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THE EVOLUTION OF ACTIVELY MANAGED EXCHANGE-TRADED FUNDS

Enormously popular with the public, ETFs are evolving from index-based to more actively traded investment vehicles. The author traces this development and discusses the issues raised by recent proposals for more actively traded ETFs that are pending before the SEC.

By Stacy L. Fuller *

In 1993, a group of financial innovators launched a new investment vehicle that effectively combined some of the best-loved features of open- and closed-end funds.¹ The innovators of 1993 called their specific product “SPDRs.”² More generally, their product was called an “exchange-traded fund” or “ETF.”

¹ The Securities and Exchange Commission, in its 1992 report “Protecting Investors: A Half Century of Investment Company Regulation,” (hereinafter, “1992 Report”) similarly advanced ideas for combining various elements of open- and closed-end funds to create a hybrid investment vehicle.

² SPDRs is an acronym for Standard & Poors Depository Receipts and derived from the investment objective of the product, which was to track the performance of the S&P 500 index. SPDR were designed to achieve this investment objective by holding all of the securities in the S&P 500 index in the same weight

* STACYL FULLER is Of Counsel in the Washington office of Kirkpatrick & Lockhart Preston Gates and Ellis LLP. Prior to joining the firm, Ms. Fuller spent eight years at the SEC, including as a branch chief in the exemptive applications office in the Division of Investment Management, where she worked extensively on ETF issues. Her e-mail address is stacy.fuller@klgates.com. She thanks Richard M. Phillips, a Partner in the firm’s San Francisco office, for his contributions to this article.

By the end of 2007, several hundreds of ETFs had been organized – all of them, index-based. As index-based funds, their standard investment objective is to track the performance of an index.

The idea of creating an actively managed ETF was first floated sometime before 2000. In 2001, the SEC issued a concept release, which led to serious discussions as to how an actively managed ETF might work.³ Until the end of 2007, however, there was no sign that an ETF sponsor had developed – or indeed

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that the securities appeared in the index. The S&P 500 is a market cap weighted index.

³ SEC Concept Release: Actively Managed Exchange-Traded Funds, Inv. Co. Act Rel. No. IC-25258 (November 8, 2001).

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could develop – an actively managed ETF that had the potential to be a workable investment vehicle, attractive to investors and acceptable to the SEC.

At the end of 2007, all that changed. A handful of ETF sponsors publicly filed exemptive applications and registration statements with the SEC, signaling that they had developed actively managed ETFs that they believed were both viable as a marketing matter and acceptable to the SEC as a regulatory matter.

This article highlights the explosive growth in the ETF market that has participants searching for the perceived holy grail of an actively managed ETF. It explains the ETF structure, including inherent features of the structure that make creating an actively managed ETF difficult. It touches on the salient regulatory requirements that pertain to ETFs and explains how regulatory oversight of ETF development by the Division of Investment Management has impacted ETF innovation. Finally, it walks through the incremental steps that have been taken to get where we are today – on the verge of seeing the first actively managed ETF launched. The article closes by discussing the future of actively managed ETFs.

ETF VITALS

Since their debut in 1993, ETFs have risen rather rapidly to new heights in the fund world. Consider the following in measuring ETFs' ascent.

- In 1993, there was one ETF (*i.e.*, SPDRs) with less than half a billion in assets under management ("AUM").
- At the end of 1999, there were 30 ETFs with approximately \$33 billion AUM.
- By the end of 2007, there were approximately 650 ETFs with \$700 billion AUM, and average daily

trading volume in ETFs reached \$72 billion on 875,000,000 shares.⁴

As noted above and discussed in more detail below, all of these ETFs are index-based funds.

Investors today are able to buy an index-based ETF to satisfy virtually any index-based investment objective.⁵ ETFs have been launched based on broad foreign and domestic equity indices, narrow(er) foreign and domestic sector equity indices, fixed-income indices (both government and corporate), and currency indices.⁶ Sponsors have also developed ETFs to track multiples of indices and inverse multiples of indices.

As indicated earlier, what there has not been is an actively managed ETF. The development of an actively managed product has taken more than seven years. To understand why the process has taken so long, it is useful to understand the nuts and bolts of ETF operations.

ETF "NUTS AND BOLTS"

An ETF is a cross between a traditional mutual fund and a closed-end fund. Like a closed-end fund, an

⁴ See Joe Morris, "New-ETF Euphoria Wanes," *ignites.com*, January 2, 2008.

⁵ Most existing ETFs are based on domestic equity indices, and most ETF assets are in broad-based domestic equity index products. See Investment Company Institute, *2007 Investment Company Fact Book*, at Section 3 (www.icifactbook.org).

⁶ Certain ETF-like investment vehicles based on currency indices are not technically ETFs, which are investment companies registered under the Investment Company Act of 1940, as amended ("1940 Act"). Due to the nature of these other vehicles' investments (*i.e.*, in currencies and not in securities), they are not required, or eligible, to register under the 1940 Act. Such vehicles' securities, however, are subject to registration under the Securities Act of 1933, like those of other companies. Due to the unique structure of these vehicles, they receive different tax treatment than ETFs and, therefore, increasingly prefer to distinguish themselves from ETFs by identifying themselves as "ETNs" or "exchange-traded notes." This article pertains largely to ETFs and not to ETNs.

ETF's shares trade on an exchange; so investors may purchase and sell them throughout each trading day at a market price that is influenced by the supply of and demand for them, as well as by the price of the securities in the ETF's portfolio. Unlike closed-end funds, however, ETFs may also transact with large investors on a daily basis to sell and redeem blocks of their shares, which are known as "Creation Units," at net asset value ("NAV"). In this regard, ETFs are more like traditional mutual funds than closed-end funds.

In other respects, ETFs are not necessarily like either type of fund – open-end or closed-end. First, they generally sell and redeem Creation Units on an in-kind basis in exchange for a basket of securities, rather than for cash. In addition they provide, on a daily basis, full portfolio transparency. Whereas most funds disclose the contents of their portfolio on a quarterly basis and with a 60-day delay,⁷ ETFs disclose to the market the entire contents of their portfolio every single day, including on their websites.⁸

The open-end-like and closed-end-like features of ETFs together with full portfolio transparency create a unique arbitrage mechanism. Given full portfolio transparency, using simple math, investors can determine at any time on any trading day the approximate NAV of an ETF.⁹ They can then compare the figure, throughout the trading day, to the market price of the ETF shares. To the extent that there is a discrepancy between these two figures (NAV and market price), an investor can either (when the market price of the ETF shares is less than the NAV) purchase the ETF shares on the market and redeem them for NAV or (when the NAV is less than the market price) purchase a Creation Unit of shares at NAV and sell them on the market, in each instance making an arbitrage

profit.¹⁰ The effect of such arbitrage activity ultimately inures to the benefit of the ETF because it keeps the market price of the ETF shares from deviating too much from the ETF's NAV. In other words, it keeps ETF shares from consistently trading at a discount to NAV, as has been the fate of many closed-end funds' shares. It also allows all investors, whether transacting in the secondary market or at NAV, to buy and sell ETF shares at the same price and with only a small spread between the bid and ask prices.¹¹

Although it is possible to impose this structure whole cloth on an actively managed ETF, the transparencies required for the arbitrage mechanism to function do not generally appeal to active managers. Active managers prefer not to tell the market the contents of their fund's portfolio. In order for an actively managed ETF to exist, however, the desire of its active manager for portfolio opacity had to give way somewhat to the need of investors, especially large investors who function as arbitrageurs, for portfolio transparency.

THE SEC AND ETF REGULATION

ETFs are subject to extensive regulation by the SEC. First, as 1940 Act registered funds they are subject to SEC regulation under the 1940 Act, which is administered by the Division of Investment Management; and with shares that trade on an exchange, they are also subject to regulation under the Securities Exchange Act of 1934, as amended ("1934 Act"), which is administered by the Division of Trading & Markets. Under the regulatory pattern of these two securities laws, all ETFs are dependent on the SEC's discretion for the

⁷ Inv. Co. Act Rel. No. IC-26372 (Feb. 27, 2004) (adopting Form N-Q under the 1940 Act). Some index funds may make more timely disclosures available, including on their websites.

⁸ ETFs also provide such disclosure via a "portfolio composition file" or "PCF" sent to their listing exchange and/or DTC/NSSC. Most ETFs make the disclosure that is applicable to each business day after the close of trading on the prior business day.

⁹ Mathematically, this requires multiplying the share price of each security in the ETF's portfolio by the number of such shares held, adding those numbers up, and dividing the sum by the number of ETF shares outstanding. To save investors the effort, ETFs have this figure, which is widely referred to as the "intraday indicative value" or "IIV," published by the ETF's listing exchange at 15 second intervals throughout the day.

¹⁰ Investors who transact on the secondary market and directly with an ETF in order to obtain the arbitrage profit (of the difference between the market price and NAV) are typically large institutional investors with the financial wherewithal to transact in Creation Units, which consist of at least 50,000 ETF shares. Such investors usually do not wait for the ETF to calculate its NAV at market close to determine the size of their arbitrage profit. Rather, such investors simultaneously transact with the ETF and enter into a variety of derivative transactions, which permit them to "lock in" an arbitrage profit equal to the difference between the market price of the securities in the ETF portfolio and the ETF's NAV *at the time of their simultaneous trades*.

¹¹ Ensuring that every investor can purchase an ETF's shares at about the same price, whether transacting with the ETF or in the secondary market, is arguably important because the 1940 Act generally mandates that all investors pay the same price for an open-end fund's shares. *See generally*, Sections 1(b)(2), 1(b)(3) and 22(d) of the 1940 Act.

issuance of exemptive relief that is necessary to the ETF structure.

Division of Investment Management

While the 1940 Act provides clear and divergent regulatory regimes for open- and closed-end funds, it does not provide a regime for open- and closed-end hybrids, such as ETFs. The SEC plays an important role in filling that vacuum, by using its exemptive powers to create a regulatory regime for ETFs.

As the arm of the SEC charged with administering the 1940 Act, the Division of Investment Management (“IM”) in particular plays an important role in ETF regulation. IM first fashioned the regulatory regime for index-based ETFs in connection with the SPDR in 1993. To IM’s credit, the regime fashioned in 1993 still largely survives today.¹²

Unfortunately, although the ETF regulatory regime has not changed dramatically since 1993, neither has the process that an ETF sponsor must endure to launch an ETF.¹³ Unlike the Division of Trading & Markets, whose role in ETF regulation is discussed in the following section, IM has not yet provided sponsors of even routine index-based ETFs with “class relief” – meaning relief permitting ETFs that meet certain criteria to launch without obtaining specific relief from the SEC

or its staff.¹⁴ No ETF sponsor – no matter how mundane or novel its proposal – has been able to, or can today, get into the ETF business without going through the exemptive process in IM.

At present, the exemptive process in IM can take as little as six months for routine index-based ETFs or several years for more novel ETFs. Practitioners, of course, know that by the time clients are in a position to know precisely the type of exemptive relief that they need to launch a product, they wanted the relief yesterday – not in several months, and certainly not in several years! As discussed more fully below, this conflict between the fast pace of the business world and the slow pace of regulation has thus far been addressed by innovations “at the margins,” which have slowly but surely moved the ETF industry ever closer to actively managed ETFs.

Division of Trading & Markets (f/k/a/ Market Regulation)

As noted above, the Division of Trading & Markets (“T&M”) also plays a role in the regulation of ETFs. Specifically, ETF sponsors require exemptions from Rules 10a-1, 10b-10, 10b-17, 14e-5, 15c1-5, 15c1-6 and Rules 101 and 102 of Regulation M under the 1934 Act and no-action relief under Section 11(d)(1) of the 1934 Act and Rules 11d1-1 and 11d1-2 thereunder. The relief, among other things, exempts ETF shares from unrestricted short selling prohibitions and certain reporting provisions under the 1934 Act. ETF sponsors also must work with T&M and a national securities exchange in order to list their ETF shares for trading.

Unlike IM, T&M has moved to provide class relief for routine index-based ETFs from the 1934 Act. The staff in T&M has granted class relief to ETFs that permits such ETFs to avoid obtaining, on an individual basis, the necessary 1934 Act exemptions and no-action relief (described above).¹⁵ In addition, T&M has

¹² Compare SPDR Trust, Series 1, Inv. Co. Act Rel. Nos. IC-18595 (Sept. 17, 1992) (notice) and IC-19055 (Oct. 26, 1992) (first ETF order) and CountryBaskets Index Fund, Inc., Inv. Co. Act Rel. Nos. IC-21736 (Feb. 6, 1996) (notice) and IC-21802 (Mar. 5, 1996) (first open-end ETF order) with MyShares Trust, Inv. Co. Act Rel. Nos. IC-28040 (Oct. 31, 2007) (notice) and IC-28066 (Nov. 27, 2007) (recent open-end ETF order).

¹³ An ETF sponsor must file an application for an exemptive order from the SEC. The staff in IM process the application, commenting on aspects of it and frequently requesting changes to it. If applicant agrees to revise the application as requested by IM staff, applicant files an amendment to the application that reflects the changes made. Once the staff is satisfied with the application, the staff may act under delegated authority to notice it in the Federal Register or, alternatively, recommend to the Commission that it notice the application. Provided that an interested party does not request a hearing on the application during the comment period, which lasts for approximately 25 days from the notice date, the order of exemption described in the notice issues automatically at the close of the comment period. Only very rarely might an application that is not supported by the SEC staff be noticed and granted an exemptive order.

¹⁴ The SEC is working on an exemptive rule, which would eliminate the need for each sponsor to file an exemptive application for routine index-based ETFs and for certain actively managed ETFs. See Andrew “Buddy” Donahue, Remarks Before the Investment Company Institute 2007 Operations and Technology Conference (Oct. 18, 2007); see also PowerShares Capital Management LLC, et al., Inv. Co. Act Rel. No. 40-28140 (Feb. 1, 2008) (“PowerShares Notice”) (implying in condition A.8 that the ETF rule will extend to at least some actively managed ETFs).

¹⁵ *The American Stock Exchange, LLC*, Aug. 17, 2001 (domestic index-based ETFs); *Clifford Chance*, Oct. 24, 2006 (foreign and fixed-income index-based ETFs).

worked with the domestic exchanges to promulgate “generic listing standards,” which permit routine index-based ETFs with portfolios of securities that meet certain liquidity criteria to list without further action by T&M.¹⁶

Because the relief provided in the T&M-class letters pertains only to routine index-based ETFs, T&M will need to fashion additional relief for actively managed ETFs. Nevertheless, T&M has generally *not* used its power over these functions to play a critical role in ETF development. And there is no reason to expect that T&M will change course once ETFs move into the actively managed space. Rather, like past ETF developments, one should expect the pace of regulatory acceptance to be dictated by the SEC through the staff in IM.

ACTIVE ETF EVOLUTION

The ETF regulation developed by IM staff under the 1940 Act, especially the pace of such regulation, has played a key role in ETF innovation. Specifically, the requirement that each ETF sponsor, as well as existing ETF sponsors with novel ETF products, obtain an SEC exemptive order through IM has prompted such sponsors to innovate at the margins – meaning within parameters that are close to those previously approved by, or otherwise apparently acceptable to, IM.¹⁷ As a result, as illustrated below, actively managed features of ETFs have been, and are likely to continue to be, developed in connection with, and based on features of, index-based ETFs.

Past Active ETF Developments

From UITs to Open-end Funds. As mentioned above, SPDRs marked the beginning of ETF development. Unlike most ETFs today, the SPDR was not organized as an open-end investment company but rather as a unit investment trust (“UIT”). The UIT structure has several important consequences for a fund. First, its securities must “represent[] an undivided interest in a unit of specified securities,” meaning its portfolio must remain static or [*track an index*].¹⁸ Second, it is not overseen by a board of directors or trustees. Third, it cannot have an investment adviser to manage its portfolio.

This final requirement of the UIT structure, that it not have an investment adviser, by definition precludes the structure from serving as the basis of an actively managed ETF. Accordingly, for actively managed ETFs to evolve from their index-based predecessors, ETFs had to shed their UIT skin.

In 1996, ETFs began to organize as open-end funds.¹⁹ The ETF structure accordingly took its first critical step toward active management at that time.

From Replication to Representative Sampling. Because the SPDR was organized as a UIT and its investment objective was to track the performance of the S&P 500 index, it invested 100% of its assets in the securities of the 500 issuers that are in the S&P 500, in approximately the same proportion as the securities appear in the index itself. This manner of investing is termed “replication.”

With the movement of ETFs from the UIT to the open-end fund structure, other methods of tracking an index became possible. Most significantly, ETF sponsors began using “representative sampling” to track their funds’ underlying indices. Under the representative sampling strategies approved by the SEC, an ETF could invest 80% to 95% of its assets in the securities of an underlying index and invest the remaining 5% to 20% of its assets,²⁰ which is known as the ETF’s “asset basket,”

¹⁶ Almost all of the domestic exchanges have adopted generic listing standards to facilitate the listing of ETF shares. *E.g.*, AMEX Rule 1000A. The listing standards focus on the liquidity of an ETF’s portfolio securities because such liquidity precludes one from using the ETF shares to manipulate the prices of the underlying securities and from using the underlying securities to manipulate the price of the ETF shares. ETFs that do not satisfy the generic listing standards must work with their listing exchange and T&M to file new listing standards under 1934 Act Rule 19b-4; the Rule 19b-4 listing process generally takes between 30 and 60 days.

¹⁷ ETF sponsors usually ask for “future relief” in their first ETF exemptive application. Such future relief permits the sponsor to launch in the future additional ETFs that satisfy the terms and conditions of the application. To the extent that a future product is too different from those described in the application, the sponsor may not rely on the order to launch it; instead, the sponsor must file another application for ETF exemptive relief. ETF sponsors, accordingly, have some incentive to innovate within the parameters of their prior exemptive orders.

¹⁸ Section 4(2) of the 1940 Act. *See The SuperTrust Trust for Capital Market Fund, Inc.*, June 5, 1992; *The American Stock Exchange*, Jan. 28, 1993.

¹⁹ CountryBaskets Index Fund, Inc., Inv. Co. Act Rel. Nos. IC-21736 (Feb. 6, 1996) (notice) and IC-21802 (Mar. 5, 1996) (first open-end ETF order).

²⁰ Generally speaking, domestic equity ETFs have been required to invest at least 90% their assets in the component securities of an index (*e.g.*, First Trust Exchange-Traded Fund, Inv. Co. Act Rel. Nos. IC-27051 (Aug. 26, 2005) (notice) and IC-27068

in other financial instruments. According to SEC exemptive orders, such financial instruments may include futures, option and swap contracts, and “other securities not in the underlying index,” provided that the fund’s adviser believes such securities will help the ETF to achieve its investment objective. By using representative sampling, an adviser may exercise investment discretion over a portion (at least 5%), and in some cases a significant portion (20%), of an ETF’s portfolio.

In short, since the advent of representative sampling, ETF advisers have enjoyed some discretion to manage their funds’ portfolios. This increase in discretion marked another important step on the road to actively managed ETFs.

From Representative Sampling to Aggressive Sampling. The acceptance by the SEC of representative sampling as an investment strategy for index-based ETFs combined with market conditions to spur additional sampling innovations. ETF sponsors, surveying the market, saw the popularity of ETFs skyrocketing. They also saw that almost all, if not all, broad-based indices of a manageable size had been claimed by existing ETF sponsors as the basis of ETFs. Much larger indices, however, including those with thousands of component securities, were still available as bases for ETFs.

Prior to sampling, such larger indices were not suitable for ETFs. As discussed above, Creation Unit transactions for ETFs generally occur in kind and this in-kind feature, together with the replication strategies used to manage ETF portfolios prior to sampling, constrained ETF sponsors from using large indices as bases for ETFs because arbitrageurs could not be expected to transact in thousands of securities for Creation Units and still maintain an efficient arbitrage mechanism for an ETF. With sampling, this constraint receded; the number of securities that could be in an index underlying an ETF dramatically increased.

Given the potential increase in the size of underlying indices, the primary question became how large an index could be or, stated differently, how much sampling an ETF could do. With the launch in 2007 of the State

Street and iShares municipal bond ETFs, representative sampling may have reached its outer limit. Those ETFs proposed to aggressively sample their underlying indices. The iShares ETF proposed to hold only 39 of the approximately 3,000 securities in the underlying index. More astonishingly, the State Street ETF proposed to hold only 28 of the approximately 22,000 securities in its underlying index.

With these products, ETFs moved from mere sampling to aggressive sampling. As will be discussed below, this move may prove to have been an important one in the development of actively managed ETFs.

Current Active ETF Developments

As suggested above, a major difficulty with taking the step from sampling, even aggressive sampling, to active management of a sort that appeals to sponsors, arbitrageurs and the SEC alike, comes from the tension between the need of arbitrageurs for transparency and the desire of investment advisers for opacity. This tension must be addressed for an actively managed ETF to exist.

At least one ETF sponsor proposed to IM staff to resolve the tension by having an ETF adviser provide full portfolio transparency to the ETF’s arbitrageurs, but not to the market as a whole. The sponsor of this proposal asserted that, pursuant to confidentiality agreements funds routinely disclose some portfolio information to their brokers that they do not disclose to the market as a whole, most notably in connection with trades. The sponsor questioned why the “rules” for ETFs should be any different, why ETF operations should not similarly be able to rely on confidentiality agreements. In the sponsor’s view, the informational advantage given to arbitrageurs *vis-à-vis* retail investors was a “red herring” for rejecting a viable proposal to remove the main obstacle to actively managed ETFs.

Although the proposal was supported by arbitrageurs, it was rejected by the SEC staff. There are several possible reasons why the staff may not have supported the proposal. First, it placed retail investors at an information disadvantage, an increasingly important regulatory concern.²¹ Second, although funds do disclose some portfolio information to their brokers in connection with their trading activities, they generally do so only in piece-meal fashion and out of necessity; even

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(Sept. 20, 2005) (order)), while foreign equity ETFs have been required to invest at least 80% of their assets in their indices’ component securities (*e.g.*, First Trust Exchange-Traded Fund, Inv. Co. Act Rel. Nos. IC-27772 (Mar. 30, 2007) (notice) and IC-27784 (Apr. 25, 2007) (order)).

²¹ See generally, Regulation F-D, 17 CFR 243.100 *et seq.* (generally prohibiting disclosure to a selective group of persons).

then, some complain that such information is used to trade ahead of their funds.²² In rejecting the proposal, IM staff may have merely been moving to protect the credibility of ETFs and their arbitrage mechanism from one of the thorny problems that crop up with traditional open-end funds. In the end, for whatever reason, the SEC staff rejected the proposal.

Actively managed ETF sponsors were undeterred, however, and responded by developing a second proposal. In effect, they proposed to provide full-market, full portfolio transparency, as is currently provided for index-based ETFs. While perhaps not immediately apparent, the insight underlying this proposal – to provide for an actively managed ETF the same type of full portfolio transparency as is provided for index-based ETFs – was highly innovative.

To understand why the proposal was innovative, it is necessary to understand a feature of fund accounting – specifically, how ETFs, like all funds, book their portfolio trades. This feature is best understood by way of the following example. Let’s say that a fund buys a security for its portfolio on Monday. Although the fund buys the security on Monday, the security does not actually “hit” the fund’s portfolio until Tuesday. As a result, even though the fund bought it on Monday, the value of the security is *not* reflected in the fund’s portfolio or NAV until Tuesday.²³

This fund accounting mechanism has never been particularly visible to investors. In part, this is because, as discussed above, funds do not disclose the contents of their portfolios to the market, except once per quarter and on a 60-day delayed basis.

As ETFs, by contrast, disclose their portfolio contents on a daily basis, this fund accounting mechanism takes on meaning. Due to this fund accounting mechanism, an ETF adviser may purchase a security on Monday, yet not disclose such purchase until after it calculates its NAV on Monday because the security will not “hit” the fund’s portfolio until Tuesday and, therefore, does not become relevant to investors until Tuesday. Accordingly, the ETF may refrain from disclosing the purchase until just prior to the opening of trading on Tuesday, when investors transacting with the fund need to know of its presence in the portfolio to account for it in connection with arbitrage transactions. Thus, under the full portfolio transparency proposed by the above-described

ETF sponsors, an ETF manager may acquire the security at its Monday price, tell the market of the purchase on Tuesday, provide the same degree of portfolio transparency that is provided by existing ETFs and that is necessary for an ETF’s arbitrage mechanism to work, yet avoid making portfolio disclosures that permit the fund to be front-run.

The transparency contemplated by this proposal will be the basis for the first actively managed ETFs.²⁴ It provides some of the opacity coveted by active managers. It provides all of the transparency needed by, and familiar to, arbitrageurs to support transactions in Creation Units and keep the fund’s market price in line with its NAV. Last but not least, it avoids creating information disparities and other issues that may not win SEC approval.²⁵

Future Active ETF Developments

Given where actively managed ETF development has come from, and where it is today, what might the future hold? Where might further innovation come from?

In 2007, in addition to the municipal bond ETFs launched by State Street and iShares (as discussed above), Van Eck launched a municipal bond ETF. Like the State Street and iShares products, the original registration statement for the Van Eck product contemplated aggressive sampling of the underlying index. The Van Eck ETF, however, contemplated sampling on an entirely different scale.

The initial registration statement for the Van Eck municipal bond ETF proposed to expand upon the idea of the asset basket. Specifically, Van Eck proposed for the largest part of the ETF portfolio, at least 80% thereof, to be invested in securities in the underlying

²² See Joe Morris, “Fidelity May be Victim of Merrill Front-Running,” *ignites.com*, January 14, 2008.

²³ *E.g.*, PowerShares Notice at note 6.

²⁴ See PowerShares Order and File No. 811-22148 (registration statement for PowerShares actively managed ETF); see also Bear Stearns Asset Management, Inc., *et al.* Inv. Co. Act Rel. No. 28143 (Feb. 5, 2008) (notice of exemption for actively managed ETFs), Barclays Global Fund Advisors, *et al.*, Inv. Co. Act Rel. No. 28146 (Feb. 6, 2008) (same), WisdomTree Trust, *et al.*, Inv. Co. Act Rel. No. 28147 (Feb. 6, 2008) (same), and File No. 811- 22154 (registration statement for Grail Advisors actively managed ETF).

²⁵ Full portfolio transparency of the type described may not be viable for all asset classes or all investment advisers. Specifically, such transparency may be less useful with respect to funds invested in asset classes that are less liquid. Second, such transparency may not work well for advisers that build portfolio positions over time.

index or “similar securities.” The registration statement defined “similar securities” to mean securities that “the adviser deems to have” salient characteristics that are similar to the underlying index’s securities.²⁶ According to the registration statement, the fund’s 20% asset basket could then be invested, in typical fashion, in any other securities that the adviser believed would help the fund to track the underlying index.

The initial Van Eck registration statement thus appeared to contemplate an ETF that followed the sampling convention of dividing the ETF portfolio into two parts and investing the largest part (at least 80%) in the underlying index’s securities and investing the asset basket (up to 20%) in other securities that the adviser believed would help the fund to track its index. In effect, however, with respect to ETFs described in the registration statement, an adviser could invest up to 80% of an ETF’s assets in securities that it “deem[ed]” to be similar to the underlying index’s securities and up to 20% in other securities that it believed would help the fund to track its index. In short, an adviser could invest 100% of the assets in the ETF portfolio in securities that it believed would help the fund to achieve its investment objective. Stated differently, the adviser could actively manage the ETF.

To date, Van Eck does not appear to have been allowed by the SEC to proceed with its proposal; and, as a result, the structure and its usage of “similar securities” have not been able to be tested by the market. Further, the fungibility necessary for an ETF to track an index or achieve a particular return vis-à-vis an index without

investing in the securities of the index may not exist in asset classes other than municipal bonds, where fungible issues are plentiful.

As discussed at the beginning of this article, however, there are powerful incentives at work in the ETF space that make continued innovation likely. Even innovation that extends the concept of fungibility to other asset classes, including equity securities, which are generally considered to be less fungible than municipal bonds and other fixed-income securities, is possible. Indeed, given the proliferation of complex quantitative management techniques in recent years, it does not seem out of the question that algorithms may be developed to identify fungible equity securities.

Assuming fungibility, “tracking baskets” should be one of the next frontiers in actively managed ETFs. A tracking basket, in essence, is a basket of securities identified by an ETF adviser as providing investors with substantially the same investment as the basket of securities in the ETF portfolio. By using a well-created

tracking basket, an adviser can tell the world the precise nature of a fund’s investment portfolio and/or the names of surrogates for the securities in the portfolio, without disclosing any one issue actually in the portfolio. Such an ETF strategy would likely have broad appeal for arbitrageurs and active managers, including those not inclined to launch an ETF for which full portfolio transparency must be provided; the primary question will be whether such an ETF can win SEC approval. ■

²⁶ The Van Eck registration statement specifically proposed to “divide the [underlying index] into manageable risk categories,” such as “(1) credit rating; (2) sector (*e.g.*, revenue, pre-refunded, or insured bonds); (3) issuer (or state of issuer); (4) duration; (5) maturity; (6) coupon yield; and (7) liquidity.” Van Eck further proposed to treat the bonds within each category as “substantially fungible.”