering underwritten by an affiliated broker-dealer and sold the shares to the registered investment company).

5. *Affiliated Index Providers*

Federal securities laws and the rules of national securities exchanges require funds and their advisers to adopt measures reasonably designed to prevent misuse of non-public information.[105] Funds are likely to be in a position to well understand the potential circumstances and relationships that could give rise to the misuse of non-public information, and can develop appropriate measures to address them. We believe these requirements should be sufficient to protect against the abuses addressed by the terms in the exemptive applications of ETF sponsors that represented they would use an affiliated index provider. The proposed rule, therefore, does not include terms from previous applications that are designed to prevent the communication of material non-public information between the ETF and the affiliated index provider.[106]

---

105 *See* rule 38a-1 (requiring funds to adopt policies and procedures reasonably designed to prevent violation of federal securities laws); rule 17j-1 (requiring funds to adopt a code of ethics containing provisions designed to prevent certain fund personnel ("access persons") from misusing information regarding fund transactions); Section 204A of the Investment Advisers Act of 1940 ("Advisers Act") (15 U.S.C. 80b-204A) (requiring an adviser to adopt policies and procedures that are reasonably designed, taking into account the nature of its business, to prevent the misuse of material, non-public information by the adviser or any associated person, in violation of the Advisers Act or the Exchange Act, or the rules or regulations thereunder); Section 15(f) of the Exchange Act (15 U.S.C. 78o(f)) (requiring a registered broker or dealer to adopt policies and procedures reasonably designed, taking into account the nature of the broker's or dealer's business, to prevent the misuse of material, nonpublic information by the broker or dealer or any person associated with the broker or dealer, in violation of the Exchange Act or the rules or regulations thereunder).

See, e.g. Rule Commentary .02(b)(i) of American Stock Exchange Rule 1000A (requiring "firewalls" between an ETF and an affiliated index provider).

106 The terms are intended to address the potential conflicts of interest between the ETF adviser and its affiliated index provider, and include: (i) all of the rules that govern inclusion and weighting of securities in each index are made publicly available; (ii) the ability to change the rules for index compilation is limited and public notice is given before any changes are made; (iii) "firewalls" exist between (A) the staff responsible for the creation, development and modification of the index compilation rules and (B) the portfolio management staff; (iv) the calculation agent, who is responsible for all index maintenance, calculation, dissemination, and reconstitution activities, is not affiliated with the index provider, the ETF or any of their affiliates; and (v) the component securities of the index may not be changed more frequently than on a specified periodic basis. *See* HealthShares Notice, *supra* note 90; WisdomTree Notice, *supra* note 12.

We request comment on our proposal to eliminate these terms. Should the rule include any of the terms included in previous exemptive applications for affiliated index providers? If so, which terms and why?

C. Exemptive Relief

The unique structure of ETFs has required ETF sponsors to seek relief from certain provisions of the Act and our rules in order to form and operate. Proposed rule 6c-11 would permit an ETF that meets the conditions of the rule to redeem shares in creation unit aggregations, to trade at current market prices, to engage in in-kind transactions with certain affiliates and, in certain circumstances, to pay the proceeds from the redemption of shares in more than seven days. The proposed exemptions would be subject to certain conditions that are designed to address the concerns underlying the statute and thereby satisfy the requirement that exemptions from statutory provisions are in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy of the Act.[107]

1. Issuance of "Redeemable Securities"

Our exemptive orders have provided ETFs with relief from sections 2(a)(32) and 5(a)(1)[108] of the Act so that they may register under the Act as open-end funds while issuing shares that are redeemable in creation units only.[109] In support of the relief, ETF sponsors have noted that because the market price of ETF shares is disciplined by arbitrage opportunities, investors in ETF shares generally should be able to sell the shares in secondary market

---

107 *See* 15 U.S.C. 80a-6(c).

108 15 U.S.C. 80a-2(a)(32) (defining "redeemable security" as any security the terms of which permit the holder upon presentation to receive the holder's proportionate share of the issuer's current net assets, or the cash equivalent); 15 U.S.C. 80a-5(a)(1).

109 These exemptions are granted under section 6(c) of the Act. *See supra* note 76.

transactions at approximately their NAV.[110]

Proposed rule 6c-11 would deem an equity security issued by an ETF to be a "redeemable security" for purposes of section 2(a)(32) of the Act.[111] This provision would permit an ETF to register with the Commission as an open-end fund, which the Act defines as an investment company that issues redeemable securities,[112] even though ETF shares are issued and redeemed in creation unit aggregations.[113] This approach would provide ETFs with the same relief contained in our exemptive orders without exempting ETFs from other requirements imposed under the Act and our rules that apply to funds that issue redeemable securities.[114]

We request comment on this aspect of the proposed rule. Are there differences in ETFs and other funds that would justify not applying any provision of the Act or our rules that applies to funds that issue redeemable securities?

As discussed above, ETFs today operate with an arbitrage mechanism designed to minimize the potential deviation between the market price and NAV of ETF shares. The proposed rule would require that an ETF establish creation unit sizes the number of shares of which are reasonably designed to facilitate arbitrage, which is described in the proposed

---

110 *See, e.g.*, Ziegler Exchange Traded Trust, Investment Company Act Release No. 27610 (Dec. 22, 2006) [72 FR 163 (Jan. 3, 2007)] ("Ziegler Notice"); PowerShares Actively Managed ETF Notice, *supra* note 20, at text following n.5.

111 Proposed rule 6c-11(a). Our orders provided an exemption from sections 2(a)(32) and 5(a)(1) to allow ETFs to redeem securities in creation unit aggregations rather than individually.

112 *See* 15 U.S.C. 80a-5(a)(1).

113 ETF creation units have ranged from 25,000 to 200,000 ETF shares. *See, e.g.*, PowerShares Actively Managed ETF Notice, *supra* note 20 (creation units are blocks of 50,000 to 100,000 ETF shares); ProShares Trust, Investment Company Act Release No. 27323 (May 18, 2006) [71 FR 29991 (May 24, 2006)] (notice) ("ProShares Notice") (creation units are blocks of 25,000 to 50,000 ETF shares); WisdomTree Notice, *supra* note 12 (creation units are blocks of 25,000 to 200,000 ETF shares).

114 *See, e.g.*, 15 U.S.C. 80a-22; 17 CFR 270.22c-1. In addition, the rules under the Exchange Act that apply to redeemable securities issued by a mutual fund would apply to ETFs. *See, e.g.*, 17 CFR 240.15c3-1.

definition of creation unit as the purchase (or redemption) of shares from the ETF with an offsetting sale (or purchase) of shares on a national securities exchange at as nearly the same time as practicable for the purpose of taking advantage of a difference in the Intraday Value and the current market price of the shares.[115] The proposed rule also would require an ETF to disclose in its prospectus and any sales literature the number of ETF shares for which it will issue or redeem a creation unit to alert investors that they cannot purchase or redeem individual ETF shares directly from or with the ETF.[116]

The proposed condition regarding creation unit size is intended to require ETFs that rely on the proposed rule to choose creation unit sizes that promote an arbitrage mechanism and to preclude ETFs from setting very low or high thresholds, such as one ETF share per creation unit or one million ETF shares per creation unit. A low creation unit size could, as a practical matter, make the use of creation unit redemption irrelevant. The ETF would, in effect, be issuing and redeeming ETF shares like a traditional mutual fund, but the shares would trade on an exchange. Conversely, a high creation unit size could reduce the willingness or ability of institutional arbitrageurs to engage in creation unit purchases or redemptions. Impeding the ability of arbitrageurs to purchase and redeem ETF shares could disrupt the arbitrage pricing discipline, which could lead to more frequent occurrences of pricing premiums or discounts.

---

115 Proposed rule 6c-11(e)(3). We note that the Board of Governors of the Federal Reserve defines "arbitrage" in a similar manner in section 220.6(b) of Regulation T ("Arbitrage. A creditor may effect and finance for any customer bona fide arbitrage transactions. For the purpose of this section, the term "bona fide arbitrage" means: (1) A purchase or sale of a security in one market together with an offsetting sale or purchase of the same security in a different market at as nearly the same time as practicable for the purpose of taking advantage of a difference in prices in the two markets; or (2) A purchase of a security which is, without restriction other than the payment of money, exchangeable or convertible within 90 calendar days of the purchase into a second security together with an offsetting sale of the second security at or about the same time, for the purpose of taking advantage of a concurrent disparity in the prices of the two securities."). 12 CFR 220.6.

116 Proposed rule 6c-11(e)(4)(ii); Proposed Item 6(h)(3) to Form N-1A.

We request comment on the proposed requirement for creation unit size, which is included in the proposed rule's definition of "creation unit." Does the requirement that an ETF establish creation unit sizes the number of which is reasonably designed to facilitate arbitrage provide the sponsor or adviser of the ETF with sufficient guidance in setting appropriate thresholds? Should we include other elements in our description of arbitrage, which is included in the definition of creation unit? If so, what elements? Should the proposed rule instead require the board of directors of the ETF to make a finding that the ETF is structured in a manner reasonably intended to facilitate arbitrage? This finding could require the board, for example, to look at the number of shares in each creation unit and the liquidity of the portfolio securities and other assets. What other elements, if any, should the board be required to review in making this finding?

The proposed rule does not include numerical thresholds for the number of ETF shares in each creation unit. Should the proposed rule include minimum or maximum numerical thresholds? If so, what would be appropriate thresholds and why? For example, should the rule set a minimum of 100 ETF shares, and/or a maximum of 500,000 ETF shares, per creation unit? Are our concerns with respect to smaller- or larger-sized creation units addressed by requiring ETFs to establish creation unit sizes that facilitate arbitrage? If the rule does not include any thresholds, would any of the exemptions provided by the proposed rule be inappropriate for an ETF with smaller- or larger-sized creation units? If so, which exemptions?

ETF applicants represent that ETF share prices are disciplined by arbitrage opportunities created by the ability to purchase and redeem creation units at NAV on a daily basis.[117] Would

---

117 *See, e.g.*, Zeigler Application, *supra* note 91, at 52-53; *see also supra* notes 25-26 and accompanying and preceding text.

this pricing mechanism function differently for smaller-or larger-sized creation units? Because ETFs charge transaction fees for direct purchases and redemptions from the fund, ETF applicants have asserted that the interests of long-term shareholders should not be diluted by frequent traders, if those transaction fees accurately reflect the costs to the fund.[118] Are smaller-sized creation units likely to cause the transaction fees charged by ETFs to be insufficient to protect the long-term shareholders in the event of more frequent purchases and redemptions? If so, should an ETF relying on the proposed exemption be required to take additional measures designed to protect long-term shareholder interests from being diluted by frequent traders? If so, what measures?

As discussed above, ETFs issue and redeem shares in creation unit aggregations in exchange for the deposit or delivery of a basket of securities and other assets. The proposed rule defines "basket assets" to mean the securities or other assets specified each business day in name and number by the ETF as the securities or assets in exchange for which it will issue, or in return for which it will redeem, ETF shares.[119] The rule does not require that the basket mirror the portfolio of the ETF because in some circumstances it may not be practicable, convenient or operationally possible for the ETF to operate on an in-kind basis.[120] The rule, like our orders,

---

[118] *See* Zeigler Application, *supra* note 91, at 23; PowerShares Actively Managed ETF Application, *supra* note 62, at 17-18.

[119] Proposed rule 6c-11(e)(1). Under the proposed rule, the term "business day" with respect to an ETF would mean any day that the fund is open for business, including any day on which it is required to make payment under section 22(e) of the Act. Section 22(e) of the Act prohibits registered funds from suspending the right of redemption or postponing the date of payment upon redemption of any redeemable security for more than seven days except for certain periods specified in the provision. *See* 15 U.S.C. 80a-22(e). Proposed rule 6c-11(e)(2).

[120] The ETF and its adviser may decide to permit cash-only purchases of creation units to minimize transaction costs or enhance the ETF's operational efficiency. For example, on a day when a substantial rebalancing of an index-based ETF's portfolio is required, the adviser might prefer to receive cash rather than in-kind securities so that it has the liquid resources at hand to make the necessary purchases. If the ETF received in-kind securities on that day, it might have to sell

(footnote continued)

allows an ETF to require or permit a purchasing or redeeming shareholder to substitute cash for some or all of the securities in the basket assets.[121]

We request comment on the proposed definition of basket assets. Are there any reasons why an ETF should not be permitted to substitute cash for some or all of the assets in the basket? Should the proposed rule include any conditions for when an ETF may require or permit cash substitutions? If so, what conditions should be included? Should the rule specify how the ETF would announce the composition of the basket? For example, should the rule mandate that the ETF post the information on its Internet Web site? Should the rule specify the frequency with which the ETF must announce the composition of the basket? If so, how often?

2. Trading of ETF Shares at Negotiated Prices

As noted above, section 22(d), among other things, prohibits a dealer from selling a redeemable security that is being offered currently to the public by or through an underwriter, except at a current public offering price described in the prospectus.[122] Rule 22c-1 generally requires that a dealer selling, redeeming, or repurchasing a redeemable security do so only at a

---

some securities and acquire new ones to properly track its underlying index, incurring transaction costs that could have been avoided if the ETF had received cash instead. *See*, *e.g.*, Ziegler Application, *supra* note 91, at 21-22. For some ETFs that track country-specific equity securities indexes, it is operationally necessary to engage in cash-only transactions because of local law restrictions on transferability of securities. *See* iShares, Inc., Investment Company Act Release Nos. 25595 (May 29, 2002) [67 FR 38684 (June 5, 2002)] (notice) and 25623 (June 25, 2002) (order) (certain iShares ETFs that invest in certain foreign markets currently effect purchases and redemptions through cash transactions).

[121] Proposed rule 6c-11(e)(1). Though the standard operations of most existing ETFs involve in-kind purchases and redemptions, the Commission has consistently permitted the substitution of cash for certain securities in the basket assets. *See, e.g.*, WisdomTree Notice, *supra* note 12 at text preceding n.9. In addition, the Commission has permitted ETFs that primarily hold financial instruments, cash and cash equivalents in their portfolios to operate on a cash-only basis because of the limited transferability of financial instruments. *See*, *e.g.*, ProShares Notice, *supra* note 113, at n.2 and accompanying text. *See also* SPDR Lehman Municipal Bond ETF, Prospectus 19-22 (Sept. 10, 2007) (ETF generally sells creation units for cash only and redeems creation units in-kind only).

[122] 15 U.S.C. 80a-22(d).

price based on its NAV.[123] Because secondary market trading in ETF shares takes place at current market prices, and not at the current offering price described in the prospectus or based on NAV, ETFs have obtained exemptions from section 22(d) and rule 22c-1.

The provisions of section 22(d), as well as rule 22c-1, are designed to prevent dilution caused by certain riskless trading schemes by principal underwriters and dealers, and to prevent unjust discrimination or preferential treatment among investors purchasing and redeeming fund shares.[124] The proposed rule would exempt a dealer in ETF shares from section 22(d) of the Act and rule 22c-1(a) with regard to purchases, sales and repurchases of ETF shares in secondary market transactions at current market prices.[125] As discussed above, we have provided exemptions from section 22(d) and rule 22c-1 in our orders because the arbitrage function appears to address the potential concerns regarding shareholder dilution and unjust discrimination that these provisions were designed to address.[126] In addition, secondary market trading should not cause dilution for ETF shareholders because those transactions do not directly involve ETF portfolio assets (the transactions are with other investors, not the ETF), and thus have no direct impact on the NAV of ETF shares held by other investors. Moreover, to the extent that different prices for ETF shares exist during a given trading day, or from day to day, these variations occur as a result of third-party market forces, such as supply and demand, and

---

[123] 17 CFR 270.22c-1.

[124] For a complete legislative history of section 22(d), *see* Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, Investment Company Act Release No. 13183 (Apr. 22, 1983) [44 FR 19887 (May 10, 1983)]. *See also* Adoption of Rule 22c-1 under the Investment Company Act of 1940 Prescribing the Time of Pricing Redeemable Securities for Distribution, Redemption, and Repurchase and Amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 Requiring Dealers to Time Stamp Orders, Investment Company Act Release No. 5519 (Oct. 16, 1968) [33 FR 16331 (Nov. 7, 1968)].

[125] Proposed rule 6c-11(b).

[126] *See supra* notes 71-7573 and accompanying text.

not as a result of discrimination or preferential treatment among purchasers.

We request comment on this proposed relief. Should the relief also apply to parties other than dealers in ETF shares? If so, which other parties require similar relief, and why? Do dealers (or others) need relief from other provisions to facilitate transactions in ETF shares on the secondary market?

3. In-Kind Transactions between ETFs 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.[127] Purchases and redemptions of ETF creation units are typically in-kind rather than cash transactions,[128] and section 17(a) prohibits these in-kind purchases and redemptions by persons who are affiliated with the ETF, including those affiliated because they own 5 percent or more, and in some cases more than 25 percent, of the ETF's outstanding securities ("first-tier affiliates"), and by persons who are affiliated with the first-tier affiliates or who own 5 percent or more, and in some cases more than 25 percent, of the outstanding securities of one or more funds advised by the ETF's investment adviser ("second-tier affiliates").[129]

---

[127] 15 U.S.C. 80a-17(a).

[128] ETFs must comply with the federal securities laws in accepting and satisfying redemptions with basket assets, including the registration provisions of the Securities Act. *See, e.g.,* Ameristock Notice, *supra* note 13, at n.3.

[129] An affiliated person of a fund includes, among others: (i) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the fund; (ii) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the fund; and (iii) any person directly or indirectly controlling, controlled by, or under common control with such other person. 15 U.S.C. 80a-2(a)(3)(A), (B) and (C). A control relationship will be presumed where one person owns more than 25 percent of another person's outstanding voting securities. 15 U.S.C. 80a-2(a)(9).

We have granted exemptions from sections 17(a)(1) and (a)(2)[130] of the Act to allow these first- and second-tier affiliates of the ETF to purchase and redeem creation units through in-kind transactions.[131] In seeking this relief, applicants have submitted that because the first- and second-tier 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. All purchases and redemptions of creation units are at an ETF's next-calculated NAV (pursuant to rule 22c-1), and the securities deposited or delivered 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.

The proposed rule would permit first- and second-tier affiliates of the ETF to purchase and redeem creation units through in-kind transactions.[132] The proposed exemption would not, however, apply to a specific category of redemptions that would be addressed in new rule 12d1-4, which we also are proposing today. Section 12(d)(1) of the Act imposes substantial limitations on the ability of investment companies to invest in other investment companies.[133] As discussed in Section IV of this release, proposed rule 12d1-4 would permit investment companies to acquire shares of ETFs in excess of the limitations on those investments under section 12(d)(1) of the Act subject to certain conditions intended to address the concerns underlying those limitations. One of the proposed conditions would prohibit investment

---

[130] 15 U.S.C. 80a-17(a)(1), 80a-17(a)(2).

[131] *See, e.g.,* HealthShares Notice, *supra* note 90, at text following n.10.

[132] Proposed rule 6c-11(d).

[133] *See infra* note 194 and accompanying text.

companies from redeeming certain ETF shares acquired in reliance on proposed rule 12d1-4.[134] In order to make proposed rule 6c-11 consistent with the conditions in proposed rule 12d1-4, we propose to exclude investment companies that acquire ETF shares in reliance on proposed rule 12d1-4 from relying on proposed rule 6c-11(d) to redeem those ETF shares in kind.[135]

We request comment on this proposed exemption. Does the proposed exemption raise any risks with regard to affiliated transactions with the ETF? If so, should the exemption include any conditions to minimize those risks? Should the relief extend to parties that are affiliated persons of an ETF for other reasons? For example, should a broker-dealer that is affiliated with the ETF's adviser be allowed to transact in-kind with the ETF?

4. Additional Time for Delivering Redemption Proceeds

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 satisfaction of redemption requests more than seven days after the tender of a security for redemption.[136] Some ETFs that track foreign indexes have stated that local market delivery cycles for transferring foreign securities to redeeming investors, together with local market holiday schedules, require a delivery process in excess of seven days. These ETFs have requested, and we have granted, 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

---

[134] As discussed in Section IV.B.2, *infra*, this condition is designed to prevent a fund that relies on the proposed rule to acquire ETF shares in excess of the limits of section 12(d)(1)(A)(i) from unduly influencing the ETF by the threat of a large-scale redemption.

[135] The proposed rule would not permit an investment company that has acquired ETF shares in excess of the limits in section 12(d)(1)(A)(i) of the Act in reliance on proposed rule 12d1-4(a) to rely on proposed rule 6c-11(d) with regard to the purchase of basket assets (*i.e.*, the purchase of securities identified in the basket when redeeming ETF shares). Proposed rule 6c-11(d).

[136] 15 U.S.C. 80a-22(e).

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.[137]

Section 22(e) of the Act is designed to prevent unreasonable delays in the satisfaction of redemptions, and ETF sponsors have asserted that the requested relief will not lead to the problems that section 22(e) was designed to prevent.[138] They have represented that the ETF's SAI would disclose those local holidays (over the period of at least one year following the date of the SAI) that are expected to prevent the satisfaction of redemptions in seven days and the maximum number of days needed to satisfy redemption requests with respect to the foreign securities at issue.[139]

The delay in satisfying redemption requests seems reasonable under the circumstances described by the ETF sponsors because it is for a limited period of time and disclosed to investors. The proposed rule, therefore, would codify the relief from section 22(e) of the Act previously provided to ETFs. If an ETF has a foreign security in its basket assets and a foreign holiday prevents timely delivery of the foreign security, the ETF would be exempt from the prohibition in section 22(e) against postponing the date of satisfaction upon redemption for more than seven days. To rely on this exemption, the ETF would be required to disclose in its SAI the foreign holidays it expects to prevent timely delivery of the foreign securities and the maximum

---

137 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.,* In re Barclays Global Fund Advisors, Second Amended and Restated Application, File No. 812-11598, filed May 11, 2000 ("Barclays Foreign Application"), at 76. (available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549). Rule 15c6-1 requires that most securities transactions be settled within three business days of the trade date. 17 CFR 240.15c6-1.

138 *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 291-293 (statements of David Schenker).

139 *See, e.g.,* Barclays Foreign Application, *supra* note 137, at 76-84.

number of days it anticipates it would need to deliver the foreign securities. Finally, the delivery would have to take place no more than 12 calendar days after the tender of ETF shares (in a creation unit).[140]

We request comment on this relief in the proposed exemption. Is the relief necessary? We specifically request comment from ETFs regarding the frequency with which they have relied on this exemption. Could an ETF pay cash (as part of the basket assets) in lieu of foreign securities in the case of delays in settlement? Should the relief be limited to ETFs that satisfy redemptions entirely through in-kind transactions? Is the number of days in the proposed rule sufficient or is it too long? Should the rule refer to the applicable local market's settlement cycle without specifying a number of days? Should the disclosure be included in the prospectus of the ETF instead of the SAI, which is only delivered upon request? Should the disclosure be included in any sales literature of the ETF?

The rule would provide relief if the ETF's basket assets include a foreign security. Should the rule also provide relief if an ETF has foreign securities included in its portfolio and, if so, why? 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)?

The proposed rule defines "foreign security" to mean any security issued by a government or any political subdivision of a foreign country, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign

---

140 Proposed rule 6c-11(c). Applicants requesting this exemptive relief generally have represented that they would be able to deliver redemption proceeds within 12 calendar days. *See, e.g.*, WisdomTree Notice, *supra* note 12. An ETF relying on this exemption would disclose the information in the SAI. *See* Item 18 of Form N-1A (requiring disclosures regarding purchase, redemption, and pricing of shares).

country, and for which there is no established United States public trading market as that term is used in Item 201 of Regulation S-K under the Exchange Act. Use of the phrase "established United States public trading market" is designed to limit this relief to ETFs that invest in securities that do not have an active trading market in the United States. The rule does not rely on registration status because an unregistered large foreign private issuer may have an active U.S. market for its securities, in which case the ETF should be able to meet redemption requests in a timely manner.[141]

We request comment on the definition of "foreign security." Should the definition provide any additional exceptions?

D. Disclosure Amendments

Congress enacted the federal securities laws to promote fair and honest securities markets, and an important purpose of these laws is to promote full and fair disclosure of important information by issuers of securities to the investing public. The Securities Act and the Exchange Act, as implemented by Commission rules and regulations, provide for systems of mandatory disclosure of certain material information in securities offerings and in periodic reports. Accordingly, the Securities Act requires delivery of a prospectus meeting the requirements of section 10(a) to each investor in a registered offering.[142] The Securities Act also

---

[141] *See* Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty To File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Securities Exchange Act Release No. 55540 (Mar. 27, 2007) [72 FR 16934 (Apr. 5, 2007)] (adopting rule 12h-6 under the Exchange Act, which permits a foreign issuer to terminate its Exchange Act registration and reporting obligations regarding a class of equity securities if the average daily trading volume ("ADTV") of the securities in the United States has been 5 percent or less of the ADTV of that class of securities in the issuer's principal trading market during a recent 12-month period, regardless of the size of its U.S. public float).

[142] 15 U.S.C. 77j(a). This is known as a "final prospectus." In 2005, the Commission adopted rule 172 under the Securities Act which generally deems final prospectus delivery satisfied when the prospectus is filed with the Commission ("access equals delivery"). 17 CFR 230.172. The

(footnote continued)

requires dealers in a security, for a specified period of time after the registration statement for the security becomes effective, to deliver a final prospectus to purchasers, including to most persons purchasing shares in secondary market transactions.[143] The Investment Company Act, however, requires dealers to continue prospectus delivery to investors in open-end funds, including ETFs, which continuously offer their securities to the public.[144]

1. Delivery of Prospectuses to Investors

Our orders generally have exempted broker-dealers selling ETF shares from the obligation to deliver prospectuses in most secondary market transactions.[145] Applicants have represented that broker-dealers would instead deliver a "product description" containing basic

---

Commission, however, specifically excluded registered investment companies from rule 172. *See* Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)]. For a detailed discussion on the prospectus delivery requirements and related liabilities with respect to open-end investment companies, *see* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28064 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)] ("Enhanced Disclosure Proposing Release") at sections II.B.1 and II.B.4.

[143] Under section 4(3) of the Securities Act, dealers must deliver a prospectus in connection with original sales by the dealer of securities obtained from or through an underwriter, and resales by the dealer occurring during the 40 days (90 days for first-time issuers) after the effective date of the registration statement (or, under certain circumstances, a different date). This aftermarket delivery obligation applies to all dealers, whether or not they participated in the offering itself. 15 U.S.C. 77d(3). *See also* rule 174 under the Securities Act, which provides an exception from the requirement in section 4(3) that a prospectus be delivered prior to the expiration of the applicable 40-day or 90-day period. 17 CFR 230.174.

[144] Section 24(d) of the Act eliminates the dealer's exception with respect to securities issued by funds and UITs on the theory that, because those issuers continuously offer their securities to the public, all dealers should be compelled to use the statutory prospectus. *See* H.R. REP. NO. 1542, 83d Cong., 2d Sess. 29-30 (1954).

[145] Most of the orders have granted exemptions from section 24(d) of the Act, which makes inapplicable the dealer exception in section 4(3) of the Securities Act to transactions in redeemable securities issued by an open-end fund. 15 U.S.C. 80a-24(d); 15 U.S.C. 77(d)(3); *see, e.g.,* WisdomTree Notice, *supra* note 12, at n.14. ETFs that have this relief continue to be subject to prospectus delivery requirements in connection with sales of creation units and other non-secondary market transactions. Our most recent orders permitting certain actively managed ETFs do not, however, provide this exemption. *See* Actively Managed ETF Orders, *supra* note 20.

information about the ETF and its shares.[146] Proposed rule 6c-11 would not include a similar exemption, and thus broker-dealers would be required to deliver a prospectus meeting the requirements of section 10(a) of the Securities Act to investors purchasing ETF shares.[147]

We understand that many, if not most, broker-dealers selling ETF shares in secondary market transactions do, in fact, transmit a prospectus to purchasers, and thus they have not relied on the exemptions we have provided in our orders. More important, we believe an exemption allowing dealers to deliver product descriptions would be unnecessary given our proposal regarding summary prospectus disclosure. As discussed below,[148] we recently proposed amendments to Form N-1A and to rule 498 under the Securities Act,[149] in order to enhance the disclosures that are provided to mutual fund investors ("Enhanced Disclosure Proposing Release").[150] The proposed amendments, if adopted, would require key information to appear in plain English in a standardized order at the front of the mutual fund prospectus ("summary section").[151] A person could satisfy its mutual fund prospectus delivery obligations under section 5(b)(2) of the Securities Act by sending or giving this key information directly to investors in the form of a summary prospectus and providing a prospectus that meets the requirements of section

---

[146] *See, e.g.*, Ziegler Notice, *supra* note 110. The product description provides a summary of the salient features of the ETF and its shares, including the investment objectives of the fund, the manner in which ETF shares trade on the secondary market, and the manner in which creation units are purchased and redeemed. National securities exchanges on which ETFs are listed have adopted rules requiring the delivery of product descriptions. *See, e.g.*, American Stock Exchange Rules 1000 and 1000A.

[147] 15 U.S.C. 77j(a). This prospectus delivery requirement would apply to all ETFs, including ETFs operating under current exemptive orders. Therefore, we propose to amend orders we issued to open-end ETFs to exclude the section 24(d) exemption we have issued to existing ETFs. *See infra* Section III.E for a discussion of this proposed amendment to existing orders.

[148] *See infra* notes 176-185 and accompanying text.

[149] 17 CFR 230.498.

[150] *See* Enhanced Disclosure Proposing Release, *supra* note 142.

[151] *See id.*, at Section II.A.

10(a) of the Securities Act ("statutory prospectus") on an Internet Web site.[152] If adopted, broker-dealers selling ETF shares could deliver a summary prospectus in secondary market transactions. We believe the summary prospectus would contain material information that may not be included in a product description, but, like the product description, would be in a form that would be easy to use and readily accessible.

We request comment on this approach. Are we correct in our understanding that many, if not most, broker-dealers deliver a prospectus instead of a product description in connection with sales of ETF shares in secondary market transactions? If so, why?

If we were to adopt rule 6c-11 before the amendments proposed in the Enhanced Disclosure Proposing Release, we would expect to permit delivery of a product description in lieu of a prospectus, pending final determination of that proposal by the Commission. We request comment on this approach. Should we permit all ETFs, including actively managed ETFs and index-based ETFs that rely on the rule instead of an exemptive order to deliver product descriptions? Should we prescribe the form of the product description? For example, should we propose specific requirements for product descriptions that would provide ETF investors with information similar to that received by traditional mutual fund investors, such as the fee table, name and length of service of the portfolio manager, and return information, as noted above? Alternatively, should the product description conform to the disclosures in the summary section as proposed in Section III.D.2 below?[153] If so, are there any additional disclosures to those in the proposed summary section that ETFs should be required to include in a product description? Are there any disclosures in the proposed summary section that ETFs should not be required to

---

[152] 15 U.S.C. 77j(a). The fund also would be required to provide additional information on its Web site. *See* Proposed rule 498(c).

[153] *See infra* notes 175-189 and accompanying text.

include in the product description?

If we do not adopt the amendments proposed in the Enhanced Disclosure Proposing Release, we would anticipate that dealers in ETF shares will nevertheless continue their current practice of delivering prospectuses to investors. We request comment on whether the rule should require dealers to deliver prospectuses instead of product descriptions.[154] ETFs are becoming more like traditional mutual funds in several respects. As discussed above, when we began issuing exemptive orders to ETFs, they had basic investment objectives (to track a widely-followed index) and simple investment techniques (investment in all, or a representative sample of, the securities of a widely followed index).[155] Soon, however, some ETFs will be actively managed and have portfolio managers whose role is important to the success of the fund.[156] ETF operations, investment objectives, expenses, and other characteristics may become more varied as well. Because prospectuses contain information in a standardized form prescribed by the Commission, the use of these disclosure forms could promote greater uniformity in the content and level of disclosure among ETFs.[157] In addition, as discussed below, we are proposing to amend Form N-1A to include additional information relevant to a retail investor in an ETF, who does not typically buy or redeem individual shares directly from the fund.

If we were to retain the prospectus delivery exemption for broker-dealers, should the

---

[154] For a discussion of the additional burdens associated with the requirement that broker-dealers deliver prospectuses in secondary market transactions involving ETF shares, *see infra* discussion at Section VIII.

[155] *See supra* note 10 and accompanying text.

[156] The investment objectives and techniques of index-based ETFs also have become more complex. Some ETFs today follow specialized or custom-designed indexes; others are leveraged through use of futures contracts and other types of derivative instruments.

[157] Certain disclosures required by Form N-1A that generally are not included in product descriptions may be important to some investors given the evolution of ETFs. Product descriptions do not, for example, include a fee table itemizing the ETF’s expenses, or the name and length of service of the portfolio manager.

exemption be limited to index-based ETFs or only to certain index-based ETFs, such as those that replicate the components of a broad-based stock market index? If we were to retain the exemption, should we require broker-dealers to deliver prospectuses instead of product descriptions to purchasers of actively managed ETF shares?

2. Amendments to Form N-1A

We are proposing several amendments to Form N-1A, the registration form used by open-end management investment companies to register under the Act and to offer their securities under the Securities Act, to accommodate the use of this form by ETFs. The proposed amendments for ETF prospectuses are designed to meet the needs of investors (including retail investors) who purchase shares in secondary market transactions rather than financial institutions purchasing creation units directly from the ETF.

We request comment on our proposal to amend Form N-1A to meet the needs of secondary market investors. Is this distinction we propose to draw between purchasers of shares in secondary market transactions and purchasers of creation units from the fund appropriate? Should we instead revise Form N-1A to include the additional disclosure (as discussed below) we are proposing today for secondary market investors without eliminating (as discussed below) certain disclosures relevant to creation unit purchasers? Would secondary market investors be confused if Form N-1A included disclosure relevant to both types of investors?

Purchasing and Redeeming Shares. We propose to amend Item 6 of Form N-1A to eliminate the requirement that ETF prospectuses disclose information on how to buy and redeem shares of the ETF because it is not relevant to secondary market purchasers of ETF shares.[158] Instead ETF prospectuses would simply state the number of shares contained in a creation unit

---

[158] Proposed Item 6(h)(1) of Form N-1A.

(*i.e.* the amount of shares necessary to redeem with the ETF) and that individual shares can only be bought and sold on the secondary market through a broker-dealer.[159] Similarly, we also would amend Item 3 to exclude from the fee table fees and expenses for purchases or sales of creation units.[160] Instead, the proposed amendment would require an ETF to modify the narrative explanation preceding the example in the fee table to state that individual ETF shares are sold on the secondary market rather than redeemed at the end of the periods indicated, and that investors in ETF shares may be required to pay brokerage commissions that are not reflected in the fee table.[161]

We request comment on our assumption that investors (including most individual investors) purchasing their shares in secondary market transactions do not need to know information on how creation units are purchased and redeemed, or the payment of transaction fees by investors purchasing or redeeming creation units. If they do need this information, why?

ETFs would still be required to include disclosure on how creation units are offered to the public in the SAI.[162] We are not proposing to amend this disclosure to include information on creation unit redemption, which Item 6 currently requires and which we propose to eliminate. Should we amend the SAI to include the disclosure requirements we are proposing to eliminate from Item 6? Should we require that the information in the SAI regarding the purchase of creation units also specify associated fees and expenses? As an alternative, should we require purchase and redemption information and associated fees and expenses to remain in Item 3 and

159 Proposed Item 6(h)(3) of Form N-1A.

160 Proposed Instruction 1(e)(i) to Item 3 of Form N-1A.

161 Proposed Instruction 1(e)(ii) to Item 3 of Form N-1A. We also are proposing a conforming amendment to the fee table in ETF annual and semi-annual reports. Proposed Instruction 1(e) to Item 22(d) of Form N-1A.

162 Item 18(a) of Form N-1A.

Item 6 only for prospectuses provided to investors purchasing creation units, such as in the form of a supplementary prospectus?

The proposed alternative disclosures in Items 3 and 6 would not be available, however, to ETFs with creation units of less than 25,000 shares because more retail investors would be able to transact directly with an ETF that has smaller-sized creation units.

We request comment on whether the exemptions we are providing from Items 3 and 6 of Form N-1A should be based on the size of the creation unit, and whether 25,000 shares per creation unit is an appropriate threshold. Should it be higher or lower? Should we instead adopt a threshold based on the value of shares rather than the number of shares?

Total Return. We propose to modify instructions to several items that require the use of the ETF's NAV to determine its return. In addition to returns based on NAV, ETFs also would be required to include returns based on the market price of fund shares.[163] As discussed above, returns based on market price may be different than returns based on the fund's NAV and better relate to an ETF investor's experience in the fund.

---

163 We propose to amend the average annual return table to include a separate line item for returns based on the market price of ETF shares. Proposed Instruction 5(a) to Item 2(c)(2) of Form N-1A. This would codify, with modifications, a condition in ETF exemptive orders. *See, e.g.*, Ziegler Notice, *supra* note 110. The condition in our exemptive orders did not specify the location of the disclosure in the prospectus. As a result, ETFs include an additional table in the prospectus, rather than including market price returns in the average annual returns table required by Item 2. In addition, ETFs use different time periods for the disclosure, with some using calendar years and others fiscal years. The proposed amendment would eliminate use of a second table, which may confuse investors. It also would standardize the reporting period by requiring all ETFs to present the information using calendar years.

We also propose to amend the financial highlights table to require ETFs to calculate total return at market prices in addition to returns at NAV. This proposed amendment would provide secondary market investors with more pertinent information as to the effect of market price movements on their investments. Proposed Instruction 3(f) to Item 8(a) of Form N-1A. Under the proposed amendment, ETFs would be required to include two bar charts under Item 2 of the form; one using market price returns and one using NAV returns. *See* Instruction 1(a) to Item 2(c)(2) of Form N-1A.

We request comment on whether use of market prices, in addition to NAV, would provide secondary market purchasers of ETF shares with meaningful information on their investments. Alternatively, should we require returns to be computed solely using market prices? Would investors find it confusing to have fund returns presented using both market price and NAV? Should we limit this amendment to ETFs with creation units of 25,000 shares or more because more retail investors may be able to transact directly with the ETF in the event of smaller creation units?

For purposes of determining ETF returns, we would define "market price" as the last price at which ETF shares trade on their principal U.S. trading market during a regular trading session (*i.e.* closing price).[164] Is this an appropriate definition for market price, or should we instead (or in addition) define the market price as the mid-point price between the highest bid and the lowest offer on the principal U.S. market on which the ETF shares are traded, at the time the fund's NAV is calculated?[165]

Premium/Discount Information. We propose to require that each ETF disclose to investors information about the extent and frequency with which market prices of fund shares have tracked the fund's NAV.[166] This disclosure, which would be required on the fund's Internet

---

164 Proposed definition of "Market Price" in General Instruction A of Form N-1A. We consider the closing price to be the strongest indicator of market value. *See* Codification of Financial Reporting Policies, Section 404.03.b.ii, "Valuation of Securities—Securities Listed for Trading on a National Securities Exchange," reprinted in SEC Accounting Rules (CCH) ¶ 38,221 ("ASR 118"), at 38, 424-38, 425. *See also* Fair Value Measurements, Statement of Financial Accounting Standards No. 157, § 24 (Fin. Accounting Standards Bd. 2006) ("FASB 157") ("[A] quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.").

165 In circumstances where closing price may be less accurate because the last trade occurred at a much earlier point in the day than NAV calculation, some ETFs have used the mid-point price, rather than the closing price. *See, e.g.,* Claymore Exchange-Traded Fund Trust, Investment Company Act Release No. 27469 (Aug. 28, 2006) [71 FR 51869 (Aug. 31, 2006)].

166 Proposed Item 6(h)(4) to Form N-1A.

Web site and included in its prospectus, is a condition to relief in ETF exemptive orders.[167] Proposed rule 6c-11 also would require each ETF to disclose on its Internet Web site the prior business day's last determined NAV, the market closing price of its shares and the premium/discount of the closing price to NAV.[168] This disclosure is designed to alert investors to the current relationship between NAV and the market price of the ETF's shares, and that they may sell or purchase ETF shares at prices that do not correspond to the NAV of the fund.

Proposed Item 6(h)(4) of Form N-1A would require disclosure in the ETF prospectus of the number of trading days, during the most recently completed calendar year and quarters since that year, on which the market price of the ETF shares was greater than the fund's NAV and the number of days it was less than the fund's NAV (premium/discount information).[169] In addition to alerting investors that the ETF's NAV and share price may differ, this disclosure also would provide historical information regarding the frequency of these deviations. In light of the historical premium/discount disclosure in the ETF prospectus and in order to avoid duplicative disclosures that may result in additional regulatory burdens, proposed rule 6c-11, unlike the exemptive orders, would not require ETFs to include historical premium/discount information on their Internet Web sites.

We request comment on whether daily and historical premium/discount information, which ETFs currently provide, is useful to investors. One commenter to the 2001 Concept

---

[167] *See, e.g.,* WisdomTree Notice *supra* note 12; Zeigler Notice *supra* note 110.

[168] Proposed rule 6c-11(e)(4)(iv).

[169] Consistent with current orders, ETFs would be required to present premiums or discounts as a percentage of NAV. They also would be required to explain that shareholders may pay more than NAV when purchasing shares and receive less than NAV when selling, because shares are bought and sold at market prices. Proposed Instructions 2, 3 to Item 6(h)(4) of Form N-1A. In addition, the amendments also would require each ETF to identify the trading symbol(s) and principal U.S. market(s) on which the shares are traded. Proposed Item 6(h)(2) of Form N-1A.

Release suggested that investors need not receive premiums/discounts against NAV disclosure because the more useful information is the Intraday Value of the fund's basket as disseminated by national securities exchanges at regular intervals.[170] This information, according to the commenter, provides investors with contemporaneous pricing of the fund's portfolio and enables the investor to see, at the time his order is entered, whether the Intraday Value is close to (or between) the bid-asked price.

We request comment on whether investors need premium/discount disclosure in light of the dissemination of the ETF's Intraday Value at regular intervals during trading hours. We request ETF sponsors commenting on this condition of the rule to provide us with data regarding the frequency with which visitors to their Internet Web sites access this information. In addition to current premium/discount information, should we also require ETF Web sites to provide historical premium/discount information as is currently required by exemptive orders? If the Web site includes historical premium/discount information, should the rule also require historical information in Form N-1A? If so, over what periods?

Periodic Report Information. We are proposing conforming amendments to ETF return information in ETF annual reports. The proposed amendments would require each ETF to use the market price of fund shares in addition to NAV to determine its return,[171] and include a table

---

170 *See* Comment Letter of Nuveen Investments, File No. S7-20-01 (Jan. 14, 2002). *See also* GASTINEAU, *supra* note 17, at 230-241.

171 Proposed Instruction 12(b) to Item 22(b)(7) of Form N-1A. This proposed disclosure would be identical to proposed Instruction 5(a) to Item 2(c)(2) of Form N-1A. *See supra* note 163. We also are proposing to require ETFs to include a new line graph comparing the initial and subsequent account values using market price, following the line graph using NAV required by Item 22(b)(7)(ii)(A) of Form N-1A. Proposed Instruction 12(a) to Item 22(b)(7) of Form N-1A. Consistent with the amendments proposed above, this proposed amendment also is designed to provide individual investors with the effect of market price fluctuations on their investment.

with premium/discount information for the five recently completed fiscal years.[172]

We request comment on whether it is necessary to include similar disclosure in both the prospectus and annual report of an ETF. Should ETFs that provide this information on their Internet Web sites be exempt from this annual report requirement? Is it necessary for the ETF to provide premium/discount data for the most recently completed five fiscal years? Should the reporting period conform to that proposed under Item 6 of the form (*i.e.*, one calendar year and most recent quarters since that year)?

We also are proposing to amend the prospectus and annual report requirements of Form N-1A to require an index-based ETF to compare its performance to its underlying index rather than a benchmark index.[173] This amendment would permit use of a narrow-based or affiliated index and eliminate the opportunity for an index-based ETF to select an index different from its underlying index which should better reflect whether the ETF's performance corresponds to the index the performance of which it seeks to track.[174]

We request comment on whether it is appropriate to require an index-based ETF to compare its performance to its underlying index. Should an index-based ETF that tracks an

---

[172] Proposed Item 22(b)(7)(iv) of Form N-1A. Although similar to the proposed disclosure amendment to the shareholder information in Item 6 of the form, this proposed disclosure would span a longer, and different, reporting period: five fiscal years instead of the most recent calendar year and quarter(s). *See* Proposed Item 6(h)(4) of Form N-1A. The proposed amendment would require fiscal year disclosure to conform to currently required disclosure in Item 22(b)(7). We are also proposing to include instructions similar to those proposed in Item 6 to assist funds in meeting this proposed disclosure obligation. Proposed Instructions to Item 22(b)(7)(iv) of Form N-1A.

[173] Proposed Instruction 5(b) to Item 2(c)(2) of Form N-1A; Proposed Instruction 12(c) to Item 22(b)(7) of Form N-1A.

[174] Item 2(c)(2)(iii) of Form N-1A; Instruction 12(c) to Item 22(b)(7) of Form N-1A. The form requires use of a broad-based index and prohibits use of affiliated indexes unless widely used and recognized. Our amendment would require ETFs that track narrow, custom indexes or affiliated indexes, to use the underlying index when presenting this return information.

index compiled by an affiliated index provider use a benchmark index instead of, or in addition to, its underlying index? Should an index-based ETF that tracks a fundamental or other custom-designed index use a benchmark index instead of, or in addition to, its underlying index?

Summary Prospectus. As noted above, we recently issued the Enhanced Disclosure Proposing Release, which would require key information to appear in plain English in a summary section of the prospectus.[175] In addition, a person could satisfy its mutual fund delivery obligations under section 5(b)(2) of the Securities Act by delivering the summary prospectus to investors and providing a statutory prospectus on an Internet Web site. Upon request, a fund also would be required to send the statutory prospectus to the investor.[176]

As proposed, the summary section would include certain key information, which also would comprise the information in the summary prospectus. This key information would include: (i) investment objectives;[177] (ii) costs;[178] (iii) principal investment strategies, risks, and

---

175 *See supra* notes 148-152 and accompanying text. References to Form N-1A amendments in the Enhanced Disclosure Proposing Release, *supra* note 142, are to the "proposed summary prospectus."

176 *See* Enhanced Disclosure Proposing Release, *supra* note 142, at Section II.B (proposed rule 498 under the Securities Act).

177 *See id.*, at n.43 and accompanying text (proposed summary prospectus Item 2 of Form N-1A). This is the same information required by current Item 2(a) of Form N-1A.

178 *See id.*, at nn.44-55 and accompanying text (proposed summary prospectus Item 3 of Form N-1A). This information would be substantially the same as that required by current Item 3 of Form N-1A (the risk/return summary fee table and example), except for proposed amendments that would: (i) require funds that offer discounts on front-end sales charges for volume purchases (*i.e.* breakpoints) to include a brief narrative disclosure alerting investors to the availability of those discounts; (ii) revise the parenthetical following the heading "Annual Fund Operating Expenses" to read "ongoing expenses that you pay each year as a percentage of the value of your investment" in place of "expenses that are deducted from Fund assets"; (iii) require funds to add brief disclosure regarding portfolio turnover immediately following the fee table example; and (iv) permit funds to include additional captions directly below the "Total Annual Fund Operating Expenses" caption in cases where there were expense reimbursement or fee waiver arrangements that reduced fund operating expenses and that will continue to reduce them for no less than one year from the effective date of the fund's registration statement.

performance;[179] (iv) the fund's top ten portfolio holdings as of the end of its most recent calendar quarter;[180] (v) identity of investment advisers and portfolio managers;[181] (vi) brief purchase and sale and tax information;[182] and (vii) financial intermediary compensation.[183] This information is drawn largely from the current risk/return summary and rule 498 fund profile.[184] In addition, the summary prospectus would be required to include on the cover page or at the beginning: (i) the

---

179 *See id.*, at nn.56-57 and accompanying text (proposed summary prospectus Item 4 of Form N-1A). This would include the same information required by current Items 2(b) and (c) of Form N-1A.

180 *See id.*, at nn.58-66 and accompanying text (proposed summary prospectus Item 5 of Form N-1A). This information currently is not required in a fund's prospectus. The proposal would allow funds to list an amount not exceeding five percent of the total value of the portfolio holdings in one amount as "Miscellaneous securities" provided certain specified conditions are met. *Id.* at n.66 and accompanying text (proposed Instruction 3 to proposed summary prospectus Item 5 of Form N-1A).

181 *See id*., at nn.67-72 and accompanying text (proposed summary prospectus Item 6 of Form N-1A) (proposing that a fund disclose the name of each investment adviser and sub-adviser of the fund, followed by the name, title, and length of service of the fund's portfolio managers). This information is similar to disclosures required by current Item 5 of Form N-1A. Certain additional disclosures regarding investment advisers and portfolio managers that are currently required in the statutory prospectus would continue to be required in the statutory prospectus, but not in the summary section. *See id.*, at n.68.

182 *See id.*, at nn.73-74 and accompanying text (proposed summary prospectus Item 7 of Form N-1A) (proposing that a fund disclose minimum initial or subsequent investment requirements, the fact that the shares are redeemable, and identify the procedures for redeeming shares (*e.g.*, on any business day by written request, telephone, or wire transfer)), and nn.75-76 and accompanying text (proposed summary prospectus Item 8 of Form N-1A) (proposing that a fund state, as applicable, that it intends to make distributions that may be taxed as ordinary income or capital gains or that the fund intends to distribute tax-exempt income, and proposing that a fund that holds itself out as investing in securities generating tax-exempt income provide, as applicable, a general statement to the effect that a portion of the fund's distributions may be subject to federal income tax).

183 *See id.*, at nn.77-78 and accompanying text (proposed summary prospectus Item 9 of Form N-1A) (proposing that a fund provide disclosure that, if an investor purchases the fund through a broker-dealer or other financial intermediary (such as a bank), the fund and its related companies may pay the intermediary for the sale of fund shares and related services, and state that these payments may influence the broker-dealer or other intermediary and the salesperson to recommend the fund over another investment).

184 Registrants would not be permitted to include any additional information in the summary section. *See id.*, at n.37 and accompanying text (proposed summary prospectus General Instruction C.3.(b) of Form N-1A).

fund's name and the share classes to which the summary prospectus relates; (ii) a statement identifying the document as a "summary prospectus"; (iii) the approximate date of the summary prospectus's first use; and (iv) the following legend:

> Before you invest, you may want to review the Fund's prospectus, which contains more information about the Fund and its risks. You can find the Fund's prospectus and other information about the Fund online at [_______]. You can also get this information at no cost by calling [______] or by sending an e-mail request to [________].[185]

If adopted, the amendments to Form N-1A and rule 498 proposed in the Enhanced Disclosure Proposing Release would require open-end ETFs to include the summary section in their prospectuses and permit persons to satisfy their prospectus delivery obligations by sending or giving the summary prospectus and providing the statutory prospectus on an Internet Web site in the manner set forth in the proposed rules. Today, we also propose that, if the Enhanced Disclosure Proposing Release is adopted, ETFs include in the summary section of their prospectuses, and in their summary prospectuses, the additional proposed disclosures discussed above. Specifically, we would modify the amendments proposed in the Enhanced Disclosure Proposing Release to include our proposed amendments to ETF disclosures as follows: (i) our proposed amendments regarding disclosures about creation units and the purchase and sale of individual ETF shares would be included in proposed summary prospectus Item 7, which would require brief purchase and sale information;[186] (ii) the additional information on market price returns would be included in proposed summary prospectus Item 4, which includes the

---

[185] *See id*., at n.98 and accompanying text (proposed rule 498(b)(1) under the Securities Act).

[186] The disclosures in our proposed Items 6(a)(1), 6(h)(2) and 6(h)(3) to Form N-1A would be included in proposed summary prospectus Item 7 of Form N-1A. As noted, our proposed amendments also would require the ETF to modify the narrative explanation preceding the example in the fee table, *see supra* note 160, which would remain in current Item 3 of Form N-1A.

risk/return summary, bar chart and table;[187] and (iii) premium/discount information would be included in proposed summary prospectus Item 7 (purchase and sale information).[188] We also would permit ETFs to exclude proposed information regarding the purchase and sale of creation units consistent with our proposal today.[189]

We request comment on whether ETFs should send or give the proposed additional items in the summary prospectus. If so, should any information from the statutory prospectus, in addition to the items that we are proposing today, be included in the summary section of an ETF's prospectus and, therefore, in its summary prospectus? Should ETFs not be required to include certain items in the summary section? For example, in light of the transparency of portfolio holdings of an ETF, should ETFs not have to include the top ten portfolio holdings? Should ETFs be permitted or required to locate any of the specific disclosures proposed in this release or in the Enhanced Disclosure Proposing Release elsewhere in the prospectus outside the summary section?

E. Amendment of Previously Issued Exemptive Orders

As discussed above, our orders have exempted ETFs from compliance with section 24(d) of the Act to relieve dealers from delivering prospectuses to investors in secondary market

---

[187] Our proposed instructions 5(a) and (b) to the risk return bar chart and table (current Item 2(c)(2) of Form N-1A), *see* note 163 and accompanying and following text, would be added to the end of the proposed instructions to proposed summary prospectus Item 4.

[188] The disclosure in our proposed Item 6(h)(4) to Form N-1A, *see* notes 167-169 and accompanying and following text, would be included at the end of proposed summary prospectus Item 7 of Form N-1A. Our proposed amendments to the financial highlights (current Item 8 of Form N-1A) and the financial statements (current Item 22 of Form N-1A) would be included in the proposed summary prospectus Items 14 and 28 of Form N-1A, respectively.

[189] ETFs would be permitted to exclude from the fee table (current Item 3 and proposed summary prospectus Item 3 of Form N-1A) the fees and expenses associated with creation unit purchases and redemptions and would be permitted to exclude the disclosure required by proposed summary prospectus Items 7(a) and 7(b) of Form N-1A. *See supra* notes 158-160 and accompanying text.

transactions. We are proposing today not to include such an exemption in rule 6c-11 to ensure that broker-dealers are subject to the same delivery requirements with respect to all ETFs.[190] In addition, we are proposing amendments to Form N-1A that would revise the prospectus requirements in that form in order to provide more useful information to investors in ETF shares. Therefore, pursuant to our authority under section 38(a) of the Act, we propose to amend the exemptive orders we have issued to ETFs that are open-end funds to eliminate the section 24(d) exemptions and require ETFs to satisfy their statutory prospectus delivery requirements.[191]

The consequence of the amendment to these orders, if adopted, would be to put ETFs that have received exemptive orders on the same footing as ETFs that may in the future rely solely on rule 6c-11, and thus eliminate any competitive advantage they might otherwise obtain by having obtained orders before adoption of the rule.[192] The amendment would be limited to orders issued to ETFs seeking to operate as open-end management companies.

We are not proposing to rescind the orders we have issued because we do not believe rescission would be necessary to eliminate competitive advantages for ETFs that have already received exemptive orders. With the exception of the section 24(d) exemption (and the related prospectus disclosure requirements), the proposed rule contains broader exemptive relief than that provided in our orders and therefore we expect most, if not all, ETFs would rely on the rule

---

190 *See supra* Section III.D.1.

191 Section 38(a) of the Act provides the Commission with the authority to amend orders when necessary or appropriate to the exercise of its powers conferred elsewhere in the Act. We are not proposing to amend the orders of UITs that have sought and obtained an exemption from section 24(d) of the Act because those ETFs do not prepare their prospectuses in accordance with Form N-1A.

192 For the same purpose, we expect all funds seeking exemptive orders to operate an ETF after today to agree as a condition of the order that the requested order would expire on the effective date of any Commission rule under the Act that provides relief permitting the operation of index-based or actively managed ETFs.

if and when it is adopted.

We request comment on whether we should rescind our previous orders. Is our assumption correct that most ETFs that have orders would rely on the rule?

IV. EXEMPTION FOR INVESTMENT COMPANIES INVESTING IN ETFS

A. Background

As we discussed above, institutional investors, including funds, have invested in ETFs to achieve asset allocation, diversification, or other investment objectives.[193] Some funds invest primarily in ETFs. A fund's ability to invest in ETFs, however, is limited because section 12(d)(1) of the Act prohibits a fund (and companies or funds it controls) ("acquiring fund") from:

(i) acquiring more than three percent of any other investment company's outstanding voting securities ("acquired fund");

(ii) investing more than five percent of its total assets in any one acquired fund; or

(iii) investing more than ten percent of its total assets in all acquired funds.[194]

Section 12(d)(1) was enacted to limit so-called "fund of funds" arrangements. Congress was concerned about "pyramiding," a practice under which investors could use a limited

---

[193] *See supra* note 15 and accompanying text (funds also use ETFs for hedging purposes). *See also, e.g.*, iShares Trust, Investment Company Act Release No. 25969 (Mar. 21, 2003) [68 FR 15010 (Mar. 27, 2003)].

[194] *See* 15 U.S.C. 80a-12(d)(1)(A). Both registered and unregistered funds are subject to these limits with respect to their investments in a registered fund. Registered funds are also subject to these same limits with respect to their investments in an unregistered fund. Unregistered funds are not subject to limits on their investments in another unregistered fund. *Id*. ETFs are registered funds and therefore both registered and unregistered funds are subject to section 12(d)(1)(A)'s limits with respect to investments in ETFs. Section 12(d)(1)(B) prohibits a registered open-end fund from selling any security issued by the fund to any other fund (including unregistered funds) if, after the sale, the acquiring fund would: (i) together with companies and funds it controls, own more than three percent of the acquired fund's voting securities; or (ii) together with other funds (and companies they control) own more than ten percent of the acquired fund's voting securities. 15 U.S.C. 80a-12(d)(1)(B).

investment in an acquiring fund to gain control of another (and potentially much larger) fund and use the assets of the acquired fund to enrich themselves at the expense of acquired fund shareholders.[195] Control could be exercised either directly (such as through holding a controlling interest) or indirectly (such as by coercion through the threat of large-scale redemptions).[196] Congress also was concerned about the potential for excessive fees when one fund invested in another,[197] and the formation of overly complex structures that could be confusing to investors.[198]

---

195 The legislative history of these provisions cites examples of controlling investors in an acquiring fund using "pyramiding schemes" to force acquired funds to purchase securities of companies in which the investors had an interest and to direct underwriting and brokerage business to broker-dealers they controlled. In an open-end fund, controlling investors were able to exert control and influence over acquired funds through the threat of large-scale redemptions. In the 1960s, Fund of Funds, Ltd., an unregistered foreign investment company, acquired controlling interests in several registered U.S. funds and was able to exert undue influence over the management of those acquired funds by threatening advisers to those funds with large redemptions. *See* SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. at 315-16 (1966) ("1966 Study"). Congress enacted section 12(d)(1) to prevent these abuses and amended the section in 1970 to prevent similar abuses by investors in unregistered acquiring funds. Congress later amended section 12(d)(1) to give the Commission specific authority to provide exemptions from these limitations. *See infra* notes 200 and 214 and accompanying text.

196 Large-scale redemptions may disrupt portfolio management or increase transaction fees if fund managers must hold cash or sell portfolio securities at an inopportune time to meet redemptions. Large-scale redemptions also may be threatening to a fund manager because they decrease the fund's assets under management, on which the manager's fee is based.

197 Pyramiding schemes resulted in fund shareholders paying excessive charges due to duplicative fees at the acquiring and acquired fund levels. *See* SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 279, 76th Cong., 1st Sess., pt.3, at 2721-95 (1939) ("INVESTMENT TRUST STUDY"). *See also* Fund of Funds Investments, Investment Company Act Release No. 26198 (Oct. 1, 2003) [68 FR 58226 (Oct. 8, 2003)] ("Fund of Funds Proposing Release") at nn.2-6 and accompanying text. For example, from 1927 to 1936, it was estimated that the duplication of expenses incurred by funds investing in other funds exceeded five percent of the total operating expenses for all management funds. *See* INVESTMENT TRUST STUDY, at 2727-2728. Fund of Funds, Ltd. also charged duplicative advisory fees at the acquiring and acquired fund levels, provided sales loads to an affiliated broker for each investment the acquiring fund made in an acquired fund, and directed brokerage to an affiliate of the fund of funds. *See* 1966 Study, *supra* note 195, at 318-320; *Arthur Lipper Corp., et al. v. SEC*, Securities Exchange Act Release No. 11773, 46 S.E.C. 78 (Oct. 24, 1975), *sanction modified*, 547 F.2d 171 (2d Cir. 1976) (a Fund of Funds, Ltd. affiliated broker-dealer received commissions under step-out arrangements with Arthur Lipper Corp, a registered broker-dealer, and other broker-dealers).

198 Pyramiding of funds resulted in complicated corporate structures that were confusing to

(footnote continued)

Congress imposed these limits, in part, based on our conclusion in 1966 that fund of funds structures served little or no economic purpose.[199]

Our views and those of Congress regarding the economic value of fund of funds arrangements have changed over the years as fund of funds arrangements have been created that serve new, legitimate purposes. Recognizing this, in 1996, Congress granted us specific authority to provide exemptions allowing fund of funds arrangements, and directed that we use it "in a progressive way."[200] Pursuant to this authority, we have provided exemptions to permit certain fund of funds arrangements that would otherwise be prohibited under section 12(d)(1). For example, in 2006 we adopted rule 12d1-1, which allows funds to invest in money market funds in excess of section 12(d)(1) limits.[201] We also have issued exemptive orders that allow many funds to invest in unaffiliated traditional funds ("multigroup fund orders") and that allow the sale of shares issued by several ETFs to unaffiliated funds in excess of the statutory limits.[202]

---

shareholders and made it difficult for shareholders to determine the nature and value of the holdings ultimately underlying each shareholder's investment. *See* INVESTMENT TRUST STUDY, *supra* note 197, at 2778-93.

199 *See id*., at 2725-41.

200 *See* National Securities Markets Improvement Act of 1996, P.L. 104-290, § 202(4), 110 Stat. 3416, 3427 (1996) ("NSMIA"); H.R. REP. NO. 622, 104TH CONG., 2D SESS., at 43-44 (1996) ("H.R. REP. NO. 622") (discussing new section 12(d)(1)(J) of the Act that gives the Commission authority, by rule or order, to provide exemptions from the limits of section 12(d)(1) when it is consistent with the public interest and the protection of investors). In 1996, Congress also amended the Act to include a statutory exemption from section 12(d)(1) limits for funds that invest in funds in the same fund group. NSMIA, § 202(5). *See also infra* note 214 and accompanying text.

201 *See* Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) [71 FR 36640 (June 27, 2006)] ("Fund of Funds Adopting Release"); 17 CFR 270.12d1-1.

202 *See, e.g.,* Schwab Capital Trust, *et al.*, Investment Company Act Release Nos. 24067 (Oct. 1, 1999) [64 FR 54939 (Oct. 8, 1999)] (notice) ("Schwab Notice") and 24113 (Oct. 27, 1999) (order) ("Schwab Order"); First Trust Exchange-Traded Fund, *et al.*, Investment Company Act Release Nos. 27812 (Apr. 30, 2007) [72 FR 25795 (May 7, 2007)] (notice) and 27845 (May 30, 2007) (order); iShares Trust, *et al.*, Investment Company Act Release Nos. 25969 (Mar. 21, 2003) [68 FR 15010 (Mar. 27, 2003)] (notice) and 26006 (Apr. 15, 2003) (order).

The exemptions provided under the rule and these orders facilitate the acquiring funds' ability to achieve their investment objectives by expanding their investment options to include investments in unaffiliated funds in a manner consistent with the protection of investors. These exemptions also increase the potential pool of investors and assets available for investment in ETFs and traditional funds.

ETF applicants have sought exemptive orders similar to those we have issued to funds investing in unaffiliated traditional funds.[203] The conditions included in those orders were designed to prevent the abuses that historically were associated with fund of funds arrangements and that led Congress to enact section 12(d)(1).[204] The conditions include: (i) limits on the control and influence an acquiring fund can exert on the acquired fund;[205] (ii) limits on certain

---

203 Fifteen orders have been issued to ETFs allowing other funds to invest in ETFs beyond the limits of section 12(d)(1). *See, e.g.*, iShares Trust, *et al.*, Investment Company Act Release No. 25969 (Mar. 21, 2003) [68 FR 15010 (Mar. 27, 2003)].

204 *See, e.g.*, Schwab Notice and Order, *supra* note 202.

205 The exemptive orders permitting investments in ETFs contain the following conditions relating to influence and control: (i) the acquiring fund's investment adviser or sponsor, any person in a control relationship with that investment adviser or sponsor, any investment company (including a company that would be an investment company but for the exceptions provided in sections 3(c)(1) and 3(c)(7) of the Act) that is advised or sponsored by the acquiring fund's investment adviser or sponsor, or any person in a control relationship with that investment adviser or sponsor cannot control the ETF within the meaning of section 2(a)(9) of the Act; (ii) neither the acquiring fund nor certain of its affiliates cause any existing or potential investment by the acquiring fund in ETF shares to influence the terms of any services or transactions between the acquiring fund or its affiliate and the ETF or an ETF affiliate; (iii) the board of directors (or trustees) of the acquiring fund, including a majority of the independent directors, adopts procedures reasonably designed to assure that the acquiring fund's investment adviser(s) is conducting the acquiring fund's investment program without taking into account any consideration received by the acquiring fund or an acquiring fund affiliate from the ETF or an ETF affiliate in connection with any services or transactions; (iv) the board of directors of an open-end ETF, including a majority of its independent directors, determines that any consideration paid by the ETF to the acquiring fund or an acquiring fund affiliate in connection with any services or transactions: (a) is fair and reasonable in relation to the nature and quality of the services and benefits received by the ETF; (b) is within the range of consideration that the ETF would be required to pay to another unaffiliated entity in connection with the same services or transactions; and (c) does not involve overreaching on the part of any person concerned; (v) neither the acquiring fund nor certain of its affiliates (except to the extent it is acting in its capacity as an investment adviser or sponsor to the

(footnote continued)

fees charged to the acquiring fund and its shareholders;[206] (iii) limits on the acquired fund's ability to invest in other funds;[207] (iv) the acquired fund and each acquiring fund must enter into an agreement stating that both funds understand the terms and conditions of the order and agree

---

ETF) causes the ETF to purchase a security in any affiliated underwriting (an underwriting in which an affiliate of the acquiring fund is a principal underwriter); (vi) the board of directors of an open-end ETF, including a majority of the independent directors, adopts procedures reasonably designed to monitor any purchases of securities by the ETF in an affiliated underwriting, including any purchases made directly from the affiliate, and the board reviews these purchases at least annually to determine whether the purchases were influenced by the acquiring fund's investment in the ETF, in its review the board must consider: (a) whether the purchases were consistent with the ETF's investment objectives and policies; (b) how the performance of the purchased securities compares to the performance of comparable securities purchased during a comparable period of time in an unaffiliated underwriting or to a benchmark such as a comparable market index; and (c) whether the amount of securities purchased has changed significantly from prior years; and (vii) the ETF maintains and preserves permanently in an easily accessible place a written copy of the procedures designed to monitor purchases made in an affiliated underwriting and maintains and preserves for at least six years, the first two in an easily accessible place, a written record of each purchase (and the terms thereof) of securities in an affiliated underwriting and the information or materials upon which the board's determinations were made. *See, e.g.,* Healthshares™, Inc. and XShares Advisors LLC, Investment Company Act Release No. 27844 (May 29, 2007) [72 FR 30885 (June 4, 2007)] ("Healthshares™, Inc. and XShares Order").

206 The exemptive orders permitting investments in ETFs contain the following conditions relating to fee limits: (i) before approving any advisory contract under section 15 of the Act, the board, including a majority of independent directors, finds that the advisory fees charged under the contract are based on services provided that are in addition to, rather than duplicative of, the services provided under the ETF advisory contract(s) and these findings and their basis are recorded in the minute books of the acquiring fund; (ii) the acquiring fund's adviser(s) (or if the acquiring fund is a UIT, its trustee or sponsor) waives fees payable to it by the acquiring fund in an amount at least equal to any compensation (including fees received pursuant to any 12b-1 plan) received from the ETF by the acquiring fund's adviser, trustee, or sponsor or an affiliated person of the acquiring fund's adviser, trustee, or sponsor (other than any advisory fees paid by the ETF to the adviser, trustee, or sponsor or its affiliated person) in connection with the acquiring fund's investment in the ETF; and (iii) any sales charge and/or service fees charged with respect to shares of the acquiring fund do not exceed the limits applicable to a fund of funds as set forth in Rule 2830 of the NASD Conduct Rules (or with respect to registered separate accounts that invest in a fund of funds, no sales load is charged at the acquiring fund level or ETF level and other sales charges and services fees, if any, are only charged at either the acquiring fund level or ETF level, not both). *See, e.g.,* Healthshares™, Inc. and XShares Order, *supra* note 205.

207 Under the exemptive orders permitting investments in ETFs, the ETF may not invest in shares of other funds (including companies relying on sections 3(c)(1) and 3(c)(7) of the Act) in excess of the limits in section 12(d)(1)(A) of the Act (some orders allow a few exceptions to this condition, *see infra* note 225). *See, e.g.,* Healthshares™, Inc. and XShares Order, *supra* note 205.

to fulfill their responsibilities under the order ("participation agreement");[208] and (v) the acquiring fund provides a list of certain of its affiliates to the acquired fund.[209]

More recently, sponsors of some ETFs as well as managers of funds investing in ETFs have expressed concern to our staff that some of the conditions in the exemptive orders are burdensome and unnecessary in the context of a fund investment in an ETF, which is less likely to be subject to at least some of the abuses these conditions were designed to prevent.[210] For example, ETF sponsors have communicated to our staff that the participation agreement condition is cumbersome and costly because the ETFs must enter into an agreement with each acquiring fund and each acquiring fund seeks to negotiate different terms in its agreement.[211] They have suggested that we develop conditions that address the concerns underlying section 12(d)(1) in a manner that is more suited to fund investments in ETFs.[212]

---

208 The exemptive orders require an agreement between the acquiring fund and the ETF stating that their boards and investment advisers, or their sponsors and trustees, as applicable, understand the terms and conditions of the order and agree to fulfill their responsibilities under the order (and the acquiring fund transmits to the ETF a list of certain of its affiliates and underwriting affiliates) and the acquiring fund and ETF maintain and preserve a copy of the exemptive order, participation agreement, and the list of affiliates with any updated information for the duration of the investment and for at least six years thereafter, the first two years in an easily accessible place. *See, e.g.,* Healthshares™, Inc. and XShares Order, *supra* note 205.

209 *See supra* note 208.

210 *See infra* Section IV.B.

211 Acquiring funds also have indicated to the staff that it is burdensome for them to enter into participation agreements with each ETF in which the funds want to invest.

212 Many funds also appear to consider investments in ETFs to be different than investments in other investment companies. In 2004, our staff conducted examinations of a number of mutual fund complexes, which focused on the funds' investments in ETFs and whether those investments were made in accordance with section 12(d)(1) of the Act. Most of the examined mutual fund complexes treated ETF investments like investments in traditional equity securities and did not identify ETFs as registered funds subject to the requirements of section 12(d)(1) of the Act. Thus, those that acquired more than three percent of the voting securities of an ETF or invested more than five percent of the acquiring fund's assets in the voting securities of an ETF were inconsistent with section 12(d)(1). Most of the mutual funds examined invested in ETFs in order to: (i) hedge the portfolio; (ii) "equitize" cash balances in order to earn returns in excess of money market rates; and (iii) gain exposure to a specific market and/or industry sector in an

(footnote continued)

B. Proposed Rule 12d1-4 Conditions

Today, we are proposing a new rule 12d1-4, which would provide an exemption to permit acquiring funds to invest in ETFs in excess of the limits of section 12(d)(1), subject to four conditions that are designed to address the historical abuses that result from pyramiding and the threat of large-scale redemptions and may arise in connection with investments in ETFs.[213] The relief we propose is subject to fewer conditions than our exemptive orders but, unlike our orders, would limit an acquiring fund's ability to redeem ETF shares.[214]

1. Control

In order to address the concern that a fund could exert control over another fund, the proposed rule would limit the exemption to an acquiring fund (and any entity in a control relationship with the acquiring fund) that does not "control" an ETF.[215] The Act defines

---

efficient manner.

[213] We are also proposing related amendments to rule 12d1-2 under the Act to include within its exemptive relief investments in ETFs made in reliance on proposed rule 12d1-4 and investments in non-security assets. *See infra* Section V.

[214] In 1996, Congress added section 12(d)(1)(J) to the Act, which gave us specific authority to exempt any person, security or transaction, or any class or classes of transactions, from section 12(d)(1) of the Act if the exemption is consistent with the public interest and the protection of investors. NSMIA, § 202(4) (codified at 15 U.S.C. 80a-12(d)(1)(J)). The House Report accompanying the legislation urged the Commission to use the additional exemptive authority under section 12(d)(1)(J) "in a progressive way as the fund of funds concept continues to evolve over time." H.R. REP. NO. 622, *supra* note 200, at 43-44 (1996). The House Report explained that, in exercising its exemptive authority, the Commission should consider factors that relate to the protection of investors, including the extent to which a proposed arrangement is subject to conditions that are designed to address conflicts of interest and overreaching by a participant in the arrangement, so as to avoid the abuses that gave rise to the initial adoption of the Act's restrictions against funds investing in other funds. *Id.* at 44.

[215] Proposed rule 12d1-4(a)(1). The condition would provide that: (i) an acquiring fund and any of its investment advisers or depositors, and any company in a control relationship with the acquiring fund or any of its investment advisers or depositors, each individually or in the aggregate, do not control an ETF; and (ii) if, as a result of a decrease in the outstanding voting securities of an ETF, the acquiring fund, any of its investment advisers, and any company in a control relationship with the acquiring fund or its investment adviser, either individually or together in the aggregate, become holders of more than 25 percent of the outstanding voting securities of an ETF (*i.e.*, are presumed to control the ETF, *see infra* notes 217-218 and

(footnote continued)

"control" to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."[216] The Act also creates rebuttable presumptions that any person who directly or indirectly beneficially owns more than 25 percent of the voting securities of a company controls the company and that one who does not own that amount does not control it.[217] The effect of the proposed rule, if adopted, would be that an acquiring fund's beneficial ownership of up to 25 percent of the voting securities of an ETF, *by itself*, would not constitute control over the ETF. As a result, a fund relying on the rule could make a substantial investment in an ETF (*i.e.*, up to 25 percent of the ETF's shares) without seeking further exemption from us.

If, however, an acquiring fund uses its ownership interest in the ETF (even if that interest is 25 percent or less) to exercise a controlling influence over the ETF's management or policies, the fund would not be able to rely on the proposed rule.[218] For example, an acquiring fund that used its share position to persuade an ETF manager to enter into a transaction with an affiliate of the acquiring fund or its adviser would almost certainly exercise a controlling influence on the ETF's management and thus lose its exemption under the proposed rule.[219]

---

accompanying text), each of those shareholders must vote its shares of the ETF in the same proportion as the vote of all the other ETF shareholders. The same condition is in our exemptive orders.

216 15 U.S.C. 80a-2(a)(9).

217 *Id*. These presumptions continue until the Commission makes a final determination to the contrary by order either on its own motion or on application by an interested person. *Id.*

218 A determination of control depends on the facts and circumstances of the particular situation. "[N]o person may rely on the presumption that less than 25 percent ownership is not control when, in fact, a control relationship exists under all the facts and circumstances." Exemption of Transactions by Investment Companies with Certain Affiliated Persons, Investment Company Act Release No. 10698 (May 16, 1979) [44 FR 29908 (May 23, 1979)] at n.2. (citing Fundamental Investors, Inc., 41 SEC 285 (1962)) ("Fundamental Investors") (Commission order noting that rebutting presumption of control can have retrospective as well as prospective effect).

219 We have long held that "controlling influence" includes, in addition to voting power, a

(footnote continued)

We request comment on the proposed condition. Do ETF sponsors believe that it would sufficiently protect the ETF from the type of coercive behavior on the part of acquiring funds that section 12(d)(1) was intended to prevent?

2. Redemptions

The proposed rule includes two provisions that would prevent an acquiring fund from redeeming shares it acquired in reliance on the proposed rule. First, the rule would prohibit an acquiring fund that relies on the proposed rule to acquire shares in excess of section 12(d)(1)(A)(i) limits (*i.e.*, to acquire more than three percent of an ETF's shares) from redeeming those shares.[220] As a result, acquiring funds would not be able to threaten large-scale redemptions as a means of coercing an ETF. It is our understanding that most acquiring funds purchase and sell ETF shares in secondary market transactions. Accordingly, this condition, while precluding one of the historical abuses associated with fund of funds arrangements, would not prevent acquiring funds from taking passive shareholder positions in ETF shares (in excess of section 12(d)(1) limits) in order to, for example, gain exposure to a particular market segment.

We request comment on whether the condition achieves this purpose. If not, are there

---

dominating persuasiveness of one or more persons, the act or process that is effective in checking or directing action or exercising restraint or preventing free action, and the latent existence of power to exert a controlling influence. *See, e.g.*, Investors Mutual, Inc., Investment Company Act Release No. 4595 (May 11, 1966) at text accompanying nn.11-14 (*citing* The Chicago Corporation, Investment Company Act Release No. 1203 (Aug. 24, 1948); Transit Investment Corporation, Investment Company Act Release No. 927 (July 31, 1946); In the Matter of the M.A. Hanna Company, Investment Company Act Release No. 265 (Nov. 26, 1941)).

220 Proposed rule 12d1-4(a)(2). Under the proposed rule, an acquiring fund would be deemed to have redeemed or sold the most recently acquired ETF shares first. *Id.* As a result, an acquiring fund could redeem shares from an ETF only when the fund (and companies or funds it controls) holds ETF shares in an amount consistent with section 12(d)(1)(A)(i) limits. An acquiring fund that relies on the proposed rule to invest more than five percent of its assets in the acquired ETF (prohibited by section 12(d)(1)(A)(ii)) and/or to invest more than 10 percent of its assets in all funds (including the acquired ETF) (prohibited by section 12(d)(1)(A)(iii)) but that does not acquire more than three percent of the acquired ETF's outstanding securities would not be prohibited from redeeming shares of the ETF under the proposed rule.

other conditions that would better address the concern?

Second, the proposed rule would prohibit an ETF, its principal underwriter, and a broker or a dealer that relies on the rule to sell ETF shares in excess of section 12(d)(1)(B) limits from redeeming (or submitting an order to redeem) those shares acquired by another fund that exceed the three percent limit in section 12(d)(1)(A)(i).[221] We recognize that it may be difficult in all circumstances for an ETF, its principal underwriter, a broker or a dealer to know whether a redemption order is submitted by an acquiring fund that acquired more than three percent of the ETF's shares in reliance on the proposed rule. Accordingly, we are proposing to include a safe harbor for each of those entities if it has: (i) received a representation from the acquiring fund that none of the ETF's shares the acquiring fund is redeeming includes any shares that it acquired in excess of three percent of the ETF's shares in reliance on proposed rule 12d1-4(a); and (ii) no reason to believe that the acquiring fund is redeeming ETF shares that the acquiring fund acquired in excess of three percent of the ETF's shares in reliance on the proposed rule.[222] If an acquiring fund attempts to redeem ETF shares in connection with a threat to coerce the ETF, the ETF would know of the attempt. In those circumstances, or if the principal underwriter, broker or dealer knows or has reason to know of the threat, the entity could not redeem (or submit for

---

[221] Proposed rule 12d1-4(b)(1). Under the proposed rule, an exchange-traded fund, any principal underwriter thereof, and a broker or a dealer may sell or otherwise dispose of exchange-traded fund shares if the exchange-traded fund does not redeem, or the principal underwriter, broker or dealer does not submit for redemption any of the exchange-traded fund's shares that were acquired by an acquiring fund in excess of the limits of section 12(d)(1)(A)(i) in reliance on proposed rule 12d1-4(a). *Id.* An acquiring fund would be deemed to have redeemed or sold the most recently acquired exchange-traded fund shares first. *Id. See also supra* note 220.

We note that our adoption of proposed rule 12d1-4 would not preclude an acquiring fund from continuing to rely on exemptive orders we have previously issued that permit funds to invest in ETFs in excess of the limits of section 12(d)(1) but which do not restrict their ability to redeem ETF shares, subject to the conditions set forth in the orders and described above. Moreover, we intend to continue to issue such orders and may consider their codification in a rule in the future.

[222] Proposed rule 12d1-4(b)(2).

redemption) the ETF shares held by the acquiring fund. We believe that the proposed condition prohibiting acquiring funds from redeeming ETF shares acquired in reliance on the proposed rule should sufficiently prevent an acquiring fund from threatening redemptions as a means of coercing an ETF adviser.

We request comment on these conditions. Do most funds that invest in ETFs redeem their shares or sell them in secondary market transactions? Would the prohibition on redemption impede the ability of acquiring funds to dispose of ETF shares? Do acquiring funds realize significant benefits from the ability to redeem ETF shares?

The proposed conditions limiting redemptions of ETF shares are designed to eliminate the threat of redemption that an acquiring fund could otherwise use to coerce an ETF. Accordingly, the proposed rule does not include the conditions in our exemptive orders that require the ETF[223] and the acquiring fund to take measures to prevent the acquiring fund from

---

[223] The orders require that: (i) the board of directors of an ETF, including a majority of its independent directors, determines that any consideration paid by the ETF to the acquiring fund or any investment adviser, depositor, or principal underwriter of the acquiring fund and any person controlling, controlled by, or under common control with an investment adviser, depositor, or principal underwriter of the acquiring fund, (but not including any investment adviser of the ETF or any person controlling, controlled by, or under common control with the investment adviser of the ETF) ("acquiring fund affiliate") in connection with any services or transactions: (a) is fair and reasonable in relation to the nature and quality of the services and benefits received by the ETF; (b) is within the range of consideration that the ETF would be required to pay to another unaffiliated entity in connection with the same services or transactions; and (c) does not involve overreaching on the part of any person concerned; (ii) the ETF board of directors, including a majority of the independent directors, adopts procedures reasonably designed to monitor any purchases of securities by the ETF in an underwriting in which a principal underwriter is an officer, director, member of an advisory board, acquiring fund investment adviser, acquiring fund depositor, or an acquiring fund employee or an affiliated person of any such person ("affiliated underwriting"), and the board reviews these purchases at least annually to determine whether the purchases were influenced by the acquiring fund's investment in the ETF; and (iii) the ETF maintains and preserves a copy of the procedures designed to monitor purchases made in an affiliated underwriting and maintains a written record of each purchase of securities in an affiliated underwriting and the information or materials upon which the board's determinations were made. *See supra* note 205.

unduly influencing the ETF.[224]

We request comment on the exclusion of these conditions from the proposed rule. Is there a concern that if the acquiring fund and ETF do not take particular measures to prevent the acquiring fund from unduly influencing the ETF, acquiring funds may be able more easily to coerce the ETF? Notwithstanding the prohibition on control and redemption, should we be concerned about particular transactions between an acquiring fund (or an acquiring fund affiliate) and an ETF, or an ETF's purchase of securities during an underwriting in which a principal underwriter is an affiliate of the acquiring fund or its adviser? If there is reason for concern about ETF purchases of securities in an affiliated underwriting, is that concern limited to purchases from an affiliate of the acquiring fund or its adviser? Should any specific conditions in the exemptive orders be included in the proposed rule in addition to or in place of the proposed conditions to prevent an acquiring fund or an acquiring fund affiliate from unduly influencing an ETF?

3. Complex Structures

To prevent the formation of overly complex multi-tiered fund structures, the proposed rule would prohibit an acquired ETF from itself being a fund of funds (*i.e.*, the rule would

---

224 The orders require that: (i) neither the acquiring fund nor any acquiring fund affiliate cause any existing or potential investment by the acquiring fund in an ETF to influence the terms of any services or transactions between the acquiring fund or an acquiring fund affiliate and the ETF (or certain affiliates of the ETF); (ii) neither the acquiring fund nor an acquiring fund affiliate causes the ETF to purchase a security in any affiliated underwriting; and (iii) the acquiring fund board of directors, including a majority of its independent directors, adopts procedures reasonably designed to assure that the acquiring fund's investment adviser(s) is conducting the acquiring fund's investment program without taking into account any consideration received by the acquiring fund or an acquiring fund affiliate from the ETF (or certain affiliates of the ETF). *See supra* note 205.

As discussed above, the proposed rule would however include the condition from our exemptive orders that an acquiring fund (and any entity in a control relationship with the acquiring fund) could not "control" the ETF. *See supra* note 215 and accompanying text.

prohibit a fund of funds of funds, or three-tier fund, structure).[225] A fund of ETFs has the potential to become a complicated corporate structure of the kind that concerned Congress when section 12(d)(1) was enacted.[226] If an acquiring fund invests in an ETF that in turn invests in other funds (including other ETFs), an acquiring fund shareholder could find it difficult to determine the nature and value of the holdings ultimately underlying his or her investment. The proposed rule is designed to allow an ETF the flexibility to invest in other funds in order to meet its investment objectives while preventing shareholder confusion as to the nature of their investment in an acquiring fund by limiting the extent of those ETF investments.[227]

We request comment on the proposed limits on an ETF itself being a fund of funds. Are

---

225 Proposed rule 12d1-4(a)(4) ("The exchange-traded fund has a disclosed policy that prohibits it from investing more than 10 percent of its assets in: (i) Other investment companies in reliance on section 12(d)(1)(F) or section 12(d)(1)(G) of the Act or [rule 12d1-4]; and (ii) Any other company that would be an investment company under section 3(a) of the Act but for the exceptions to that definition provided in sections 3(c)(1) and 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7))."). Section 12(d)(1)(A)(iii) of the Act limits an acquiring fund's total investment in other funds to no more than 10 percent of the acquiring fund's assets. An ETF would still be able to make limited investments in other funds, including other ETFs. This is similar to a condition in section 12(d)(1)(G) of the Act that provides an exemption from section 12(d)(1) limits for funds to invest in other funds in the same group provided, among other things, the acquired fund has a policy that it will not rely on exemptions allowing it to be a fund of funds. *See* 15 U.S.C. 80a-12(d)(1)(G)(i)(IV). The exemptive orders generally prohibit an acquired ETF from investing in other funds beyond section 12(d)(1)(A) limits. Many of the orders have provided exceptions to this general prohibition, which permit the ETF to invest in money market funds beyond the limits of section 12(d)(1)(A) either in reliance on another exemptive order allowing the ETF to do so or in reliance on rule 12d1-1. In addition, some of the orders permit the ETF to invest in another fund beyond the limits of section 12(d)(1)(A) to the extent permitted by section 12(d)(1)(E) of the Act. An acquiring fund relying on any of these exceptions may have difficulty determining whether an acquired ETF would itself be considered a fund of funds because the acquiring fund might not be able to ascertain easily if the ETF is relying on an order, section 12(d)(1)(E) of the Act, or rule 12d1-1 to invest in other funds beyond the limits of section 12(d)(1)(A) of the Act. The orders also do not anticipate any future exemptive relief the Commission might provide to allow acquired ETFs to invest in other non-money market funds in excess of section 12(d)(1)(A) limits. Limiting exemptive relief to investments in ETFs with disclosed policies would allow an acquiring fund to determine easily if it could invest in a particular ETF.

226 *See supra* note 198 and accompanying text.

227 Under the proposed rule, an acquiring fund could invest in an ETF that invests up to 10 percent of its assets in other ETFs.

the proposed limits on an underlying ETF's investments in other funds sufficient to prevent investor confusion? If not, what limits should the proposed rule include to prevent shareholder confusion? Should the proposed rule include the same limit (and exceptions to the limit) as in our exemptive orders?[228] Are there reasons not to restrict the ability of an acquired ETF itself to invest in other funds, including ETFs, beyond the limits of section 12(d)(1)(A)?[229] Does the fact that ETF shares trade more like a typical equity security make it less likely that investors would be confused if we were to allow an acquiring fund to invest in an ETF that itself invests more than ten percent of its assets in other ETFs in reliance on proposed rule 12d1-4?

4. Layering of Fees

As discussed above, one of Congress' concerns regarding fund of funds arrangements was that acquiring fund shareholders might pay excessive charges due to duplicative fees at the acquiring and acquired fund levels.[230] To prevent duplicative fees at the acquiring and acquired fund levels, the proposed rule would limit sales charges and service fees charged by the acquiring fund to those set forth in the Financial Industry Regulatory Authority's ("FINRA") sales charge rule, which takes into consideration fees charged at both levels of a fund of funds arrangement.[231] In addition, like all acquiring funds, funds that invest in ETFs would be subject

---

[228] As discussed above, the orders generally prohibit an acquired ETF from investing in other funds beyond the limits of section 12(d)(1)(A). Some of the orders include a few exceptions to this general prohibition. *See supra* note 225.

[229] The proposed rule would allow an acquired ETF to invest in other funds, including ETFs, beyond the limits of section 12(d)(1)(A) in reliance on sections 12(d)(1)(F) and 12(d)(1)(G) and to invest in other ETFs beyond the limits of section 12(d)(1)(A) in reliance on the proposed rule. However, the proposed rule would limit an acquired ETF's aggregate investment in these funds to no more than 10 percent of the acquired ETF's assets. Proposed rule 12d1-4(a)(4).

[230] *See supra* note 197 and accompanying text.

[231] Proposed rule 12d1-4(a)(3). The proposed rule would limit the sales charge (including any 12b-1 fee) or service fee charged in connection with the purchase, sale, or redemption of securities issued by the acquiring fund to the FINRA fee limits for fund of funds set forth in NASD

(footnote continued)

to our disclosure rules for fund investments in other funds. These rules require all registered funds to disclose in their prospectus fee tables expenses paid by both the acquiring and acquired funds so that shareholders can evaluate the costs of investing in a fund that invests in other funds, including ETFs.[232] These rules and the proposed fee limit may fully address congressional concerns with the duplication and layering of fees that hide the real cost of investing in an investment company.[233]

We request comment on the proposed condition limiting the fees charged by an acquiring fund. Would the proposed fee limits adequately prevent acquiring fund shareholders from paying excessive distribution or service fees?[234] Are there any special concerns as to how to

---

Conduct Rule 2830(d)(3). Some ETFs charge a 12b-1 fee. *See, e.g.,* Select Sector SPDRs®, Prospectus 20,28 (Jan. 31, 2008). FINRA does not, however, apply Conduct Rule 2830 to variable annuity contracts. *See* NASD Conduct Rule 2820(a) (rule 2820 applies exclusively and in lieu of rule 2830 to the activities of members in connection with variable contracts to the extent the activities are subject to federal securities law regulation). To address the potential for excessive layering of fees in a separate account that invests in an acquiring fund, proposed rule 12d1-4(a)(3)(ii) would: (i) prohibit an acquiring fund in which a separate account invests and any ETF in which the acquiring fund invests from charging a sales load and would allow only the acquiring fund or ETF, but not both, to impose asset-based sales charges or service fees; and (ii) require the aggregate fees associated with the variable insurance contract and the sales charges and service fees charged by the acquiring fund and the ETF to be reasonable in relation to the services rendered, the expenses expected to be incurred and, with respect to the variable insurance contract, the risks assumed by the insurance company.

232 *See* Item 3(f) to Form N-1A; Fund of Funds Adopting Release, *supra* note 201, at Section II.D.

233 *See supra* note 197.

234 The proposed rule would not include the condition from our orders requiring the acquiring fund adviser (or sponsor or trustee) to waive its fee in an amount at least equal to any compensation (including fees received pursuant to any 12b-1 plan but excluding advisory fees) received from the ETF by the acquiring fund's adviser, trustee, or sponsor or an affiliated person of the acquiring fund's adviser, trustee, or sponsor in connection with the acquiring fund's investment in the ETF. The proposed rule also does not include the condition from our orders that requires the board of the acquiring fund to find that the advisory fees charged under an advisory contract are based on services provided that will be in addition to, rather than duplicative of, the services provided by an adviser to an acquired ETF. As we noted in the proposing and adopting releases for rule 12d1-1 explaining our exclusion of a similar condition from rule 12d1-1, an acquiring fund board is already obligated to protect the fund from being overcharged for services provided to the fund regardless of any special findings we might require. *See* Fund of Funds Adopting Release, *supra* note 201, nn.51-52 and accompanying text; Fund of Funds Proposing Release,

(footnote continued)

apply the proposed fee limits to an acquiring fund when a separate account invests in an acquiring fund? Do our disclosure requirements provide sufficient information to investors to allow them to determine whether the total fees imposed on a fund of ETFs are consistent with their investment objectives?

C. Scope of Proposed Rule 12d1-4

1. Acquiring Funds and ETFs Eligible for Relief

Proposed rule 12d1-4 would permit open-end and closed-end management companies (including business development companies)[235] and UITs[236] that comply with the rule's conditions to invest in ETFs beyond the limits of section 12(d)(1).[237] Our orders to date have provided exemptions only for investments in ETFs by registered management funds and UITs.[238]

---

supra note 197, at nn.65-67 and accompanying text.

235 A business development company is any closed-end company that: (i) is organized under the laws of, and has its principal place in, any state or states; (ii) is operated for the purpose of investing in securities described in section 55(a)(1)-(3) of the Act and makes available "significant managerial assistance" to the issuers of those securities, subject to certain conditions; and (iii) has elected under section 54(a) of the Act to be subject to the sections addressing activities of business development companies under the Act. *See* 15 U.S.C. 80a-2(a)(48). Section 60 of the Act extends the limits of section 12(d) to a business development company to the same extent as if it were a registered closed-end fund. Section 6(f) of the Act exempts business development companies that have made the election under section 54 of the Act from registration and other provisions of the Act. We similarly included business development companies within the scope of rule 12d1-1 to allow then to invest in money market funds beyond the limits of section 12(d)(1). *See* Fund of Funds Adopting Release, *supra* note 201, at nn.44-46 and accompanying text.

236 Because an ETF can be organized either as an open-end management company or UIT, s*ee supra* note 8, it could rely on the proposed rule to invest in other ETFs beyond the limits contained in section 12(d)(1).

237 Section 12(d)(1)(B)'s limits on sales of an acquired fund's securities apply only to shares of an ETF organized as an open-end investment company.

238 We have not had the opportunity to consider a request for an individual exemptive order for other types of investment companies. Our orders also have permitted funds to invest in ETFs organized as UITs (and as open-end funds). Proposed rule 12d1-4 would include relief for investments in ETFs that are organized as UITs as long as the UITs satisfy the criteria enumerated in proposed rule 6c-11(e)(4). Proposed rule 12d1-4(d)(2). As noted above, proposed rule 6c-11 would not include a UIT within its relief because we have not received an exemptive application for a new

(footnote continued)

We do not anticipate that providing a similar exemption for business development companies would raise particular concerns that section 12(d)(1) was designed to address.

We request comment on the inclusion of business development companies within the scope of proposed rule 12d1-4. Would these entities benefit from this exemption? Are there reasons not to extend the exemption to these companies? Do any special concerns arise with respect to extending the exemption to these companies?

2. *Investments in Affiliated ETFs Outside the Fund Complex*

In addition to providing an exemption from section 12(d)(1) of the Act, the proposed rule would provide exemptions from sections 17(a)(1), 17(a)(2), 57(a)(1) and 57(a)(2) of the Act. These provisions restrict a fund's ability to enter into transactions with affiliated persons.[239] They are designed to prevent affiliated persons from managing the fund's assets for their own benefit, rather than for the benefit of the fund's shareholders.[240] These provisions would

---

ETF to be organized as a UIT in a number of years. *See supra* note 65 and accompanying text.

[239] Section 17 of the Act limits transactions between a fund and its affiliated persons. Section 17(a) of the Act generally prohibits affiliated persons of a registered fund ("first-tier affiliates") or affiliated persons of the fund's affiliated persons ("second-tier affiliates") from selling securities or other property to or purchasing securities or other property from the fund (or any company the fund controls). Section 57 of the Act restricts certain transactions between business development companies and certain of their affiliates. An affiliated person of a fund includes: (i) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the fund; and (ii) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the fund. *See* 15 U.S.C. 80a-2(a)(3)(A), (B). Thus, if an acquiring fund holds five percent or more of the outstanding voting shares of the ETF, the acquiring fund is an affiliated person of the ETF and the ETF is an affiliated person of the acquiring fund.

[240] *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency,* 76th Cong., 3d Sess. 37 (1940) (Statement of Commissioner Healy). Section 17 also would restrict an acquiring fund from investing in an ETF that is affiliated with the acquiring fund because both funds have a common investment adviser or other person exercising a controlling influence over the management or policies of the funds. *See* 15 U.S.C. 80a-2(a)(3)(C). The determination of whether a fund is under the control of its adviser, officers, or directors depends on all the relevant facts and circumstances. *See* Investment Company Mergers, Investment Company Act Release No. 25259 (Nov. 8, 2001) [66 FR 57602 (Nov. 15, 2001)], at n.11. For purposes of this release, we presume that funds with a common

(footnote continued)

otherwise effectively preclude a fund that acquires five percent or more of the securities of an ETF in another fund complex from making any additional purchases of shares from the ETF.[241] They also would prohibit an affiliated acquiring fund from depositing (*i.e.*, "selling") securities identified in the creation basket. Permitting an acquiring fund to purchase additional ETF shares from the ETF at NAV on the same basis as any other purchaser of a creation unit, by itself, seems to provide little opportunity for the acquiring fund to manage the ETF for its own benefit.[242] Allowing the ETF to acquire securities identified in a creation basket from an affiliated acquiring fund on the same basis as any other investor also would not seem to implicate the concerns underlying section 17(a). Accordingly, we believe that exemptions from sections 17(a)(1), 17(a)(2), 57(a)(1), and 57(a)(2) of the Act for these transactions would be appropriate,

---

investment adviser are under common control because funds that are not affiliated persons would not require, and thus not rely on, the exemptions from section 17(a). Although funds in the same group of investment companies generally are under common control of an investment adviser or other person exercising a controlling interest, these funds may rely on section 12d(1)(G) of the Act to invest in an ETF in the same group. *See infra* note 249 and accompanying text.

241 An ETF would be prohibited under section 17(a)(1) from selling its shares to an affiliated acquiring fund and under section 17(a)(2) from purchasing securities (*i.e.*, securities designated in the creation basket) from the affiliated acquiring fund in exchange for ETF shares. An acquiring fund would be prohibited under section 17(a)(1) from selling any securities (*i.e.*, securities identified in the creation basket) to an affiliated ETF in exchange for the ETF's shares. An acquiring fund also would be prohibited under section 17(a)(2) from purchasing (creation basket) securities from an affiliated ETF for the redemption of ETF shares. The ETF would be prohibited under section 17(a)(1) from selling the affiliated acquiring fund (creation basket) securities in exchange for ETF shares redeemed and under section 17(a)(2) from acquiring the ETF shares submitted for redemption by the affiliated acquiring fund.

242 The exemptive orders provide similar relief from sections 17(a)(1) and 17(a)(2) of the Act, including relief to allow the acquiring fund to redeem shares of an affiliated ETF. The proposed rule would not, however, provide an acquiring fund relief from sections 17(a)(2) and 57(a)(2) of the Act in order to redeem shares in excess of the three percent limit in section 12(d)(1)(A)(i) from an affiliated ETF. In addition, proposed rule 6c-11, which would permit persons affiliated with an ETF solely because they own five percent or more of the ETF's shares, to purchase and sell ETF shares in-kind (*i.e.*, in exchange for securities designated in the creation basket) would not extend relief to certain redemptions by acquiring funds consistent with proposed rule 12d1-4(a). *See supra* Section III.C.3 and proposed rule 6c-11(d). As noted above, no orders have been issued to business development companies therefore no order includes relief from sections 57(a)(1) and 57(a)(2) of the Act. *See supra* note 238 and accompanying text.

in the public interest, and consistent with the protection of investors and the purposes of the Act.[243]

We seek comment on these exemptions. Are there risks other than the concerns we addressed with respect to section 12(d)(1) limitations, regarding the potential that the acquiring fund could manage the ETF, that would arise from the proposed exception allowing a fund to acquire more than five percent of the shares of an affiliated ETF in another complex?

3. Use of Affiliated Broker to Effect Sales

In order to allow acquiring funds to take full advantage of the exemptive relief, proposed rule 12d1-4 also would provide limited relief from section 17(e)(2) of the Act. If an investment company in one complex acquired more than five percent of the assets of an ETF in another complex, any broker-dealer affiliated with that ETF would become a (second-tier) affiliated person of the acquiring fund.[244] As a result of the affiliation, the broker-dealer's fee for effecting the sale of securities to (or by) the acquiring fund would be subject to the conditions set forth in rule 17e-1, including the quarterly board review and recordkeeping requirements with respect to certain securities transactions involving the affiliated broker-dealer.[245] We believe that it is

---

243 Our proposal would not provide an exemption for any transactions other than the sale of securities by an acquiring fund to an affiliated ETF for a creation unit of ETF shares. The proposed rule also would not provide an exemption for any other transactions between a business development company and an affiliated ETF that would be subject to section 57 limitations.

244 *See supra* notes 239-240.

245 Section 17(e)(2) of the Act prohibits an affiliated person (or second-tier affiliate) of a fund from receiving compensation for acting as a broker, in connection with the sale of securities to or by the fund if the compensation exceeds limits prescribed by the section. Rule 17e-1 sets forth a conditional exemption under which a commission, fee or other remuneration shall be deemed as not exceeding the "usual and customary broker's commission" for purposes of section 17(e)(2)(A) of the Act. Rule 17e-1(b)(3) requires the fund's board of directors, including a majority of the directors who are not interested persons under section 2(a)(19) of the Act, to determine at least quarterly that all transactions effected in reliance on the rule have complied with procedures which are reasonably designed to provide that the brokerage compensation is consistent with the rule's standards. Rule 17e-1(d)(2) specifies the records that must be

(footnote continued)

unlikely that a broker-dealer would be in a position to take advantage of the acquiring fund merely because that fund owned a position in an ETF affiliated with the broker-dealer.[246] Accordingly, the proposed rule would permit an acquiring fund to pay commissions, fees, or other remuneration to a (second-tier) affiliated broker-dealer without complying with the quarterly board review and recordkeeping requirements set forth in rules 17e-1(b)(3) and 17e-1(d)(2).[247] This relief would be available only if the broker-dealer and the acquiring fund are affiliated solely because of the acquiring fund's investment in the ETF.

We request comment on the proposed exemptions. Is the scope of the proposed exemptions from section 17 limitations sufficiently broad to allow funds to take full advantage of the proposed relief? Are the proposed exemptions from board review and recordkeeping requirements with respect to transactions with an affiliated broker-dealer necessary? Do funds engage in these transactions with broker-dealer affiliates of acquired ETFs? Is there additional section 17 relief that would be helpful in order for acquiring funds to take full advantage of the proposed exemption for investments in ETFs? If so, please be specific regarding the transactions that would prevent funds from relying on the proposed rule.

---

maintained by each fund with respect to any transaction effected pursuant to rule 17e-1.

246 We expect that the ETF's adviser would have no influence over the decisions made by the acquiring fund's adviser. In addition, because the interests of the adviser to the ETF and the adviser to the acquiring fund are directly aligned with their respective funds, transactions between the acquiring fund and a broker-dealer affiliate of the ETF are likely to be at arm's length.

247 Proposed rule 12d1-4(c). The proposed relief is similar to relief we have provided in rule 12d1-1, which permits funds to invest in money market funds in excess of section 12(d)(1) limits. *See* Fund of Funds Adopting Release, *supra* note 201, at nn.32-36 and accompanying text. An acquiring fund relying on this exemption would be required to comply with all of the provisions of rule 17e-1, except for those in paragraphs (b)(3) and (d)(2). It does not appear that having to comply with the other provisions contained in rule 17e-1 would deter acquiring funds from taking full advantage of the exemption provided by proposed rule 12d1-4.

V. EXEMPTION FOR AFFILIATED FUND OF FUNDS INVESTMENTS

A. Affiliated Fund of Funds Investments in ETFs

As noted above, Congress recognized that the investment limits in section 12(d)(1) might restrict certain legitimate fund of funds arrangements, and included three exceptions to those limits.[248] One of these exceptions—section 12(d)(1)(G)—permits a registered open-end investment company or UIT to invest in other registered open-end investment companies or UITs (including ETFs) that are in the "same group of investment companies" ("affiliated funds") beyond the section 12(d)(1) limits.[249] A fund that invests in unaffiliated ETFs (*i.e.*, ETFs in other fund groups) in many cases, however, is still subject to the section 12(d)(1) limits.[250] Section

---

248 For a full discussion of section 12(d)(1) limitations and the exceptions under sections 12(d)(1)(E), 12(d)(1)(F), and 12(d)(1)(G) of the Act, *see* Fund of Funds Proposing Release, *supra* note 197, at Section I.

249 *See* 15 U.S.C. 80a-12(d)(1)(G). Section 12(d)(1)(G)(ii) of the Act defines "same group of investment companies" to mean "any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services." Section 12(d)(1)(G) imposes the following conditions on funds relying on this exception: (i) other investments are limited to short-term paper and government securities; (ii) acquired funds must have a policy against investing in shares of other funds in reliance on sections 12(d)(1)(F) or 12(d)(1)(G) (to prevent multi-tiered structures); and (iii) overall distribution expenses are limited.

250 A fund could invest in unaffiliated funds in reliance on two other statutory exemptions. Under section 12(d)(1)(E) an investment company may acquire securities issued by another investment company provided that (i) the acquiring fund's depositor or principal underwriter is a broker or dealer registered under the Securities Exchange Act of 1934, (or a person the broker-dealer controls), (ii) the security is the only investment security the acquiring fund holds (or the securities are the only investment securities the acquiring investment company holds if it is a registered UIT that issues two or more classes or series of securities, each of which provides for the accumulation of shares of a different investment company), and (iii) the acquiring investment company is obligated (a) to seek instructions from its shareholders with regard to voting the acquired investment company's securities or to vote the acquired investment company's shares in the same proportion as the vote of all other acquired investment company shareholders, and (b) if unregistered, to obtain Commission approval before substituting the investment security. A fund relying on section 12(d)(1)(F) of the Act (and its affiliated persons) may acquire no more than three percent of another investment company's outstanding stock, cannot charge a sales load greater than 1½ percent; is restricted in its ability to redeem shares of the acquired investment company; and must vote shares of an acquired investment company either by seeking instructions from the acquiring fund's shareholders, or voting the shares in the same proportion as the vote of

(footnote continued)

12(d)(1)(G) restricts the other investments an acquiring fund investing in affiliated funds can make to government securities and short-term paper.[251]

When it added section 12(d)(1)(G) to the Act, Congress also gave us specific authority to provide certain exemptions from the limitations of section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors.[252] In conjunction with the adoption of rule 12d1-1 in 2006 (allowing funds to invest in money market funds beyond the limits of section 12(d)(1)), we adopted rule 12d1-2, which allows funds relying on section 12(d)(1)(G) also to invest in: (i) unaffiliated money market funds when the acquisition is in reliance on rule 12d1-1; (ii) securities issued by unaffiliated funds (including ETFs), subject to the investment limits in sections 12(d)(1)(A) and 12(d)(1)(F) of the Act;[253] and (iii) securities not issued by an investment company. Under rule 12d1-2, therefore, a fund that invests in affiliated funds in reliance on section 12(d)(1)(G) and desires to invest in unaffiliated ETFs is subject to these statutory limitations (*e.g.*, to acquiring no more than three percent of the acquired ETF's shares). There seems no reason, however, to maintain the statutory limitations on investments in ETFs in these circumstances when we are proposing to permit other types of funds to invest in ETFs in excess of section 12(d)(1) limits. No special issues appear to arise in connection with an acquiring fund's investments in an unaffiliated ETF simply because the acquiring fund also invests in

---

all other shareholders of the acquired investment company.

[251] Congress imposed this limitation to restrict the use of the exemption provided by section 12(d)(1)(G) to a "bona fide" fund of funds. Congress permitted other investments to include only government securities and short-term paper, which provide the fund with a source of liquidity to redeem shares. *See* H.R. REP. NO. 622, *supra* note 200, at 42.

[252] Section 12(d)(1)(J) of the Act authorizes the Commission to exempt any person, security or transaction, or any class or classes of transactions, from section 12(d)(1) of the Act if the exemption is consistent with the public interest and the protection of investors. *See supra* note 214.

[253] *See supra* note 250.

affiliated funds. Accordingly, we propose to amend rule 12d1-2 to 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.[254] This is similar to the relief we provided to affiliated funds of funds to allow them to acquire shares in money market funds, if the acquisition is in reliance on rule 12d1-1.[255]

We request comment on the proposed amendment. Are there reasons not to extend the proposed relief to affiliated funds of funds? Do investments by an acquiring fund that invests in affiliated funds raise any special concerns if the acquiring fund also invests in unaffiliated ETFs? Are these concerns different than any other fund's investment in unaffiliated ETFs?

B. Affiliated Fund of Funds Investments in Other Assets

We also are proposing an amendment to rule 12d1-2 that would allow funds relying on section 12(d)(1)(G) to invest in assets other than securities. As discussed above, in 2006 we adopted rule 12d1-2 to permit 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)."[256] The rule was intended to allow an acquiring fund greater flexibility to meet investment objectives that may not be met as well by investments in affiliated funds. We noted that these investments would not seem to present any additional concerns that section 12(d)(1)(G) was intended to address.[257]

Since we adopted the rule, it has been brought to our attention that funds relying on section 12(d)(1)(G) wish to invest in other types of financial assets, including futures and other

---

[254] Proposed rule 12d1-2(a)(4).

[255] *See* 17 CFR 270.12d1-2(a)(3).

[256] *See* 17 CFR 270.12d1-2(a)(1), 17 CFR 270.12d1-2(a)(2).

[257] *See* Fund of Funds Proposing Release, *supra* note 197, at n.80 and accompanying text.

financial instruments that might not be securities under the Act and thus may not be within the scope of rule 12d1-2.[258] Investments in these types of assets may allow an acquiring fund greater flexibility to meet investment objectives that may not be met as well by investments in securities. In addition, like investments in securities, investments in these assets do not appear to raise concerns that the investment limits on fund of funds arrangements contained in section 12(d)(1) were intended to address. Accordingly, we propose to amend rule 12d1-2 to allow funds relying on section 12(d)(1)(G) to invest in assets or instruments other than securities.[259] Under the proposed rule, funds relying on the exemptive relief in section 12(d)(1)(G) would be able to invest in, among other things, real estate, futures contracts, and other financial instruments that do not qualify as a security under the Act.[260] Those investments would, of course, have to be consistent with the fund's investment policies.[261]

We seek comment on this proposal. Would any concerns arise if a fund relying on section 12(d)(1)(G) could invest directly in non-securities? Do these concerns differ from a traditional fund that can invest in such assets and invests in other funds subject to the limits of

---

258 *See* 15 U.S.C. 80a-2(a)(36) (defining "security"). If a future or other financial instrument in which a fund relying on section 12(d)(1)(G) proposes to invest is included within the Act's definition of "security," investments in such an instrument would be permitted under current rule 12d1-2(a)(2).

259 Proposed rule 12d1-2(a)(5).

260 We have issued exemptive orders to funds that rely on section 12(d)(1)(G) to allow those funds to invest in futures contracts and other financial instruments. *See, e.g.*, Schroder Series Trust, *et al.*, Investment Company Act Release Nos. 28133 (Jan. 24, 2008) [73 FR 5603 (Jan. 30, 2008)] (notice) and 28167 (Feb. 25, 2008) (order); The UBS Funds, *et al.*, Investment Company Act Release Nos. 28080 (Dec. 19, 2007) [72 FR 74372 (Dec. 31, 2007)] (notice) and 28122 (Jan. 16, 2008) (order); Vanguard Star Funds, *et al.*, Investment Company Act Release Nos. 28009 (Sept. 28, 2007) [72 FR 56813 (Oct. 4, 2007)] (notice) and 28024 (Oct. 24, 2007) (order) (permitting funds relying on section 12(d)(1)(G) and rule 12d1-2 under the Act to invest in financial instruments that may not be securities within the meaning of section 2(a)(36) of the Act).

261 *See* Item 4 of Form N-1A (requiring disclosure of funds' investment objectives and principal investment strategies).

section 12(d)(1)?

VI. Request for Comment

The Commission requests comment on the rules, rule amendments, and Form N-1A amendments proposed in this release. The Commission also requests suggestions for additional changes to existing rules or forms, and comments on other matters that might have an effect on the proposals contained in this release. Commenters are requested to provide empirical data to support their views.

VII. Paperwork Reduction Act

Certain provisions of proposed rule 6c-11 would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[262] The Commission is therefore submitting this proposal to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information requirements is "Rule 6c-11 under the Investment Company Act of 1940, 'Exchange-traded funds.'" If adopted, this collection would not be mandatory, but would be necessary for ETFs that seek to form and operate as open-end management companies without seeking individual exemptive orders. Responses to the collection of information requirements of proposed rule 6c-11 would not be kept confidential.

In addition, the Commission is proposing amendments to an existing collection of information requirement titled "Form N-1A under the Investment Company Act of 1940 and Securities Act of 1933, Registration Statement for Open-End Management Companies." Compliance with the disclosure requirements of Form N–1A is mandatory. Responses to the disclosure requirements are not kept confidential.

---

[262] 44 U.S.C. 3501-3520.

Finally, proposed rule 12d1-4 would result in a new "collection of information" requirement within the meaning of the PRA. The Commission is therefore submitting the proposal for rule 12d1-4 to OMB for review. The title for the collection of information requirements is "Rule 12d1-4 under the Investment Company Act of 1940, 'Exemption for investments in exchange-traded funds.'" If adopted, this collection would not be mandatory, but would be a condition that an acquiring fund would have to satisfy in order for an ETF, its principal underwriter, a broker, or a dealer to rely on the safe harbor if an acquiring fund redeems ETF shares. Responses to the collection of information requirements of proposed rule 12d1-4 would not be kept confidential.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. OMB has not yet assigned control numbers to the new collections for proposed rules 6c-11 and 12d1-4. The approved collection of information associated with Form N-1A, which would be revised by the proposed amendments, displays control number 3235-0307.

A. Proposed Rule 6c-11

Proposed rule 6c-11 would exempt ETFs from certain provisions of the Act, permitting them to begin operating without obtaining an exemptive order from the Commission. The proposed rule also would expand the relief we have issued in the past to index-based ETFs, and to transparent, actively managed ETFs. Each ETF seeking to rely on the proposed rule would have to disclose on a daily basis specific information to market participants: (i) the contents of its basket assets; (ii) the identities and weightings of the component securities and other assets in its portfolio if it does not track an index whose provider discloses its composition daily; and (iii) the prior business day's NAV, market closing price for its ETF shares and premium/discount information.[263] In addition, each ETF would have to disclose in its registration statement: (i) the number of shares that comprise a creation unit; and (ii) the foreign holidays that would prevent timely satisfaction of redemption with respect to foreign securities in its basket assets.[264] An ETF that chooses not to disclose its portfolio would have to track an index whose provider discloses the identities and weightings of the securities and other assets that constitute the index in order to rely on the proposed rule. In addition, each ETF seeking to rely on the proposed rule also would have to, in any sales literature (as defined in the rule), identify itself as an ETF, which does not sell or redeem individual shares, and explain that investors may purchase or sell individual shares on national securities exchanges.

Two of the disclosure conditions in proposed rule 6c-11 would not result in a burden for purposes of the PRA. Disclosure of the contents of the basket assets that comprise a creation unit and the number of shares in each creation unit does not result in a burden because ETFs must disclose this information in the normal course of business.[265] Similarly, disclosure by an index provider of the identities and weightings of the component securities and other assets that comprise the index would not result in a burden because index providers disclose this information in the normal course of business.

---

[263] Proposed rule 6c-11.

[264] *Id.*

[265] *See* Section II of this release for a discussion on the operation of ETFs. Disclosure of the contents of the basket assets and the number of shares that comprise a creation unit are critical to investors who seek to purchase or redeem creation units from the ETF and, therefore, to the operation of an ETF. To purchase a creation unit, an investor would need to know the securities and other assets that must be deposited with the ETF in exchange for a creation unit. To redeem a creation unit, an investor would need to know the number of ETF shares that comprise a creation unit in order to compile enough shares to redeem from the ETF. Disclosure of the contents of the basket assets also is important to the arbitrage mechanism of the ETF. Arbitrageurs compare the NAV of the basket to the NAV of ETF shares to determine whether to purchase or redeem creation units based on the relative values of ETF shares in the secondary market and the securities contained in the basket.

The remaining four disclosure requirements are collections of information. First, the proposed rule would require an ETF that does not track an index whose provider discloses its composition daily to provide daily disclosure of the identities and weightings of the component securities and other assets in the ETF's portfolio. Currently, two ETF registrants are required to disclose their portfolios daily under the terms of their exemptive orders.[266] The Commission staff estimates that an ETF each year would spend approximately 200 hours of professional time to update the relevant Internet Web page daily with this information, at a cost of $42,000.[267] The staff also estimates that each new ETF initially would spend 100 hours to develop the Web page for this disclosure. Staff estimates the initial cost would be $22,520 for internal ETF staff time to develop the Web page and $12,600 for an external Web site developer, for a total of $35,120.[268]

We seek comments on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

Second, the proposed rule also would require each ETF to disclose its prior business

---

266 ProShares Notice, *supra* note 113; Rydex ETF Trust, Investment Company Act Release No. 27703 (Feb. 20, 2007) [72 FR 8810 (Feb. 27, 2007)]. Together, these registrants offer 64 ETFs that are required to disclose their portfolios daily.

267 Estimates on the number of burden hours and external costs associated with the collections of information are based on informal conversations between Commission staff and representatives of ETFs. The staff estimates the cost would be 200 hours for an internal Web site developer (at $211 per hour) (200 x $211 = $42,200). Hourly wages used for purposes of this PRA analysis are from the Securities Industry Association (now named Securities Industry and Financial Markets Association), SIA Report on Management & Professional Earnings in the Securities Industry 2006, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

268 Commission staff estimates the cost would equal 80 hours for Web site developers at the ETF (at $211 per hour) to develop the Web page and 20 hours for internal Web site managers (at $282 per hour) to review the Web page ((80 hours x $211) + (20 hours time x $282) = $22,520). In addition, based on discussions with industry representatives, the staff estimates that each ETF initially would spend an additional $12,600 to external Web site developers ($22,520 + 12,600 = $35,120).

day's NAV, market price for its shares, and premium/discount information, which would provide investors with information on the deviation, if any, between the price of ETF shares and the NAV of the underlying portfolio. Commission staff estimates that an ETF each year spends approximately 206 hours of professional time to update the relevant Internet Web page daily with this information. Based on staff estimates, we estimate the annual cost would be $43,466 for internal ETF staff time to update the Web page and $6,000 to acquire the data from external data providers.[269] The staff also estimates that each new ETF initially would spend 75 hours to develop the Web page for these disclosures. Based on staff estimates, we estimate the initial cost would be $16,890 for internal ETF staff time to develop the Web page and $9540 for an external Web site developer, for a total of $26,430.[270]

We seek comments on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

Third, in any sales literature each 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 national securities exchanges. This condition is similar to the condition in our exemptive orders, which requires each ETF to agree not to market or advertise the ETF as an open-end fund or mutual fund and to explain that the ETF shares are not individually redeemable. Based on conversations with ETF representatives, Commission staff estimates that an ETF each year spends approximately 30 hours at a cost of $1704 to comply with the condition in our exemptive

---

269 Commission staff estimates the cost would equal 206 hours for internal Web site developers at ($211 per hour) (206 x $211 = $43,466).

270 Commission staff estimates the cost would equal 60 hours for internal Web site developers (at $211 per hour) to develop the Web page and 15 hours for Web site managers (at $282 per hour) to review the Web page ((60 hours x $211) + (15 hours x $282) = $16,890). In addition, based on discussions with industry representatives, the staff estimates that each fund would spend an additional $9540 to external Web site developers ($16,890 + $9540 = $26,430).

orders.[271] Because the condition in the proposed rule is similar, the staff estimates that each new ETF also would spend 30 hours at a cost of $1704 to comply with the condition in the proposed rule.

We seek comment on this estimate. If commenters believe this estimate is not reasonable, we request they provide data that would allow us to make a more accurate estimate.

Finally, some ETFs that track foreign indexes have stated that local market delivery cycles for transferring foreign securities to redeeming investors, together with local market holiday schedules, require a delivery process in excess of the statutory seven days required by section 22(e) of the Act. The proposed rule would codify the disclosure requirement in existing exemptive orders that requires ETFs to disclose in their registration statements the foreign holidays that would prevent timely satisfaction of redemption.[272] The collection of information burden for this disclosure is discussed in the PRA analysis of proposed Form N-1A amendments in Section VI.B below.

As of December 2007, there were 601 ETFs.[273] The Commission staff estimates that each year 150 new ETFs will form and operate.[274] The staff estimates that each ETF each year would spend approximately 236 hours to comply with the conditions of proposed rule 6c-11. Each new ETF would spend an additional 75 hours to develop the Web sites for daily disclosure of its prior

---

271 Commission staff estimates the cost would equal 2 hours for the ETF's internal counsel (at $292 per hour) to draft the disclosure and 28 hours for clerical staff (at $40 per hour) to input and copy check the marketing materials ((2 x $292) + (28 x $40) = $1704).

272 *See supra* notes 136-141 and accompanying text for a discussion of the proposed exemption from section 22(e) of the Act.

273 ICI ETF Statistics 2007, *supra* note 5.

274 To estimate the number of new ETFs each year for purposes of this PRA, the staff has used the approximate average of the number of new ETFs for the past three years ((50 + 153 + 244)/3 =149). ICI, *Exchange-Traded Fund Assets December 2006*, Jan. 31, 2007; ICI ETF Statistics 2007, *supra* note 5.

business day's NAV, market closing price for its shares, and premium/discount information. In addition, ETFs that provide the identities and weightings of the securities and other assets in their portfolios if they do not track an index whose provider discloses its composition daily would spend an additional 100 hours to develop the Web sites for this disclosure. Each of those ETFs also would spend an estimated 200 hours each year to update the disclosures of portfolio assets on its Web site. For purposes of this PRA, the staff estimates that one-half of all new ETFs (75 ETFs) would provide this disclosure. Based on staff estimates, we estimate that ETFs would, in the aggregate, spend 205,036 hours each year to comply with the requirements of proposed rule 6c-11.[275] We estimate further that ETFs would spend 18,750 hours initially to develop the Web page for these disclosures, amortized over three years for an annual burden of 6250 hours.[276] Thus, the estimated total annual burden is 211,286 hours.[277] We estimate the annual internal costs of ongoing compliance with these disclosure requirements would be $40 million and external costs would be $4.5 million.[278] We further estimate that initial internal costs to develop the Web page for these disclosures would be $4.2 million and external costs would be $2.3 million, or $1.4 million and $0.8 million, respectively, amortized over three years.[279]

B. Form N-1A

We are proposing amendments to Form N-1A to provide more useful information to

---

275 Assuming all existing ETFs would rely on the proposed rule, these estimates are based on the following calculations: ((206 hours + 30) x 612 (existing plus estimated new index-based ETFs)) + (436 hours x 139 (existing plus estimated new actively managed ETFs) = 205,036).

276 This estimate is based on the following calculation: (75 hours x 75 (estimated new index-based ETFs)) + (175 hours x 75 (estimated new actively managed ETFs)) = 18,750.

277 This estimate is based on the following calculation: 205,036+ 6250 = 211,286.

278 These estimates are based on the following calculations: (($43,466 + $1704) x 612) + ($42,000 x 139) = $39,760,670; ($6000 x 612) + ($6000 x 139) = $4,506,000.

279 These estimates are based on the following calculations: ($16,890 x 75) + (($16,890 + $22,520) x 75) = $4,222,500; ($9540 x 75) + (($9540 + $12,600) x 75) = $2,376,000.

investors who purchase and sell ETF shares on national securities exchanges.

Creation Units. The proposed amendments would permit an ETF to exclude certain information from its prospectus that is not pertinent to investors purchasing individual ETF shares. Specifically, an ETF that has creation units of 25,000 shares or more may exclude from its prospectus: (i) information on how to purchase and redeem shares of the ETF;[280] and (ii) fee table fees and expenses for purchases and redemptions of creation units.[281] Based on conversations with industry representatives, Commission staff estimates that this proposed amendment would decrease the information collection burdens of an ETF that has creation units of 25,000 shares or more by an average of 1.4 hours per fund per filing of an initial registration statement or post-effective amendment to a registration statement.

The proposed amendment also would require disclosures designed to include important information for purchasers of individual ETF shares, as described below. An ETF would have to modify the narrative explanation preceding the example in the fee table in its prospectus and periodic reports to state that fund shares are sold on the secondary market rather than redeemed at the end of the periods indicated, and that investors in ETF shares may be required to pay brokerage commissions that are not reflected in the fee table.[282] We believe that the added information collection burdens associated with this statement, if any, would be negligible.

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

---

280 Proposed Item 6(h)(1) of Form N-1A.

281 Proposed Instruction 1(e)(i) to Item 3 of Form N-1A.

282 Proposed Instruction 1(e)(ii) to Item 3 of Form N-1A; Proposed Instruction 1(e)(ii) to Item 22(d) of Form N-1A. The proposal also would require each ETF to identify the principal U.S. market on which its shares are traded and include a statement to the effect that ETF shares are bought and sold on national securities exchanges. We believe that the added information collection burdens associated with these very brief and specific statements, if any, would be negligible.

Total Returns. The proposed amendments would require each ETF to include a separate line item for returns based on the market price of ETF shares in the average annual total returns table in Item 2 of the Form.[283] This would codify, with modifications, a condition in ETF exemptive orders. The amendments also would require ETFs to calculate total return at market prices in addition to returns at NAV for their financial highlights tables.[284] One consequence of this proposed amendment is that ETFs would be required to include two bar charts under Item 2 of Form N-1A; one using market price returns and one using NAV returns.[285] We do not believe these added disclosures would increase the hourly burdens of ETFs. ETFs are currently required by our orders to calculate and present market price returns in the prospectus and, therefore, this disclosure would not present a new substantive requirement. The proposal would eliminate industry practice of including this disclosure in a supplemental section rather than the main body of the prospectus and, therefore, would integrate the disclosure within current Form N-1A requirements.[286] Staff estimates that the time it takes to prepare the new line items and the additional bar chart would be the same as the amount of time ETFs currently spend preparing the market price return disclosure that is included in the supplemental section. Based on discussions with industry representatives, the staff estimates that each ETF currently spends approximately 0.6 hours of professional time to prepare the market price returns disclosure required by our exemptive orders.

We request comment on this estimate. If commenters believe the estimate is not reasonable, we request they provide specific data that would allow us to make a more accurate

---

[283] Proposed Instruction 5(a) to Item 2(c)(2) of Form N 1A.

[284] Proposed Instruction 3(f) to Item 8(a) of Form N-1A.

[285] *See* Item 2(c)(2)(i) of Form N 1A.

[286] *See supra* note 163.

estimate.

Premium/Discount Information. The amendments also would require ETFs to include premium/discount information in both the prospectus and annual report of each ETF. This proposed amendment codifies an existing exemptive order requirement. Based on discussions with industry representatives, the staff estimates that each ETF currently spends an average of 0.5 hours per filing of an initial registration statement or a post-effective amendment to a registration statement to include this disclosure.[287] The staff further estimates that each ETF also would spend 0.5 hours per annual report to include this disclosure.

We request comment on this estimate. If commenters believe the estimate is not reasonable, we request they provide specific data that would allow us to make a more accurate estimate.

Foreign Holidays. As noted above, proposed rule 6c-11 would require certain ETFs to disclose in their registration statements the foreign holidays that would prevent timely satisfaction of redemption. As of July 2007, there were 125 ETFs that provide exposure to international equity markets. Based on discussions with ETF representatives, the staff estimates that approximately 10% of these ETFs may need to delay satisfaction of redemption requests, and that each of those ETFs would spend approximately 0.3 hours to include the required information in its registration statement.

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide specific data that would allow us to make more accurate estimates.

---

287 This estimate is based on discussions with representatives of ETFs, which include premium/discount information as required by their exemptive orders.

The current burden for preparing an initial Form N-1A filing is 830.47 hours per portfolio. The current burden for preparing a post-effective amendment on Form N-1A is 111 hours per portfolio. The total annual hour burden approved for Form N-1A is 1,575,184. Based on Commission filings, Commission staff estimates that on an annual basis, ETFs file initial registration statements covering 98 ETF portfolios, and post-effective amendments covering 1441 ETF portfolios on Form N-1A. Based on staff estimates, we estimate that the proposed amendments would not increase the hour burden per ETF per filing on an initial registration or post-effective amendment to a registration statement.[288] Therefore, if the proposed amendments to Form N-1A were adopted, we estimate that the total annual hour burden for all ETFs for preparation and filing of initial registration statements would remain the same.

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide specific data that would allow us to make more accurate estimates.

C. Proposed Rule 12d1-4

Proposed rule 12d1-4 would permit an acquiring fund to acquire ETF shares in excess of the limits of section 12(d)(1) of the Act, subject to certain conditions.[289] In order to rely on the proposed rule for an exemption from section 12(d)(1)(B) limits, an ETF may not redeem and its principal underwriter, a broker, or dealer may not submit for redemption any of the ETF's shares that were acquired by an acquiring fund in excess of the limits of section 12(d)(1)(A)(i) of the

---

288 The proposed amendments would add approximately 1.4 hours (0.6 hours (total returns), 0.5 hours (premium/discount information), and 0.3 hours (foreign holidays)), which staff estimates would be offset by approximately 1.4 hours (elimination of description of creation units and associated fees).

289 *See* discussion in Section IV.A – B *supra*.

Act in reliance on proposed rule 12d1-4.[290] The proposed rule provides a safe harbor for these entities if the entity has (i) received a representation from the acquiring fund that none of the ETF shares it is redeeming was acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the rule, and (ii) no reason to believe that the acquiring fund is redeeming any ETF shares that the acquiring fund acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the rule.[291] The representation required for the safe harbor would be a collection of information for purposes of the PRA.

Our understanding is that acquiring funds that invest in ETFs generally do not redeem their shares from the ETF, but rather sell them in secondary market transactions. We also believe that an acquiring fund that would not rely on proposed rule 12d1-4 to acquire ETF shares (*i.e.*, an acquiring fund that acquires 3 percent or less of an ETF's outstanding voting securities) would be less likely to redeem shares because it would be less likely to have a sufficient number of shares to permit the acquiring fund to redeem its shares.[292] We estimate that ETFs, their principal underwriters, and brokers and dealers in the aggregate would choose to rely on the safe harbor to redeem or submit a redemption order with respect to ETF shares that were not acquired in reliance on proposed rule 12d1-4 on average two times each year with respect to each ETF.[293]

We request comment on this estimate. If commenters believe this estimate is not reasonable, we request they provide specific data that would allow us to make a more accurate

---

290 *See* proposed rule 12d1-4(b)(1).

291 *See* proposed rule 12d1-4(b)(2).

292 ETF shares are redeemed only in creation unit aggregations. A creation unit typically consists of at least 25,000 shares. *See supra* note 113.

293 We recognize that some ETFs may receive more redemption requests from acquiring funds and may rely on the safe harbor more often, while other ETFs may receive no redemption requests or may not choose to rely on the safe harbor when they receive a redemption request from an acquiring fund.

estimate.

There were 601 ETFs as of the end of December 2007.[294] Based on our estimate, two acquiring funds each year would provide a representation to an ETF, its principal underwriter, a broker, or a dealer with respect to each ETF, for a total of 1202 representations. We estimate that each representation would take, on average no more than 0.2 hours to prepare and submit to the ETF, principal underwriter, broker, or dealer.[295] Accordingly, we believe that the total annual collection of information burden for proposed rule 12d1-4 would be 240 hours at a cost of $70,080.[296]

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide specific data that would allow us to make more accurate estimates.

D. Request for Comments

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the

---

[294] *ICI ETF Assets 2007*, *supra* note 5.

[295] The proposed rule does not specify language that must appear in the representation. It simply requires the acquiring fund to represent that the shares submitted for redemption are not shares acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act in reliance on proposed rule 12d1-4. Accordingly, we expect that while initial representations might take half an hour to draft, these representations would soon conform to an industry standard that would take no more than a few minutes to produce.

[296] These estimates are based on the following calculations: 1202 representations x 0.2 hours = 240.4 hours; 240 hours x $292 (hourly rate for a fund attorney) = $70,080.

information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-07-08. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-07-08, and be submitted to the Securities and Exchange Commission, Public Reference Room, 100 F Street, NE, Washington, DC 20549-1520.

VIII. COST-BENEFIT ANALYSIS

The Commission is sensitive to the costs and benefits imposed by its rules. As discussed above, the proposed rules and rule amendments would permit funds to engage in activities and transactions that are otherwise prohibited under the Act without the expense and delay of obtaining an individual exemptive order. Specifically, proposed rule 6c-11 would permit ETFs to form and operate. Proposed rule 12d1-4 would permit a fund to invest in ETFs beyond the limits of section 12(d)(1) of the Act, and proposed amendments to rule 12d1-2 would expand the investment options available to funds that rely on the exemptive relief in section 12(d)(1)(G) of the Act. The proposed amendments to Form N-1A are designed to provide more useful information to investors who purchase and sell ETF shares on national securities exchanges, while simplifying the form by permitting most, if not all, ETFs to exclude information related to the purchase and redemption of creation units.[297] This cost-benefit analysis examines the costs and benefits to ETFs, acquiring funds, and investors that would result from reliance on the proposed exemptive rules and rule and form amendments, in comparison to the costs and benefits associated with obtaining an exemptive order from the Commission.

A. Rule 6c-11

1. Benefits

Proposed rule 6c-11 would codify much of the relief and conditions of exemptive orders that we have issued to ETFs in the past.[298] Proposed rule 6c-11 would require an ETF that relies on the proposed rule either to (i) disclose on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the fund, or (ii) have a stated objective of obtaining results that correspond to the returns of a securities index whose index provider discloses on its Internet Web site the identities and weightings of the component securities and other assets of the index.[299] An ETF that meets one of these requirements could redeem shares in creation unit aggregations, have its shares traded at current market prices, engage in in-kind transactions with certain affiliates, and in certain circumstances, redeem shares in more than seven days.[300]

---

[297] As noted above, information on how creation units are offered to the public is required to be disclosed in the SAI. Item 18(a) of Form N-1A.

[298] The proposed rule does not codify exemptions previously provided to ETFs organized as UITs because the Commission has not received an exemptive application for a new ETF to be organized as a UIT since 2002. *See* discussion in Section III.A.3 of this release.

[299] Proposed rule 6c-11(e)(4)(v); s*ee also* discussion in Section III.B.1 of this release for a discussion of these conditions.

[300] Proposed rule 6c-11(a)-(d); *see also* discussion in Section III.C. of this release.

<u>Elimination of Exemptive Order Costs.</u> We anticipate that ETFs, their sponsors, and ETF investors would benefit from the proposed rule. ETFs and their sponsors increasingly have sought exemptive orders (which the Commission has granted) to form and operate as open-end management companies under the Act. The application process involved in obtaining exemptive orders imposes direct costs on ETFs and their sponsors, including preparation and revision of an application, as well as consultations with Commission staff. The proposed rule would benefit ETFs and their sponsors by eliminating the direct costs of applying to the Commission for an exemptive order to form and operate as permitted under the rule.[301] The rule would further benefit ETFs and their sponsors by eliminating the uncertainty that a particular applicant might not obtain relief to form and operate as permitted under the rule. We anticipate that the elimination of the direct costs of exemptive applications also may benefit ETF investors by enabling ETFs to lower their costs as a result of lower start-up costs.

We seek comment on whether the elimination of these direct costs would result in additional benefits to ETFs or their investors. Are there other costs of the proposed rule that would offset any cost savings resulting from not having to file an exemptive application?

The exemptive application process also involves other indirect costs. ETFs and their sponsors that apply for an order forgo potential market opportunities until they receive the order, while others forgo the market opportunity entirely rather than seek an exemptive order because they have concluded that the cost of seeking an exemptive order would exceed the anticipated benefit of the market opportunity.[302] These direct and indirect costs currently may prevent

---

301 The cost to an ETF for submitting an application ranges from approximately $75,000 to $350,000. These figures are based on conversations with attorneys and ETF employees who have been involved in submitting applications to the Commission.

302 The time involved in obtaining an order from the Commission ranges from several months to several years depending on the nature, complexity, and de novo consideration of the exemptions

(footnote continued)

smaller ETFs and their sponsors from coming to market because they have determined that the cost of an exemptive application may exceed the potential benefit. Eliminating these costs may allow more ETFs, particularly smaller ETFs, to come to market.

We seek comment this analysis. Would removing the regulatory burdens facilitate greater innovation in the ETF market place, particularly with respect to smaller ETFs?

Increased Investment Options. We expect that the proposed rule also would benefit ETF investors to the extent it would remove a possible disincentive for some ETFs and their sponsors to form and operate as open-end funds and provide investors with additional investment choices. As noted above, the direct and indirect costs of the exemptive application process may discourage potential sponsors, particularly smaller sponsors interested in offering smaller, more narrowly focused ETFs which may serve the particular investment needs of certain investors. By eliminating the need for individual exemptive relief, we anticipate that the proposed rule would, over time, lead to an increase in ETFs. In those circumstances, the proposed rule would provide ETF investors with greater investment choices, while also providing them with the protections afforded by the Investment Company Act.

We seek comment on this analysis. Would the proposed rule result in increased investment options?

Elimination of Certain Exemptive Order Terms. Proposed rule 6c-11 also may benefit ETFs and their sponsors by eliminating certain terms contained in exemptive orders that we believe may be addressed by other provisions of the federal securities laws. We propose to eliminate the terms designed to prevent the communication of material non-public information between the ETF and its affiliated index provider because we believe that there are sufficient

---

sought.

requirements under federal securities laws and the rules of national securities exchanges to protect against the abuses the terms were intended to address.[303] We anticipate that eliminating these regulatory burdens may reduce costs of operating an ETF and thereby facilitate greater competition and innovation among ETFs.

We request comment on this analysis. Are there any costs associated with eliminating these terms?

2. Costs

We do not expect the proposed rule would impose mandatory costs on any ETF. As discussed above, the proposed rule is exemptive, and we expect that a fund would not operate as an ETF in reliance on the rule if the anticipated benefits did not justify the costs. We expect the costs of relying on the proposed rule are likely to be the same as or less than the costs to an ETF that relies on an existing exemptive order because the proposed rule includes the same or fewer conditions than existing orders that provide equivalent exemptive relief.

The proposed rule would affect different types of ETFs and their sponsors in different ways. A sponsor or adviser that has not sought and would not seek exemptive relief to form and operate an ETF registered under the Act would not be affected by the rule. For an ETF and its sponsor that currently rely on an exemptive order, there may be one-time "learning costs" in determining the differences between the order and rule. After making this determination, we expect that the costs for this ETF would be the same as or less than the costs of relying on its exemptive order because the rule contains the same or fewer conditions than existing orders. In addition, an ETF and its sponsor that currently rely on an exemptive order could generally satisfy all the conditions of the rule that provide similar exemptive relief without changing its operation.

[303] *See* Section III.B.4 of this release for a discussion of this condition.

Finally, a sponsor that has not relied on an exemptive order and that intends to rely on the proposed rule would bear the same or lower continuing costs of complying with conditions that it would have borne had it obtained an exemptive order. In that case, its total costs are likely to have been the same as or greater than the costs associated with the proposed rule.

We request comment on this analysis. Would ETFs that currently rely on an order bear lower costs if they relied on the proposed rule? Would an ETF have to change its operation in any way to comply with the proposed rule?

Prospectus Delivery. The proposed rule does not provide an exemption from prospectus delivery that most ETFs and their sponsors have requested and we have provided in our orders. Most of our orders have exempted broker-dealers selling ETF shares from the obligation to deliver prospectuses in most secondary market transactions.[304] Those applicants have represented that broker-dealers would instead deliver a "product description" containing basic information about the ETF and its shares.[305] Because proposed rule 6c-11 would not contain a similar exemption, broker-dealers would be required to deliver a prospectus meeting the requirements of section 10 of the Securities Act to investors purchasing ETF shares.[306] We

---

304 The orders have granted exemptions from section 24(d) of the Act, which makes inapplicable the dealer exception in section 4(3) of the Securities Act to transactions in redeemable securities issued by an open-end investment company. 15 U.S.C. 80a-24(d); 15 U.S.C. 77d(3); *see, e.g.*, WisdomTree Order, *supra* note 12. ETFs that have this exemption, however continue to be subject to prospectus delivery requirements in connection with sales of creation units and other non-secondary market transactions. Our most recent orders, however, do not provide an exemption from prospectus delivery requirements. *See* Actively Managed ETF Orders, *supra* note 20.

305 *See, e.g.*, Ziegler Notice, *supra* note 110. The product description provides a summary of the salient features of the ETF and its shares, including the investment objectives of the fund, the manner in which ETF shares trade on the secondary market, and the manner in which creation units are purchased and redeemed. National securities exchanges on which ETFs are listed have adopted rules requiring the delivery of product descriptions. *See, e.g.*, American Stock Exchange Rules 1000 and 1000A.

306 15 U.S.C. 77j. We also are proposing to amend our orders to exclude the section 24(d)

(footnote continued)

believe an exemption allowing broker dealers to deliver product descriptions would be unnecessary given our proposal regarding summary prospectus disclosure. If we adopt the Enhanced Disclosure Proposing Release, broker-dealers selling ETF shares could deliver a summary prospectus in secondary market transactions.[307] Although there may be costs associated with printing and delivering prospectuses to secondary market purchasers, we expect these costs to be minimal. We understand that many, if not most, broker-dealers selling ETF shares in secondary market transactions, in fact, transmit a prospectus to purchasers, and thus they may not have relied on the exemptions provided in the orders. In addition, we anticipate these costs could be offset by the fact that the ETFs would not have to prepare product descriptions and by the simplified prospectus disclosure in this proposal.[308]

We anticipate that any cost associated with this requirement may be justified by the benefits to ETF investors. Prospectuses provide ETF investors with standardized information about an investment in an ETF and the differences between an ETF and a traditional mutual fund. Because prospectuses are standardized forms the content of which has been prescribed by the Commission, their delivery could promote greater uniformity in the content and level of disclosure among existing and future ETFs. Finally, our proposed amendments to the prospectus should provide more useful information to investors who purchase and sell ETF shares on a national securities exchange, while simplifying prospectuses by permitting ETFs to exclude

---

exemption we have issued to existing ETFs. Accordingly, the prospectus delivery requirement would apply to all ETFs, including ETFs operating under current exemptive orders. *See supra* Section III.E for a discussion of this proposed amendment to existing orders.

307 *See supra* notes 145-152 and accompanying text. The summary prospectus would contain material information that may not appear in a product description, but like a product description, would be in a form that would be easy to use and readily accessible.

308 The preparation of a product description can cost approximately $360 to $11,000 per ETF. These figures are based on conversations with attorneys and ETF employees.

information related to the purchase and redemption of creation units.

We request comment on this analysis. Are we correct in assuming that prospectus delivery costs would be offset by the elimination of product descriptions?

Conditions. All ETFs seeking to rely on the rule would have to be listed on an exchange that disseminates the per share NAV of the ETFs' baskets at regular intervals. This condition was included in our exemptive orders and, therefore, should not result in an increased cost to existing ETFs. Each ETF also must, in any sales literature (as defined in the rule), identify itself as an ETF, which does not sell or redeem individual shares, and explain that investors may purchase or sell individual shares on national securities exchanges. This condition is similar to one included in our exemptive orders and, therefore, should not result in an increased cost to existing ETFs. In addition, the ETF would be required either to (i) disclose on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the fund, or (ii) have a stated objective of obtaining results that correspond to the returns of a securities index whose index provider discloses on its Internet Web site the identities and weightings of the component securities and other assets of the index.[309] Index-based ETFs comply with the latter requirement and, therefore, this condition should not result in an increased cost to ETFs that would track a transparent index. ETFs that choose to rely on the former condition, including the actively managed ETFs subject to the recent exemptive orders we issued, would incur costs in connection with developing a Web page for this disclosure and updating the disclosure daily.[310] We expect these costs to be of the same magnitude as the costs

---

[309] Proposed rule 6c-11(e)(4)(iv).

[310] For purposes of the Paperwork Reduction Act, the staff estimated that each ETF would spend approximately $22,520 to develop the Web site. The staff also estimates that each ETF would spend 200 hours annually to update the site daily. *See supra* notes 267-268 and accompanying text.

borne by index providers in making their indexes transparent. Although this may be a reallocation of costs from index providers to those ETFs that choose to fully disclose their portfolios, we do not believe that this change would significantly affect the costs borne by ETF investors. The new disclosure costs for ETFs that choose to disclose their portfolios rather than track a transparent index would be offset by the lack of index licensing fees that are generally charged to index-based ETFs.

We request comment on whether investors in an actively managed ETF would incur any additional costs as a result of the portfolio disclosure. We also request comment on our analysis.

B. Amendments to Form N-1A

1. Benefits

As discussed above, most of our orders have exempted broker-dealers selling ETF shares from the obligation to deliver prospectuses in secondary market transactions. Applicants for those orders have represented that they would instead require that broker-dealers deliver a product description containing basic information about the ETF and its shares. We are not including a similar exemption in proposed rule 6c-11, and thus a broker-dealer would be required to deliver a prospectus meeting the requirements of section 10 of the Securities Act to investors purchasing ETF shares. In light of this requirement, we also are proposing amendments to Form N-1A, and the summary prospectus, designed to meet the needs of investors (including retail investors) who purchase shares in the secondary market rather than institutional investors purchasing creation units from the ETF.

<u>Material Information to ETF Investors</u>. We expect that the primary benefit of our proposed amendments would be to provide ETF investors purchasing shares in the secondary market with information on the investment that currently is not included in product descriptions,

such as the fund's fee table and the name and length of service of the portfolio manager. This should provide ETF investors with information necessary to understand an investment in an ETF. This information also may be helpful to investors in making portfolio allocation decisions.

Simplified Disclosure. Our proposed amendments are designed to simplify prospectus and periodic report disclosure in two ways. First, the proposal would allow ETFs to exclude from the prospectus information on how to purchase and redeem creation units, including information on fees and expenses associated with creation unit sales or purchases. Current ETF prospectuses and periodic reports include detailed information on how to purchase and redeem creation units. The fee table and example include information on transaction fees payable only by creation unit purchasers. Our proposed amendments would permit ETFs with creation units of at least 25,000 shares to exclude this information because it is not relevant (and potentially confusing) to investors purchasing in secondary market transactions.[311] This proposed provision should simplify ETF prospectuses without compromising the disclosure provided to investors who purchase ETF shares in secondary market transactions.

Second, the proposed amendment would incorporate current disclosure requirements mandated by our exemptive orders into the prospectus instead of in a supplemental section where ETFs currently locate it. Our exemptive orders require ETFs to include in their prospectuses and annual reports returns based on market price in addition to returns based on NAV, which as discussed above, may be different than the fund's NAV and better relate to an ETF investor's experience in the fund.[312] The condition in our exemptive orders did not specify where this information must be located in the prospectus. As a result, ETFs have included an additional

---

311 *See supra* notes 158-161 and accompanying text for a discussion of this proposed amendment.

312 *See supra* notes 163-165 and accompanying text for a discussion of this proposed amendment.

table in the prospectus, rather than including market price returns in the average annual returns table required by Item 2 of the Form. The lack of specificity also resulted in ETFs using different time periods for the disclosure, with some using calendar years and others fiscal years. The proposed amendment would eliminate use of a second table, which may confuse investors. It also would require all ETFs to present the information using calendar years, standardizing the reporting period used by ETFs. The proposed amendments would mandate uniform disclosure in the prospectus, which should benefit investors by allowing them to compare ETFs more easily.

Similarly, our exemptive orders required ETFs to include in their prospectuses and annual reports premium/discount information to alert investors of the extent and frequency with which market prices deviated from the fund's NAV.[313] ETFs have generally included this information in a supplemental section of the prospectus and annual report.[314] The proposed amendments would incorporate this disclosure in the Shareholder Information section (Item 6 of Form N-1A) of the prospectus and the Management's Discussion of Fund Performance (Item 22(b)(7) of the annual report). We anticipate that this would benefit ETF investors by simplifying the prospectuses and annual reports of ETFs while codifying important disclosures mandated by our exemptive orders.

2. Costs

The primary goal of our proposed amendments is to provide investors in ETF shares with more valuable information regarding an investment in an ETF. We do not expect that the proposed amendments would result in significant additional costs to ETFs.[315] As noted above,

---

313 *See supra* notes 166-170 and accompanying text for a discussion of this proposed amendment.

314 *See e.g.*, iShares MSCI Series, Prospectus 62-65 (Jan. 1, 2007); iShares MSCI Series, 2006 Shareholders Annual Report 130-136 (Aug. 31, 2006).

315 Existing ETFs would face a one-time "learning cost" to determine the difference between the

(footnote continued)

our proposed disclosure amendments generally would codify disclosure requirements in existing ETF exemptive orders. To the extent the proposed amendments contain new disclosure requirements, such as, for example, the requirement that ETFs include market price returns in addition to NAV returns in Item 8 of Form N-1A, any costs related to these additional disclosures should be offset by our proposal to exempt ETFs with creation units of 25,000 or more shares from including creation unit purchase and redemption information in their prospectuses and annual reports. Most, if not all ETFs, would be able to rely on this exemption.[316] We anticipate that future ETFs would offer creation units of 25,000 shares or more.

We request comment on this assumption. If ETFs are likely to offer smaller creation units, what is the fewest number of shares likely to be offered in a creation unit?

In addition to codifying disclosure requirements of existing exemptive orders, we are proposing several new disclosure requirements in Form N-1A. First, we propose to require that ETFs include an additional total return calculation under Item 8 using market price returns, which would result in an additional bar chart under Item 2(c)(2)(i) of Form N-1A.[317] Because most ETFs currently calculate and present market price returns in the prospectus pursuant to their exemptive orders, this additional bar chart should result in minimal additional costs because it only requires duplicating the presentation of information in another location. Second, we would require an index-based ETF to compare its performance to its underlying index rather than a

---

current Form N-1A requirements as modified by their exemptive orders and the proposed amendments. We do not anticipate that this cost would be significant given the similarity of the amendments to the conditions in existing exemptive orders.

316 Existing ETFs typically offer creation units of 50,000 or more shares, and the lowest number of shares permitted under current exemptive orders is 25,000

317 *See supra* note 163.

benchmark index.[318] This amendment would permit use of a narrow-based or affiliated index and eliminate the opportunity for an index-based ETF to select an index different from its underlying index, which would better reflect whether the ETF's performance corresponds to the index which performance it seeks to track. This amendment replaces the type of index used to present performance data currently required under Form N-1A and, therefore, should not increase the compliance burden for ETFs. Finally, we would require each ETF to identify the principal U.S. market on which its shares are traded and include a statement to the effect that ETF shares are bought and sold on national securities exchanges and that ETF investors trading in these exchanges may be required to pay brokerage commissions.[319] Including these additional statements should present minimal, if any, printing costs.

As noted above, any additional costs incurred by an ETF in complying with these additional disclosures should be offset by the cost-savings of our proposal, which would allow most, if not all, ETFs to exclude creation unit purchase and redemption information in their prospectuses.[320]

C. Rule 12d1-4

1. Benefits

Proposed rule 12d1-4 would codify much of the relief in orders that we have issued permitting funds to invest in ETFs beyond the limits of section 12(d)(1), while eliminating most of the conditions included in the orders. Proposed rule 12d1-4 would permit fund investments in ETFs beyond the limits of section 12(d)(1) if: (i) the acquiring fund (and any entity in a control

---

318 *See supra* notes 173-174 and accompanying text.

319 *See supra* note 161 and note 282 and accompanying text.

320 For purposes of our Paperwork Reduction Act analysis, we have estimated that our proposed amendments would not change the current Form N-1A compliance costs. *See supra* discussion at Section VII of this release.

relationship with the acquiring fund) could not control the ETF;[321] (ii) the acquiring fund does not redeem certain shares acquired in reliance on the rule;[322] (iii) the fees charged by the acquiring fund do not exceed the FINRA sales charge limits;[323] and (iv) the acquired ETF is not itself a fund of funds (*i.e.*, the rule would prohibit a fund of funds of funds, or three-tier fund, structure).[324] In addition, an ETF could not redeem and its principal underwriter, a broker or a dealer could not submit an order for redemption of certain shares acquired by an acquiring fund in reliance on proposed rule 12d1-4.[325] The rule provides a safe harbor for any of those entities if it has: (i) a representation from an acquiring fund that none of the shares to be redeemed was acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act in reliance on proposed rule 12d1-4; and (ii) no reason to believe that the shares to be redeemed were acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the proposed rule.[326]

We anticipate that acquiring funds, acquired ETFs, investment advisers, and shareholders of both acquiring funds and acquired ETFs would benefit from the proposed rule. Acquiring funds would be able to purchase and ETFs would be able to sell ETF shares beyond the limits of section 12(d)(1) without obtaining an exemptive order, which can be costly to ETFs and their

---

321 Proposed rule 12d1-4(a)(1). *See supra* notes 215-219 and accompanying text for a discussion of the proposed condition.

322 Proposed rule 12d1-4(a)(2) *See supra* note 220 and accompanying and following text for a discussion of the proposed condition.

323 Proposed rule 12d1-4(a)(3). *See supra* notes 230-233 and accompanying text for a discussion of the proposed condition. Unlike the orders, however, the proposed rule would not require directors to make any special findings that investors are not paying multiple advisory fees for the same services.

324 Proposed rule 12d1-4(a)(4). *See supra* notes 225-229 and accompanying text for a discussion of the proposed condition.

325 Proposed rule 12d1-4(b)(1). *See supra* note 221 and accompanying text for a discussion of the proposed condition.

326 Proposed rule 12d1-4(b)(2). *See supra* note 222 and accompanying text for a discussion of the proposed safe harbor.

shareholders.[327] The exemptive application process also involves other indirect costs. ETFs that apply for an order to permit other funds to make additional investments in the ETFs beyond the limits of section 12(d)(1) and funds that would rely on the order issued to the ETF forgo potentially beneficial investments until the ETFs receive the order,[328] while other ETFs (and funds that would rely on the order if issued to the ETF) forgo the investment entirely rather than seek an exemptive order because they have concluded that the cost of seeking an exemptive order would exceed the anticipated benefit of the investment.

Unlike the orders, proposed rule 12d1-4 would not provide an exemption permitting acquiring funds to redeem ETF shares acquired in excess of the three percent limit in section 12(d)(1)(A)(i) of the Act in reliance on the proposed rule. This was designed to limit the potential for an acquiring fund to threaten large-scale redemptions as a means of coercing an ETF.[329] Accordingly, the conditions in the proposed rule differ from those in the exemptive orders. The proposed rule would not include: (i) the participation agreement requirement; (ii) the transmission by an acquiring fund of a list of certain of its affiliates to the ETF; (iii) certain policies and procedures designed to limit the influence an acquiring fund can exert on the ETF; and (iv) limits on certain fees. Elimination of these conditions would reduce regulatory burdens and the cost of compliance for funds that seek to invest in ETFs, facilitating

---

327 We estimate, based on discussions with fund representatives, that the cost of obtaining an exemptive order permitting an acquiring fund to invest in an ETF beyond the limits of section 12(d)(1) ranges from approximately $75,000 to $200,000.

328 Although these applications for relief are typically processed expeditiously, Commission staff estimates, based on orders issued in the past, that the exemptive application process (from initial filing to issuance of order) has taken on average about 15 months. During that time, Commission staff review and comment on applications, applicants submit responses to comments, and the completed application is summarized in a notice to the public. If an application contains a request for relief in addition to the relief from section 12(d)(1) of the Act, the application process has often taken longer than 15 months.

329 *See supra* note 220 and accompanying and following text.

greater participation by funds in the purchase and sale of ETF shares both directly with the ETF and in secondary market transactions.[330] Although the proposed rule would not allow acquiring funds to redeem certain shares from the ETF, we understand that acquiring funds generally sell ETF shares in secondary market transactions, rather than redeem them. Accordingly, we believe that this prohibition would have minimal impact on acquiring funds. Moreover, the adoption of proposed rule 12d1-4 would not preclude an acquiring fund from continuing to rely on exemptive orders we have previously issued or seeking new orders to permit funds to invest in ETFs in excess of the limits of section 12(d)(1) but which do not restrict their ability to redeem ETF shares, subject to the conditions set forth in the orders and described above.

In order to allow acquiring funds to take full advantage of the exemptive relief, proposed rule 12d1-4 also would provide limited relief from rule 17e-1 under the Act. If an investment company in one complex acquired more than five percent of the assets of an ETF in another complex, any broker-dealer affiliated with that ETF would become a (second-tier) affiliated person of the acquiring fund.[331] As a result of the affiliation, the broker-dealer's fee for effecting the sale of securities to (or by) the acquiring fund would be subject to the conditions set forth in rule 17e-1, including the quarterly board review and recordkeeping requirements with respect to certain securities transactions involving the affiliated broker-dealer.[332] The proposed rule would permit an acquiring fund to pay commissions, fees, or other remuneration to a (second-tier) affiliated broker-dealer without complying with the quarterly board review and recordkeeping

[330] Based on discussions with fund representatives, we estimate that the cost of negotiating and entering into a participation agreement (and for an acquiring fund preparing the initial list of affiliates) required by our exemptive orders ranges from approximately $5,000 to $10,000. We estimate that the cost to an acquiring fund to review and update its list of affiliates each year as required by our exemptive orders ranges from approximately $4,000 to $15,000.

[331] *See supra* note 239.

[332] *See supra* note 245.

requirements set forth in rules 17e-1(b)(3) and 17e-1(d)(2).[333] This relief would be available only if the broker-dealer and the acquiring fund became affiliated solely because of the acquiring fund's investment in the ETF. We believe that this relief would enable more funds to take advantage of the exemption provided by the proposed rule.

2. Costs

We do not believe that the rule will impose mandatory costs on any fund. As discussed above, the rule is exemptive, and we believe that a fund would not rely on it if the anticipated benefits did not justify the costs. We believe the costs of relying on the rule would be less than the costs to an acquiring fund (and ETF) that relies on an existing exemptive order to invest in (or sell) ETF shares because the rule includes substantially fewer conditions than existing orders that provide similar exemptive relief with respect to purchases and sales of ETF shares.

In order to rely on the proposed rule for an exemption from section 12(d)(1)(B) limits, an ETF may not redeem and its principal underwriter, or a broker or dealer may not submit for redemption any of the ETF's shares that were acquired by an acquiring fund in excess of the limits of section 12(d)(1)(A)(i) of the Act in reliance on proposed rule 12d1-4.[334] The proposed rule provides a safe harbor for these entities if the entity has (i) received a representation from the acquiring fund that none of the ETF shares it is redeeming was acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the rule, and (ii) no reason to believe that the acquiring fund is redeeming any ETF shares that the acquiring fund acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the rule.[335]

---

333 *See supra* note 247 and accompanying text.

334 *See* proposed rule 12d1-4(b)(1).

335 *See* proposed rule 12d1-4(b)(2). We believe that the costs associated with this safe harbor would not be significant. Only acquiring funds that intend to redeem less than three percent of an ETF's (footnote continued)

As noted above, we understand that acquiring funds that invest in ETFs generally do not redeem their shares from the ETF, but rather sell them in secondary market transactions. We also believe that an acquiring fund that would not rely on proposed rule 12d1-4 to acquire ETF shares (*i.e.*, an acquiring fund that acquires 3 percent or less of an ETF's outstanding voting securities) would be less likely to redeem shares because it would be less likely to have a sufficient number of shares to permit the acquiring fund to redeem its shares.[336] We estimate that ETFs, their principal underwriters, and brokers and dealers in the aggregate would choose to rely on the safe harbor to redeem or submit a redemption order with respect to ETF shares that were not acquired in reliance on proposed rule 12d1-4 on average two times each year with respect to each ETF.[337] We believe that the total annual cost for making this representation would be $70,080.[338]

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide specific data that would allow us to make more accurate estimates.

The rule would affect different types of sponsors or advisers in different ways. A sponsor or adviser that has not sought and would not seek exemptive relief to permit another fund to invest in its shares beyond the limits of section 12(d)(1) of the Act would not be affected by the rule. The cost for a sponsor or adviser that currently relies on exemptive relief covered by the

shares could provide the representations required under the safe harbor.

336 ETF shares are generally redeemed only in creation unit aggregations. A creation unit typically consists of at least 25,000 shares. *See supra* note 113.

337 We recognize that some ETFs may receive more redemption requests from acquiring funds and may rely on the safe harbor more often, while other ETFs may receive no redemption requests or may not choose to rely on the safe harbor when they receive a redemption request from an acquiring fund.

338 *See supra* notes 294-296 and accompanying text.

rule would be less than the costs of relying on its exemptive order because the proposed rule contains substantially fewer conditions than existing orders. In addition, a sponsor or adviser that currently relies on an exemptive order could satisfy all the conditions of the proposed rule that provides similar exemptive relief with respect to purchases and sales of ETF shares without changing its operation. Finally, a sponsor or adviser that has not relied on an exemptive order and that intends to rely on the proposed rule would avoid the cost of obtaining an exemptive order and would incur lower continuing costs to comply with the conditions included in the proposed rule than it would have borne had it obtained an exemptive order.

D. Amendments to Rule 12d1-2

1. Benefits

The proposed amendments to rule 12d1-2 would expand the type of investments that funds relying on the exemptive relief in section 12(d)(1)(G) of the Act could make. The proposed amendments 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.[339] We also propose to amend rule 12d1-2 to allow funds relying on section 12(d)(1)(G) to invest in assets other than securities.[340] Under the proposed rule, funds relying on the exemptive relief in section 12(d)(1)(G) would be able to invest in, among other things, futures contracts, options, swaps, other derivative investments, and other financial instruments that do not qualify as a security under the Act. Those investments would, of course, have to be consistent with the fund's investment policies.[341]

---

[339] Proposed rule 12d1-2(a)(4).

[340] Proposed rule 12d1-2(a)(5).

[341] *See* Item 4 of Form N-1A (requiring disclosure of funds' investment objectives and principal investment strategies).

We believe that including these types of investment opportunities would permit funds to allocate their investments more efficiently.

2. Costs

Rule 12d1-2 (and the proposed amendments to the rule) does not impose any conditions on its reliance and thus a fund would not incur any costs in relying on the rule.

E. Request for Comment

The Commission requests comment on the potential costs and benefits of the proposed rules and rule amendments. We also request comment on the potential costs and benefits of any alternatives suggested by commenters. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits. For purposes of the Small Business Regulatory Enforcement Act of 1996,[342] the Commission also requests information regarding the potential annual effect of the proposals on the U.S. economy. Commenters are requested to provide empirical data to support their views.

IX. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[343]

A. Proposed Rules 6c-11

Proposed rule 6c-11 would codify much of the relief and conditions of exemptive orders that we have issued to ETFs. The rule would provide relief to ETFs by permitting an ETF to

---

342 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

343 15 U.S.C. 80a-2(c).

operate without first obtaining an exemptive order from the Commission. As noted above, the direct and indirect costs of the exemptive application process may discourage potential ETF sponsors. The proposed rule also would not include conditions contained in exemptive orders designed to address particular concerns that we now believe are addressed by other provisions of the federal securities laws.[344] Eliminating the need for individual exemptive relief and compliance with specific conditions may reduce costs of introducing and operating an ETF, and may permit additional opportunities for sponsors to introduce new ETFs, particularly smaller sponsors interested in offering smaller, more narrowly focused ETFs which may serve particular investment needs of certain investors. We therefore anticipate that the proposed rule would, over time, lead to an increase in ETFs.

We expect that the proposal is likely to increase competition and efficiency. By making it easier for sponsors, particularly smaller sponsors, to introduce ETFs, the proposal should allow more sponsors to enter the marketplace, thereby increasing competition among ETF sponsors. The resulting increase in ETFs that we expect also should increase competition and innovation among funds. The proposal also should promote efficiency because the increase in ETFs should provide investors with more investments that may be specifically tailored to their particular investment objectives. We do not expect the proposed rule would have an adverse impact on capital formation.

B. Amendments to Form N-1A

The proposed amendments to Form N-1A are designed to provide more useful information to investors (including retail investors) who purchase shares in the secondary market, rather than institutional investors purchasing creation units from the ETF. The proposed

[344] *See supra* Section III.B.5. of this release for a discussion of these conditions.

amendments would require ETFs, in addition to providing returns based on NAV, to include returns based on the market price of fund shares, and to disclose in the ETF prospectus the number of trading days on which the market price of the ETF shares was greater than the ETF's NAV and the number of days it was less than the ETF's NAV (premium/discount information). This information should promote more efficient allocation of investments by investors and more efficient allocation of assets among competing ETFs because investors may compare and choose ETFs based on their market returns and deviations from NAV more easily. These amendments also should improve competition because they may prompt sponsors to launch ETFs that provide improved market price returns or lesser premiums/discounts. We do not believe the proposed amendments would have an adverse impact on capital formation.

C. Proposed Rule 12d1-4 and Amendments to Rule 12d1-2

Proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 would expand the circumstances in which funds can invest in ETFs without the ETF first obtaining an exemptive order from the Commission, which can be costly and time-consuming. We anticipate that the proposed rule and amendments would promote efficiency and competition. Proposed rule 12d1-4 would permit funds to acquire shares of ETFs in excess of the limitations in section 12(d)(1) of the Act. This exemption should allow acquiring funds to allocate their investments more efficiently by expanding their investment options to include holdings in ETFs beyond the limits of section 12(d)(1) in order to meet the funds' investment objectives. We also anticipate that the proposed rule would promote efficiency because permitting funds to buy creation units might benefit other ETF investors buying and selling ETF shares in secondary market transactions by increasing the number of institutional investors participating in the arbitrage process. The proposed rule might promote competition by increasing the pool of ETFs that accept investments by other funds beyond section 12(d)(1) limits. Proposed rule 12d1-4 would eliminate the need for ETFs to obtain an exemptive order from the Commission, the cost of which might discourage ETFs, particularly smaller ETFs, from accepting or seeking fund investments beyond section 12(d)(1) limits.[345]

The proposed rule would provide relief from section 17(e) for funds that execute transactions with certain broker-dealers affiliated with ETFs in which the acquiring funds invest. This relief, which is not included in our exemptive orders, should allow more funds to take full advantage of the exemption provided by the rule, thereby increasing the potential that the proposed rule would promote efficiency and competition.[346]

The proposed amendments to rule 12d1-2 expand the investment options for funds that rely on the exemption in section 12(d)(1)(G) of the Act to include investments in unaffiliated ETFs beyond the section 12(d)(1) limits and assets other than securities. This expansion of investment opportunities could permit funds to allocate their investments more efficiently. This may allow a fund to compete more effectively. We do not expect that proposed rule 12d1-4 or the proposed amendments to rule 12d1-2 would have an adverse impact on capital formation.[347]

X. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with 5 U.S.C. 603. It relates to proposed new rules 6c-11 and 12d1-4 and proposed amendments

---

345 As noted above, the proposed rule also would not incorporate many of the conditions contained in our exemptive orders. The compliance costs of such conditions might otherwise discourage ETFs, particularly small ETFs, from accepting or seeking fund investments beyond section 12(d)(1) limits. *See supra* note 330 and accompanying and following text. By eliminating most of the conditions from our exemptive orders, more ETFs may accept and seek fund investments in their shares.

346 *See supra* Section IV.C.3 for a discussion of the proposed exemption.

347 While proposed rule 12d1-4 may result in additional investments in ETFs, we do not anticipate that the rule would have a significant impact on capital formation.

to rule 12d1-2 under the Investment Company Act, and to Form N-1A under the Investment Company Act and the Securities Act.

A. Reasons for the Proposed Actions

1. ETFs

As described more fully in Sections I and III of this release, we are proposing rule 6c-11 to allow new ETFs to enter the market without first obtaining an exemptive order from the Commission.[348] The proposed rule would codify and expand upon the exemptive orders we have issued to ETFs allowing them to form and operate. In conjunction with proposed rule 6c-11, we also are proposing amendments to Form N-1A, as described more fully in Sections I and III.D of this release, to provide more useful information to investors who purchase and sell ETF shares on a securities exchange.

2. Investment Company Investments in ETFs

As described more fully in Sections I and IV of this release, we are proposing new rule 12d1-4 to permit funds to invest in shares of ETFs beyond the limits of section 12(d)(1)(A) without first obtaining an exemptive order from the Commission. The proposed rule would codify exemptions provided in orders we have issued permitting funds to invest in ETFs beyond the Act's limits. We also are proposing amendments to rule 12d1-2, as described more fully in Section V of this release, to expand the investment options available to funds that rely on Section 12(d)(1)(G) of the Act.

---

[348] Our exemptive orders have provided ETFs with relief from a number of sections in the Act in order to allow them to operate. *See supra* Section III.C.

B. Objectives of the Proposed Actions

1. ETFs

As described more fully in Sections I and III of this release, the objectives of the proposed rule 6c-11 are to allow new ETF competitors to enter the market more easily and eliminate certain conditions contained in the outstanding orders that we now believe may be unnecessary. As described more fully in Sections I and III.D of this release, the objective of the proposed amendments to Form N-1A is to provide more useful information to individual investors who purchase and sell ETF shares on national securities exchanges.

2. Investment Company Investments in ETFs

As more fully described in Sections I and IV of this release, proposed rule 12d1-4 is intended to allow funds to invest more easily in ETFs beyond the limits of section 12(d)(1) of the Act subject to certain conditions designed to protect investors. As more fully described in Section V of this release, the proposed amendments to rule 12d1-2 are intended to expand the investments options available to funds that rely on section 12(d)(1)(G) to include:
(i) investments in unaffiliated ETFs beyond the limits of section 12(d)(1) of the Act consistent with proposed rule 12d1-4; and (ii) other non-securities assets, which do not appear to raise concerns that the investment limits of section 12(d)(1)(G) were intended to address. The proposed amendments to rule 12d1-2 would provide funds relying on section 12(d)(1)(G) with greater flexibility to meet their investment objectives.

C. Legal Basis

The statutory authority for proposed rules 6c-11 and 12d1-4 and the proposed amendments to rule 12d1-2 and Form N-1A is set forth in Section XI of this release.

D. Small Entities Subject to the Proposed Rule and Amendments

A small business or small organization (collectively, "small entity") for purposes of the Regulatory Flexibility Act[349] is a fund that, together with other funds in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[350] Of approximately 601 ETFs (593 registered open-end investment companies and 8 registered UITs), only 1 (an open-end fund) is a small entity.[351] There are approximately 145 fund complexes[352] and 43 business development companies[353] that are small entities that could choose to rely on proposed rule 12d1-4 to invest in ETFs beyond the limits of section 12(d)(1).

1. ETFs

Commission staff expects proposed rule 6c-11 and amendments to Form N-1A would have little impact on small entities. Like other funds, small entities would be affected by proposed rule 6c-11 and the proposed amendments to Form N-1A only if they determine to rely on rule 6c-11 to operate as an ETF. Small entities that are open-end ETFs and currently rely on an exemptive order also would be affected by the proposed amendments to Form N-1A. Commission staff estimates that only one of the 61 orders permitting funds to operate as ETFs was issued to a small entity. The staff anticipates that the number of funds, including small

---

[349] 5 U.S.C. 601-612.

[350] 17 CFR 270.0-10.

[351] For purposes of this IRFA, any series or portfolio of an ETF is considered a separate ETF. Therefore, there are 601 portfolios or series of registered investment companies operating as ETFs. For purposes of determining whether a fund is a small entity under the Regulatory Flexibility Act, however, the assets of funds (including each portfolio and series of a fund) in the same group of related investment companies are aggregated.

[352] The 145 fund complexes contain in the aggregate 160 funds that are small entities. This estimate is derived from data reported on Forms N-SAR and N-CSR filed with the Commission for the period ending June 30, 2007.

[353] This estimate is based on data reported on Forms 10-K and 10-Q filed with the Commission for the period ending June 30, 2007.

funds, that would operate as an ETF under proposed rule 6c-11 and also therefore be subject to the disclosure requirements contained in the proposed amendments to Form N-1A would increase as compared with the number of applicants. Nevertheless, the staff believes that the proportion of small entities compared to the total number of funds that operate as ETFs would remain small.

2. Investment Company Investments in ETFs

Commission staff expects proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 to have little impact on small entities. Like other funds, small entities would only be affected by the rule and the amendments if they determine to rely on the exemptions provided by the proposed rule and amendments.[354] Commission staff estimates that none of the approximately 15 exemptive orders issued to ETFs allowing other funds to invest in the ETFs beyond the limits of section 12(d)(1) was issued to a small entity. Similarly, none of the applications that has sought to allow a fund that relied on section 12(d)(1)(G) of the Act to invest in securities other than funds in the same complex, government securities, and short-term paper was a small entity. The staff anticipates that the number of funds, including small funds, that would rely on the proposed rule and rule amendments would be greater than the number of funds that currently rely on exemptive orders. Nevertheless, the staff believes that the proportion of small entities compared to the total number of funds that would rely on the proposed rule and rule amendments would be small.

---

[354] Small acquiring funds could choose to rely on the proposed rule to invest in ETFs beyond the limits of section 12(d)(1)(A) of the Act, and small ETFs could choose to rely on the rule to sell their shares to other funds beyond the limits of section 12(d)(1)(B) of the Act. Small acquiring funds that rely on section 12(d)(1)(G) of the Act could choose to rely on the proposed amendments to rule 12d1-2 to invest in ETFs in reliance on proposed rule 12d1-4 and to invest in assets other than securities.

E. Reporting, Recordkeeping, and Other Compliance Requirements

1. ETFs

Proposed rule 6c-11 would not impose any recordkeeping requirements on any person and would not materially increase other compliance requirements. Proposed rule 6c-11 would impose reporting requirements on funds that choose to rely on the rule.[355] Funds relying on the rule would have to disclose: (i) the foreign holidays that would prevent timely satisfaction of a redemption request;[356] (ii) the basket assets;[357] (iii) the number of shares in a creation unit;[358] (iv) the fund's NAV, the market closing price for its shares, and the premium/discount between its NAV and the market closing price daily on its Internet Web site;[359] and (v) the identities and weightings of the component securities and other assets held by the fund.[360] The proposed rule also would impose compliance requirements on ETFs that are essential to the operation of an ETF. A fund that chose to rely on the proposed rule would be required to have (i) its shares

---

355 In addition to the reporting requirements, the proposed rule, unlike most of the ETF exemptive orders, would not include relief from section 24(d) of the Act and thus broker-dealers would be required to deliver prospectuses to investors in secondary market transactions. We also propose to amend the existing ETF exemptive orders issued to open-end funds to eliminate the section 24(d) exemptions and require ETFs relying on the orders to satisfy their prospectus delivery requirements. We understand that many, if not most, broker-dealers selling ETF shares in secondary market transactions, in fact, transmit a prospectus to purchasers. Therefore, we anticipate that the proposed amendment to the ETF orders would have little if any impact on ETFs, including small ETFs.

356 Proposed rule 6c-11(c)(1). Funds would have to disclose this information in their registration statements (Form N-1A) and in any sales literature.

357 Proposed rule 6c-11(e)(1).

358 Proposed rule 6c-11(e)(3). Funds would have to disclose this information in their registration statements (Form N-1A) and in any sales literature.

359 Proposed rule 6c-11(e)(4)(iii), (iv).

360 Proposed rule 6c-11(e)(4)(iv)(A). If the fund has a stated investment objective of obtaining returns that correspond to the returns of a securities index, reliance on the proposed rule would be conditioned on the ETF tracking an index whose provider discloses on its Internet Web site the identities and weightings of the component securities and other assets of the index in lieu of disclosure on the fund's Internet Web site. Proposed rule 6c-11(e)(4)(iv)(B).

approved for listing and trading on a national securities exchange,[361] and (ii) the Intraday Value of the basket assets disseminated at regular intervals during the day by a national securities exchange.[362]

Proposed rule 6c-11 may benefit fund shareholders by allowing funds to operate as ETFs without incurring the costs and delays associated with the exemptive application process and without having to comply with some of the conditions included in the exemptive orders. While the rule would require ETFs to comply with reporting and compliance requirements, these requirements would not involve any new costs for ETFs because these requirements (as well as additional requirements) are included in the ETF exemptive orders.

The proposed amendments to Form N-1A would impose reporting requirements on open-end funds that operate as ETFs. The proposed amendments would require an ETF to disclose in its prospectus and annual reports: (i) returns based on the market price of its shares;[363] (ii) the number of trading days on which the market price of its shares was greater than its NAV and the number of days it was less than its NAV (premium/discount information);[364] and (iii) a

---

361 Proposed rule 6c-11(e)(4)(iii).

362 Proposed rule 6c-11(e)(4)(i).

363 Proposed Instruction 5(a) to Item 2(c)(2) of Form N-1A; Proposed Instruction 3(f) to Item 8(a) of Form N-1A; Proposed Instruction 12(b) to Item 22(b)(7) of Form N-1A. Form N-1A currently only requires an ETF to disclose in its prospectus its return based on its NAV. The annual reports also would have to contain a new line graph comparing the initial and subsequent account values using market price, following the line graph using NAV required by Item 22(b)(7)(ii)(A) of Form N-1A. Proposed Instruction 12(a) to Item 22(b)(7) of Form N-1A.

364 Proposed Item 6(h)(4) of Form N-1A (requiring proposed premium/discount information in the prospectus to span the most recently completed calendar year and quarters since that year); Proposed Item 22(b)(7)(iv) of Form N-1A (requiring proposed premium/discount information disclosed in annual reports to span five fiscal years). The ETF would be required to present premiums or discounts as a percentage of NAV and to explain that shareholders may pay more than NAV when purchasing shares and receive less than NAV when selling, because shares are bought and sold at market prices. Proposed Instructions 2,3 to Item 6(h)(4) of Form N-1A; Proposed Instruction (b), (c) to Item 22(b)(7)(iv).

comparison of its performance, if it is an index-based ETF, to its underlying index rather than a benchmark index.[365] The proposed amendments also would require the ETF to disclose in its prospectus the trading symbol(s) and principal U.S. market(s) on which its shares are traded.[366]

The proposed amendments to Form N-1A also would eliminate some disclosure requirements for ETFs with creation units of 25,000 or more shares and replace them with fewer disclosures. Under the proposed amendments, those ETFs would not have to: (i) disclose information on how to buy and redeem shares of ETF;[367] or (ii) include in its fee table in its prospectus or annual and semi-annual reports fees and expenses for purchases or sales of creation units.[368]

The amendments to Form N-1A are designed to accommodate the use of the form by ETFs and to meet the needs of investors (including retail investors) who purchase ETF shares in secondary market transactions rather than institutional investors purchasing creation units directly from the ETF. We believe that the amendments would have a negligible impact (if any) on the disclosure burdens on ETFs while providing necessary information to ETF investors. We do not believe that the proposed amendments to Form N-1A would disproportionately impact small funds.

---

365 Proposed Instruction 5(b) to Item 2(c)(2) of Form N-1A; Proposed Instruction 12(c) to Item 22(b)(7) of Form N-1A.

366 Proposed Item 6(h)(2) of Form N-1A.

367 Proposed Item 6(h)(1) of Form N-1A. Instead ETF prospectuses could simply state that individual fund shares can only be bought and sold on the secondary market through a broker-dealer. Proposed Item 6(h)(3) of Form N-1A.

368 Proposed Instruction 1(e)(i) to Item 3 of Form N-1A; Proposed Instruction 1(e)(i) to Item 22(d) of Form N-1A. An ETF would instead modify the narrative explanation preceding the example in the fee table to state that fund shares are sold on the secondary market rather than redeemed at the end of the periods indicated, and that investors in its shares may be required to pay brokerage commissions that are not reflected in the fee table. Proposed Instruction 1(e)(ii) to Item 3 of Form N-1A; Proposed Instruction 1(e)(ii) to Item 22(d) of Form N-1A.

2. Investment Company Investments in ETFs

Proposed rule 12d1-4 and the proposed amendments to rule 121-2 would not impose any reporting or recordkeeping requirements. The proposed amendments to rule 12d1-2 also would not impose any new compliance requirements on any person. Proposed rule 12d1-4 would impose compliance requirements on funds that choose to rely on it. Proposed rule 12d1-4 would permit fund investments in ETFs beyond the limits of section 12(d)(1) if: (i) the acquiring fund (and any entity in a control relationship with the acquiring fund) does not control the ETF;[369] (ii) the acquiring fund does not redeem certain shares acquired in reliance on the proposed rule;[370] (iii) the fees charged by the acquiring fund do not exceed the FINRA sales charge limits;[371] and (iv) the acquired ETF is not itself a fund of funds (*i.e.*, the rule would prohibit a fund of funds of funds, or three-tier fund, structure).[372] In addition, an ETF could not redeem, and its principal underwriter, a broker or a dealer could not submit for redemption ETF shares acquired in reliance on proposed rule 12d1-4.[373] These compliance requirements, however, would not impose any new costs on acquiring funds or ETFs. Most of these conditions (as well as number of other conditions which are not included in the proposed rule) are included in the exemptive orders that currently permit fund investments in ETFs beyond the limits of section 12(d)(1). We do not anticipate that the additional conditions prohibiting redemptions would impose

---

369 Proposed rule 12d1-4(a)(1). *See supra* notes 215-219 and accompanying text for a discussion of the proposed condition.

370 Proposed rule 12d1-4(a)(2). *See supra* note 220 and accompanying and following text for a discussion of the proposed condition.

371 Proposed rule 12d1-4(a)(3). *See supra* notes 230-233 and accompanying text for a discussion of the proposed condition.

372 Proposed rule 12d1-4(a)(4). *See supra* notes 225-229 and accompanying text for a discussion of the proposed condition.

373 Proposed rule 12d1-4(b)(1). *See supra* note 221 and accompanying text for a discussion of the proposed condition.

significant, if any, new costs on acquiring funds or ETFs because we understand that most funds do not redeem shares with ETFs, but sell their shares in secondary market transactions.

F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission has not identified any federal rules that duplicate, overlap, or conflict with the proposed rules or rule amendments.

G. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed rules and amendments, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for small entities.

1. ETFs

Proposed rule 6c-11 is exemptive and compliance with the rule would be voluntary. We therefore do not believe that special compliance, timetable, or reporting requirements, or an exemption from coverage of the proposed rule for small entities would be appropriate. In addition, as discussed above, only one fund that meets the definition of a small entity currently relies on an exemptive order to operate as an ETF. Therefore, few of the entities that would be affected by the proposed rule would be considered to be small entities. The Commission also believes that proposed rule 6c-11 would decrease burdens on small entities by making it unnecessary for them to seek an exemptive order from the Commission allowing them to operate as ETFS and by eliminating some of the conditions included in the exemptive orders from the proposed rule. As a result, we do not anticipate the potential impact of the proposed rule on small entities would be significant. For these reasons, alternatives to the proposed rule appear unnecessary and in any event are unlikely to minimize any impact that the proposed rule might have on small entities.

The proposed amendments to Form N-1A would only apply to funds that choose to rely on proposed rule 6c-11 or that rely on an exemptive order to operate as an ETF. As discussed above, the proposed amendments to Form N-1A are designed to accommodate the use of the form by ETFs and to meet the needs of investors (including retail investors) who purchase ETF shares in secondary market transactions rather than institutional investors purchasing creation units directly from the ETF. Therefore, we believe that any further clarification, consolidation, or simplification of the proposed amendments would not be consistent with the protection of investors. An exemption for small entities also would defeat the purposes of the amendments.

2. Investment Company Investments in ETFs

Proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 are exemptive and compliance with proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 would be voluntary. We therefore do not believe that special compliance, timetable, or reporting requirements, or an exemption from coverage of the proposed rule or the proposed amendments to rule 12d1-2 for small entities would be appropriate. The Commission believes that proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 would decrease burdens on small entities by making it unnecessary for them to seek an exemptive order from the Commission allowing them to sell their shares to other funds beyond the limits in section 12(d)(1)(B) of the Act or to allow small entities that rely on section 12(d)(1)(G) to invest in assets other than securities and ETFs beyond the limits of section 12(d)(1). In addition, proposed rule 12d1-4 has a limited number of conditions, most of which are included in the exemptive orders. The proposed amendments to rule 12d1-2 do not impose any compliance requirements. As a result the potential impact of the proposed rule and amendments on small entities should not be significant. For these reasons, alternatives to the proposed rule and amendments seem unnecessary and, in any event, unlikely to minimize any impact that the proposed rule and amendments might have on small entities.

H. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this IRFA. Comment is specifically requested on the number of small entities that would be affected by the proposed rules and amendments, and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting its extent. These comments will be considered in connection with any adoption of the proposed rule and amendments, and reflected in a Final Regulatory Flexibility Analysis.

Comments should be submitted in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Comments also may be submitted electronically to the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-07-08, and this file number should be included on the subject line if e-mail is used.[374] Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 100 Fifth Street, NE, Washington, DC 20549-1520, on official business days between the hours of 10:00 am and 3:00 pm.

---

[374] Comments on the IRFA will be placed in the same public file that contains comments on the proposed rules and amendments.

Electronically submitted comment letters also will be posted on the Commission's Internet Web site (http://www.sec.gov).

XI. STATUTORY AUTHORITY

The Commission is proposing rule 6c-11 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c) and 80a-37(a)]. The Commission is proposing amendments to rule 12d1-2 and new rule 12d1-4 pursuant to the authority set forth in sections 6(c), 12(d)(1)(J), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-12(d)(1)(J), and 80a-37(a)]. The Commission is proposing amendments to registration form N-1A under the authority set forth in sections 6, 7(a), 10 and 19(a) of the Securities Act of 1933 [15 U.S.C. 77f, 77g(a), 77j, 77s(a)], and sections 8(b), 24(a), and 30 of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-24(a), and 80a-29].

List of Subjects

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULES AND FORM AMENDMENTS

For reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

1. The authority citation for Part 239 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78*l*, 78m, 78n, 78o(d), 78u-5, 78w(a), 78*ll*, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

PART 270--RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

2. The authority citation for Part 270 is amended by adding the following citation to read as follows:

Authority: 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

* * * * *

Section 270.6c-11 is also issued under 15 U.S.C. 80a-6(c) and 80a-37(a).

* * * * *

3. The specific authority citation for §§ 270.12d1-1, 270.12d1-2 and 12d1-3 is revised to read as follows:

Authority: * * *

* * * * *

Sections 270.12d1-1, 270.12d1-2, 270.12d1-3, and 12d1-4 are also issued under 15 U.S.C. 80a-6(c), 80a-12(d)(1)(J), and 80a-37(a).

* * * * *

4. Section 270.6c-11 is added to read as follows:

§ 270.6c-11 Exchange-traded funds.

(a) *Redeemable securities.* Exchange-traded fund shares are considered “redeemable securities” for purposes of section 2(a)(32) of the Act (15 U.S.C. 80a-2(a)(32)).

(b) *Pricing.* A dealer in exchange-traded fund shares is exempt from section 22(d) of the Act (15 U.S.C. 80a-22(d)) and § 270.22c-1(a) with regard to purchases, sales and repurchases of exchange-traded fund shares in the secondary market at the current market price.

(c) *Postponement of redemption.* If an exchange-traded fund includes a foreign security in its basket assets and a foreign holiday prevents timely delivery of the foreign security in response to a redemption request, the fund is exempt, with respect to the foreign security, from the prohibition in section 22(e) of the Act (15 U.S.C. 80a-22(e)) against postponing the date of satisfaction upon redemption for more than seven days after the tender of a redeemable security, if:

(1) The exchange-traded fund discloses in its registration statement the foreign holidays that it expects may prevent timely delivery of foreign securities, and the maximum number of days that it anticipates it will need to deliver the foreign securities; and

(2) Foreign securities are delivered no later than 12 calendar days after the tender of the exchange-traded fund shares.

(d) *Affiliated transactions.* A person who is an affiliated person of an exchange-traded fund solely by reason of holding with the power to vote 5 percent or more, or more than 25 percent, of securities issued by the exchange-traded fund (or who is an affiliated person of such a person), or issued by an investment company under common control with the exchange-traded fund, is exempt from sections 17(a)(1) and 17(a)(2) of the Act (15 U.S.C. 80a-17(a)(1) and (a)(2)) with regard to the deposit and delivery of basket assets. An investment company that has acquired exchange-traded fund shares in reliance on § 270.12d1-4 may not rely on this paragraph with regard to the purchase of basket assets.

(e) *Definitions.* For purposes of this section:

(1) *Basket assets* are the securities or other assets specified each business day in name and number by an exchange-traded fund as the securities or assets in exchange for which it will

issue or in return for which it will redeem exchange-traded fund shares; *provided that* the fund may require or permit a purchaser (or redeemer) of a creation unit to substitute cash for some or all of the securities in the basket assets.

(2) *Business day* means, with respect to an exchange-traded fund, any day that the fund is open for business, including any day on which it is required to make payment under section 22(e) of the Act (15 U.S.C. 80a-22(e)).

(3) *Creation unit* is a specified number of exchange-traded fund shares disclosed in the exchange-traded fund's prospectus that the fund will issue (or redeem) in exchange for the deposit (or delivery) of basket assets. The creation unit must be reasonably designed to facilitate the purchase (or redemption) of shares from the exchange-traded fund with an offsetting sale (or purchase) of shares on a national securities exchange at as nearly the same time as practicable for the purpose of taking advantage of a difference in the current value of basket assets on a per share basis and the current market price of the shares.

(4) *Exchange-traded fund* is a registered open-end management company that:

(i) Issues (or redeems) creation units in exchange for the deposit (or delivery) of basket assets the current value of which is disseminated on a per share basis by a national securities exchange at regular intervals during the trading day;

(ii) In any sales literature, identifies itself as an exchange-traded fund, which does not sell or redeem individual shares, and explains that investors may purchase or sell individual exchange-traded fund shares on a national securities exchange;

(iii) Issues shares that are approved for listing and trading on a national securities exchange under section 12(d) (15 U.S.C. 78*l*(d)) of the Securities Exchange Act of 1934 and rule 12d1-1 (17 CFR 240.12d1-1) thereunder;

(iv) Discloses each business day on its Internet Web site, which is publicly accessible at no charge, the prior business day's net asset value and closing market price of the fund's shares, and the premium or discount of the closing market price against the net asset value of the fund's shares as a percentage of net asset value; and

(v) Either:

(A) Discloses each business day on its Internet Web site, which is publicly accessible at no charge, the identities and weightings of the component securities and other assets held by the fund, or

(B) Has a stated investment objective of obtaining returns that correspond to the returns of a securities index specified in the fund's registration statement, and the index provider discloses on its Internet Web site, which is publicly accessible at no charge, the identities and weightings of the component securities and other assets of the index.

(5) *Exchange-traded fund share* is an equity security issued by an exchange-traded fund.

(6) *Foreign security* is any security issued by a government or any political subdivision of a foreign country, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign country, and for which there is no established United States public trading market as that term is used in Item 201 of Regulation S-K under the Securities Exchange Act of 1934 (17 CFR 229.201).

(7) *Index provider* is the person that determines the securities and other assets that comprise a securities index.

(8) *Sales literature* means any advertisement, pamphlet, circular, form letter, or other sales material addressed to or intended for distribution to prospective investors other than a registration statement filed with the Commission under section 8 of the Act (15 U.S.C. 80a-8).

(9) *Weighting of the component security* is the percentage of the index's value represented, or accounted for, by such component security.

5. Section 270.12d1-2 is amended by:

a. Revising the heading to paragraph (a);

b. Removing “and” at the end of paragraph (a)(2);

c. Removing the period at the end of paragraph (a)(3) and adding a “;”;

d. Adding paragraphs (a)(4) and (a)(5); and

e. Revising paragraph (b).

The additions and revisions read as follows:

§ 270.12d1-2 Exemptions for investment companies relying on section 12(d)(1)(G) of the Act.

(a) *Exemption to acquire other securities and assets*. * * *

(4) Securities issued by an exchange-traded fund, when the acquisition is in reliance on § 270.12d1-4; and

(5) Other assets.

(b) *Definitions*. For purposes of this section, “exchange-traded fund” has the same meaning as in § 270.12d1-4(d)(2) and “money market fund” has the same meaning as in § 270.12d1-1(d)(2).

6. Section 270.12d1-4 is added to read as follows:

§ 270.12d1-4 Exemptions for investments in exchange-traded funds.

(a) *Exemptions for acquisition of exchange-traded fund shares.* Notwithstanding sections 12(d)(1)(A), 17(a)(1), and 57(a)(1) of the Act (15 U.S.C. 80a-12(d)(1)(A), 15 U.S.C. 80a-17(a)(1), and 15 U.S.C. 80a-56(a)(1)), an investment company ("acquiring fund") may acquire exchange-traded fund shares if:

(1) *Control*. No acquiring fund or any of its investment advisers or depositors, and any company controlling, controlled by or under common control with the acquiring fund, or any of its investment advisers or depositors, each individually or together in the aggregate:

(i) Controls the exchange-traded fund; and

(ii) If, as a result of a decrease in the outstanding voting securities of the exchange-traded fund, any of those persons, each individually or together in the aggregate, become holders of more than 25 percent of the outstanding voting securities of the exchange-traded fund, each of those holders of shares issued by the exchange-traded fund will vote its shares of the exchange-traded fund in the manner prescribed by section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E)).

(2) *No redemption*. An acquiring fund that relies on paragraph (a) of this section to acquire exchange-traded fund shares in excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) does not redeem any of those shares. For purposes of this paragraph, an acquiring fund will be deemed to have redeemed or sold the most recently acquired exchange-traded fund shares first.

(3) *Fees*.

(i) Any sales charge, as defined in rule 2830(b)(8) of the Conduct Rules of the NASD ("sales charge"), or service fee, as defined in rule 2830(b)(9) of the Conduct Rules of the NASD ("service fee"), charged in connection with the purchase, sale, or redemption of securities issued by the acquiring fund does not exceed the limits set forth in rule 2830(d)(3) of the Conduct Rules of the NASD; and

(ii) With respect to a separate account that invests in an acquiring fund:

(A) The acquiring fund and exchange-traded fund do not charge a sales load;

(B) Any asset-based sales charge, as defined in rule 2830(b)(8)(A) of the Conduct Rules of the NASD, or service fee is charged only by the acquiring fund or the exchange-traded fund; and

(C) The fees associated with a variable insurance contract that invests in the acquiring fund and the sales charges and service fees charged by the acquiring fund and the exchange-traded fund, in the aggregate, must be reasonable in relation to the services rendered, the expenses expected to be incurred and, with respect to the variable insurance contract, the risks assumed by the insurance company.

(4) *Complex fund structures*. The exchange-traded fund has a disclosed policy that prohibits it from investing more than 10 percent of its assets in:

(i) Other investment companies in reliance on section 12(d)(1)(F) or section 12(d)(1)(G) of the Act (15 U.S.C. 80a-12(d)(1)(F) or 15 U.S.C. 80a-12(d)(1)(G)) or this section; and

(ii) Any other company that would be an investment company under section 3(a) of the Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided in sections 3(c)(1) and 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)).

(b) *Exemptions for sale of exchange-traded fund shares.*

(1) Notwithstanding sections 12(d)(1)(B), 17(a)(1), 17(a)(2), 57(a)(1), and 57(a)(2) of the Act (15 U.S.C. 80a-12(d)(1)(B), 15 U.S.C. 80a-17(a)(1), 15 U.S.C. 80a-56(a)(1), and 15 U.S.C. 80a-56(a)(2)), an exchange-traded fund, any principal underwriter thereof, and a broker or a dealer may sell or otherwise dispose of exchange-traded fund shares if the exchange-traded fund does not redeem, or the principal underwriter, broker or dealer does not submit for redemption any of the exchange-traded fund’s shares that were acquired by an acquiring fund in

excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) in reliance on paragraph (a) of this section. For purposes of this paragraph, an acquiring fund will be deemed to have redeemed or sold the most recently acquired exchange-traded fund shares first.

(2) An exchange-traded fund, a principal underwriter thereof, or broker or dealer will be deemed to have complied with the condition in paragraph (b)(1) of this section if it has:

(i) Received a representation from the acquiring fund that none of the exchange-traded fund shares it is redeeming was acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) in reliance on paragraph (a) of this section; and

(ii) No reason to believe that the acquiring fund is redeeming any exchange-traded fund shares that the acquiring fund acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) in reliance on paragraph (a) of this section.

(c) *Exemption from certain monitoring and recordkeeping requirements under § 270.17e-1*. Notwithstanding the requirements of §§ 270.17e-1(b)(3) and 270.17e-1(d)(2), the payment of a commission, fee, or other remuneration to a broker shall be deemed as not exceeding the usual and customary broker's commission for purposes of section 17(e)(2)(A) of the Act (15 U.S.C. 80a-17(e)(2)(A)) if:

(1) The commission, fee, or other remuneration is paid in connection with the sale of securities to or by an acquiring fund;

(2) The broker and the acquiring fund are affiliated persons because each is an affiliated person of the same exchange-traded fund; and

(3) The acquiring fund is an affiliated person of the exchange-traded fund solely because the acquiring fund owns, controls, or holds with power to vote five percent or more of the

outstanding securities of the exchange-traded fund.

(d) *Definitions.*

(1) *Depositor* includes the person primarily responsible for the organization of the unit investment trust, the person who has continuing functions or responsibilities with respect to the administration of the affairs of the trust, and the sponsor or manager of the trust.

(2) *Exchange-traded fund* has the same meaning as in § 270.6c-11(e)(4) and also includes a registered unit investment trust that satisfies the criteria set forth in § 270.6c-11(e)(4).

(3) *Exchange-traded fund share* has the same meaning as in § 270.6c-11(e)(5).

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

7. The authority citation for Part 274 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

* * * * *

8. Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

a. Adding the definitions “Exchange-Traded Fund” and “Market Price” in alphabetical order to General Instructions A.;

b. Adding paragraph 5 to the Instructions to Item 2 paragraph (c)(2);

c. Adding paragraph 1(e) to the Instructions to Item 3;

d. Revising paragraph 1(a) and adding paragraph (h) to Item 6;

e. Adding paragraph 3(f) to the Instructions to Item 8(a); and

f. Adding paragraph 12 to the Instructions to paragraphs (b)(7)(i) and (ii), paragraph (iv) to paragraph (b)(7), and paragraph 1(e) to the Instructions to paragraph (d) of Item 22.

The additions and revisions read as follows:

Note: The text of Form N-1A does not, and this amendment will not, appear in the Code of Federal Regulations.

Form N-1A

* * * * *

General Instructions

A. Definitions

* * * * *

"Exchange-Traded Fund" means a Fund whose shares are traded on a national securities exchange and satisfies the criteria set forth in rule 6c-11(e)(4) (17 CFR 270.6c-11(e)(4)).

* * * * *

"Market Price" refers to the last price at which Exchange-Traded Fund shares trade on the principal U.S. market on which the Fund's shares are traded during a regular trading session.

* * * * *

Item 2. Risk/Return Summary: Investments, Risks, and Performance

* * * * *

(c) *Principal risks of investing in the Fund*

* * * * *

(2) *Risk/Return Bar Chart and Table*

* * * * *

Instructions

* * * * *

5. *Exchange-Traded Funds.*

(a) Add a caption in the "Average Annual Total Returns" table directly above the caption titled "Index". Title the caption "Returns—Market Price". Disclose in the caption the Fund's average annual total return based on the Market Price for the periods indicated. In a footnote to the caption, explain how Market Price returns are calculated and how they differ from NAV returns.

(b) If the Fund has an investment objective of obtaining returns that correspond to the returns of a securities index, the table must show the average annual total returns of the securities index specified in its registration statement for the same periods. The Fund may exclude the returns of an appropriate broad-based securities market index as defined in Instruction 5 to Item 22(b)(7) for the same periods.

Item 3. Risk/Return Summary: Fee Table

* * * * *

Instructions

1. General.

* * * * *

(e) (i) If the Fund is an Exchange-Traded Fund and issues or redeems shares in creation units of not less than 25,000 shares each, exclude any fees charged for the purchase and redemption of the Fund's creation units.

(ii) Modify the narrative explanation to state that Fund shares are sold on a national securities exchange at the end of the time periods indicated, and that brokerage commissions for buying and selling Fund shares through a broker are not reflected.

* * * * *

Item 6. Shareholder Information

(a) * * *

(1) An explanation that the price of Fund shares is based on the Fund's net asset value and the method used to value Fund shares (market price, fair value, or amortized cost); except that if the Fund is an Exchange-Traded Fund, an explanation that the price of Fund shares is based on Market Price.

* * * * *

(h) *Exchange-Traded Funds*.

(1) If the Fund issues or redeems Fund shares in creation units of not less than 25,000 shares each, the Fund may omit from the prospectus the information required by Items 6(a)(2), (b) and (c).

(2) Identify the principal U.S. market or markets on which the Fund shares are traded and the trading symbol(s) for those shares, unless the information appears on the front cover page.

(3) Specify the number of Fund shares that the Fund will issue (or redeem) in exchange for the deposit (or delivery) of basket assets as defined in rule 6c-11 [17 CFR 270.6c-11] (*i.e.*, a creation unit) and explain that individual Fund shares may only be purchased and sold on a national securities exchange through a broker-dealer.

(4) *Premium/Discount Information.* Provide a table showing the number of days the Market Price of the Fund shares was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value for the most recently completed calendar year, and the most recently completed calendar quarters since that year, or the life of the Fund (if shorter).

Instructions.

1. Provide the information in tabular form.

2. Express the information as a percentage of the net asset value of the Fund, using separate columns for the number of days the Market Price was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value. Round all percentages to the nearest hundredth of one percent.

3. Adjacent to the table, provide a brief explanation that: shareholders may pay more than net asset value when they buy Fund shares and receive less than net asset value when they sell those shares, because shares are bought and sold at current market prices.

4. Include a statement that the data presented represents past performance and cannot be used to predict future results.

* * * * *

Item 8. Financial Highlights Information

(a) * * *

Instructions.

* * * * *

3. Total Return. * * *

(f) *Exchange-Traded Funds.* (i) Change the caption "Total Return" to "Total Return—NAV".

(ii) Add a caption following "Total Return—NAV" titled "Total Return—Market Price". Disclose in the caption the Fund's total return using Market Price, assuming a purchase of Fund shares at the Market Price on the first day and a sale of the shares on the last day of each period shown.

*   *   *   *   *

Item 22. Financial Statements

*   *   *   *   *

(b) *Annual Report*. * * *

(7) *Management's Discussion of Fund Performance*. * * *

Instructions.

12. *Exchange-Traded Funds.*

(a) Include a second line graph immediately following the line graph required by paragraph (b)(7)(ii)(A) of this Item, assume an initial investment of $10,000 was made at the Market Price on the business day before the first day of the first fiscal year, and base the subsequent account values on the Market Price on the last business day of the first and each subsequent fiscal year. Calculate the final account value by assuming the investor sold all Exchange-Traded Fund shares at the Market Price on the last business day of the most recent fiscal year.

(b) For purposes of the table required by paragraph (b)(7)(ii)(B) of this Item, add a caption titled "Returns—Market Price". Disclose in the caption the Fund's average annual total return based on Market Price for the periods indicated. In a footnote to the caption, explain how Market Price returns are calculated and how they differ from returns based on net asset value.

(c) If the Fund has an investment objective of obtaining returns that correspond to the returns of a securities index, the table must show the average annual total returns of the securities index specified in its registration statement for the same periods. The Fund may exclude the returns of an appropriate broad-based securities market index as defined in Instruction 5 to paragraph (b)(7)(i) and (ii) of this Item for the same periods.

* * * * *

(iv) *Premium/Discount Information.* Provide a table showing the number of days the Market Price of the Fund shares was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value for the most recently completed five fiscal years (or the life of the Fund if shorter), but only for periods subsequent to the effective date of the Fund's registration statement.

Instructions.

(a) Provide the information in tabular form.

(b) Express the information as a percentage of the net asset value of the Exchange-Traded Fund, using separate columns for the number of days the Market Price was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value. Round all percentages to the nearest hundredth of one percent.

(c) Adjacent to the table, provide a brief explanation that: shareholders may pay more than net asset value when they buy Fund shares and receive less than net asset value when they sell those shares, because shares are bought and sold at current market prices.

(d) Include a statement that the data presented represents past performance and cannot be used to predict future results.

* * * * *

(d) Annual and Semi-Annual Reports. * * *

Instructions.

1. General.

*   *   *   *   *

(e) (i) If the Fund is an Exchange-Traded Fund and issues or redeems shares in creation units of not less than 25,000 shares each, exclude from the narrative explanation and the Example any fees charged for the purchase and redemption of the Fund's creation units.

(ii) Modify the narrative explanation to state that Fund shares are sold on a national securities exchange at the end of the time periods indicated, and that brokerage commissions for buying and selling Fund shares through a broker are not reflected.

*   *   *   *   *

By the Commission.

Nancy M. Morris
Secretary

Dated: March 11, 2008