A PROCESS OF NATURAL CORRECTION: ARBITRAGE AND THE REGULATION OF EXCHANGE-TRADED FUNDS UNDER THE INVESTMENT COMPANY ACT

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I. INTRODUCTION

In early 2008, the Securities and Exchange Commission (SEC) issued for the first time exemptive orders permitting fully transparent actively managed exchange-traded funds (ETFs) to list on national stock exchanges,[1] with the first listing occurring on March 25, 2008.[2] Also in March, the Commission issued proposed rule 6c-11 under the Investment Company Act of 1940 (the "1940 Act" or the "Act"),[3] which would exempt

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1. *See, e.g.*, WisdomTree Trust et al., Order Under Sections 6(c), 12(d)(1)(J) and 17(b) of the Investment Company Act of 1940, Investment Company Act Release No. 28,174, 2008 SEC LEXIS 1360 (Feb. 27, 2008); *see also* WisdomTree Trust, et al., Notice of Application, Investment Company Act Release No. 28,147, 73 Fed. Reg. 7776 (Feb. 6, 2008) [hereinafter WisdomTree Trust, Notice of Application].

2. The first actively managed bond ETF, the Bear Stearns Current Yield Fund (YYY) was launched on the American Stock Exchange (AMEX) on March 25, 2008. *See* Murray Coleman, *Bear Stearns Launches First Ever Active ETF*, SEEKING ALPHA, March 25, 2008, http://seekingalpha.com/article/69871-bear-stearns-launches-first-ever-active-etf. The fund was liquidated in early October. *See* Scott Ebner, Bear Stearns Current Yield Fund (Ticker: YYY) to be Liquidated, ETF Notice #08-040, American Stock Exchange, Sept. 29, 2008, http://www.amex.com/amextrader/tdrInfo/data/axNotices/2008/etf08040.pdf. Other actively managed ETFs, including equity-based funds, continue to trade. *See, e.g.*, NYSE Euronext, Press Release, "PowerShares Lists its First Ever Actively-Managed ETFs on NYSE Arca," Apr. 11, 2008, http://www.nyse.com/press/1207739565764.html.

3. Comments on the Proposed Rules were due May 19, 2008. Exchange-Traded Funds, Investment Company Act Release No. 33-8901, 73 Fed. Reg. 53, at 14,618 (Mar. 18, 2008) (to be codified at 17 C.F.R. pts. 239, 270 and 274) [hereinafter SEC Proposed Rules]. While it is difficult to predict when the SEC is likely to implement the Proposed Rules, some practitioners anticipate "that the likely implementation date for any final rules based

transparent ETFs—those that track a published securities index or are actively managed with disclosed portfolio holdings—from various requirements of the Act.[4] After years of speculation about when the SEC would approve the first actively managed ETFs,[5] the first structures acceptable to regulators are more of the same,[6] with a twist. While the newly-approved actively managed ETFs increase flexibility by permitting portfolio holdings to detach from published indices, they nonetheless remain fully transparent, much like their index-tracking predecessors.[7] As the SEC notes, "an actively managed ETF would operate in the same manner as an index-based ETF,"[8] with Intraday Value transmitted every fifteen seconds.[9] Daily disclosure of portfolio holdings, a feature emblematic of the traditional equity index structure, also characterizes the new, actively managed ETFs approved by the SEC.[10]

Still, while the first actively managed ETFs do not free innovators from transparency requirements, the SEC nonetheless indicates that its recent actions do not foreclose the possibility that future structures may operate with less openness. In a comment that could easily encourage a

on the Proposed Rules would occur no earlier than the beginning of 2009." Client Advisory, Katten Muchin Rosenman LLP, SEC Proposes New Rules to Streamline ETF Formation (Mar. 24, 2008), http://www.kattenlaw.com (search "ETF"; then follow article hyperlink).

4. SEC Proposed Rules, *supra* note 3, at 14,618; *see* Exchange-Traded Funds, SEC News Dig., Issue 2008-49 (Mar. 12, 2008), http://sec.gov/news/digest/2008/dig031208.htm (explaining further how the proposed rule changes would impact Investment Company Act exemptions applicable to ETFs).

5. *See* John Authers & Rebecca Knight, *Active Solution is Within Reach*, FIN. TIMES USA, Jan. 30, 2007, at 1 ("It has been talked about for years, but 2007 might be the year that the first actively managed exchange traded fund makes it to market."); Diya Gullapalli, *Actively Traded ETFs: A Step Closer to Reality*, WALL ST. J., Feb. 5, 2008, at C3 ("Regulators appear to be on the verge of approving a highly anticipated new type of exchange-traded fund."); Chuck Jaffe, *Next Generation of ETFs Will Reshape Fund Business*, THOMSON FIN. NEWS (Sept. 27, 2006) (Westlaw, Thomsonfin) ("Regulators who have been winking at the new [ETFs] and allowing them to be 'active' but not 'actively managed' are likely to cross that line in the near future. You can expect actively managed ETFs by year's end.").

6. SEC Proposed Rules, *supra* note 3, at 14,620 n.27 ("[E]ach 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.").

7. *Id.* at 14,623; *see* Stacy L. Fuller, *The Evolution of Actively Managed Exchange-Traded Funds*, REV. SEC. & COMMODITIES REG., Apr. 16, 2008, at 89 ("By the end of 2007, several hundreds of ETFs had been organized—all of them, index-based.").

8. SEC Proposed Rules, *supra* note 3, at 14,623.

9. *Id.* at 14,625 n.95.

10. *See* Press Release, Foley & Lardner LLP, Foley & Lardner LLP Counsels First Actively-Managed Exchange Traded Fund (Mar. 12, 2008), http://www.foley.com/news/news_detail.aspx?newsid=3408 (discussing how the first actively managed ETF, The Bear Stearns Current Yield Fund (YYY), would report its entire underlying portfolio online each day).

new round of speculation regarding the next era in the evolution of ETF products, the SEC noted, "[b]y proposing [a rule to permit fully transparent ETFs to register without securing individual exemptive orders] 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."[11]

Prior to recent approvals, the SEC had left actively managed ETFs suspended in regulatory stasis pending the resolution of transparency concerns.[12] As reflected in a 2001 concept release, the SEC hesitated to approve actively managed structures because fund managers might sacrifice transparency—"a hallmark of ETFs"[13]—for stronger market performance.[14] Equity index ETFs had always published daily the securities needed to acquire shares from funds, as well as the securities tendered to investors when creation units were redeemed.[15] Andrew Donohue, Director of the SEC's Division of Investment Management, explained that the Commission feared fund managers would act to prevent "too much transparency,"[16] a move perceived as dangerous, particularly in a shifting market environment where increasing numbers of retail investors are trading ETF shares.[17] In approving the first actively managed ETFs, the SEC, rather than overcoming its concerns with transparency, simply limited current approvals to transparent structures. As a result, while active management represents a new evolution in the ETF industry, newly-approved funds remain firmly anchored—at least for now—to the same principles that underlie previous approvals of equity index ETFs.

This Article does not attempt to predict whether or when the SEC will approve an actively managed ETF that does not conform to current transparency requirements, but instead takes a backward glance at the regulatory approval process, with the view that a look back may reveal significant information about the future. As curious investment structures

11. SEC Proposed Rules, *supra* note 3, at 14,623.

12. *See* Andrew J. Donohue, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm'n, Speech by SEC Staff: Remarks Before the 4th Annual Art of Indexing Summit (Sept. 20, 2006), http://www.sec.gov/news/speech/2006/spch092006ajd.htm.

13. *Id.*

14. *Id.*

15. *See, e.g.*, 1 Reg. of Inv. Companies (MB) § 26.02[1][a] (2008) (describing transparency in ETF formation and operation).

16. Donohue, *supra* note 12.

17. *See, e.g.*, Rebecca Knight, *Irresistible Rise of the Flexible Fund*, FIN. TIMES USA, Jan. 10, 2006, at 10 (reporting that two-thirds of a major U.S. bank's ETF trades have come from retail investors); *see also* Lawrence C. Strauss, *New Frontier: ETFs Are Surging in Popularity. Get Ready for Actively Managed Versions. (Exchange-Traded Funds)*, BARRON'S, Jan. 3, 2005, at F5 (noting ETFs are popular with both retail and institutional investors).

that traverse the line between open-end[18] and closed-end[19] funds, ETFs already have raised numerous regulatory headaches underscored by unspoken normative judgments, some of which can be extracted from a web of exemption letters and statutory language. If there is an element common to ETF approvals, it is that all are based on a delicate regulatory surgery performed under the Investment Company Act of 1940.[20]

Rather than strike directly at the issue of active management, this Article seeks to distill the underlying assumptions, goals, and regulatory values that inform the history of exemptive relief under the Investment Company Act for equity index ETFs and, now, actively managed, transparent ETFs. The Article concludes that the common principles behind various exemptions unite to support a general theory of how regulators believe the ETF market should function. Transparency, at both the index and the portfolio level, has been the cornerstone of exemptive relief from various provisions of the Act, because it fosters an arbitrage mechanism that protects retail investors by creating price effects that ripple through the secondary market and push trading prices toward net asset value (NAV).[21] Embedded within regulatory deference to the ETF arbitrage system is the SEC's implicit recognition that the natural corrective abilities of a liquid and transparent market often protect investors more effectively than regulatory mandates. This Article takes the position that an arbitrage-driven price stability regime is the central reason why index-tracking and transparent actively managed ETFs have received exemptive relief from various constraints imposed by the Investment Company Act.[22]

18. The Investment Company Act defines an open-end company as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer." 15 U.S.C. § 80a-5(a)(1) (2000).

19. *See, e.g.*, 15 U.S.C. § 80a-5(a)(2) (2000) (defining a closed-end investment company under the Investment Company Act as simply "any management company other than an open-end company"); *see also* SEC, Closed-End Funds, Answers Page, http://www.sec.gov/answers/mfclose.htm (last visited Oct. 16, 2008) (explaining that closed-end funds typically offer a fixed number of shares in an initial public offering and later trade on secondary exchanges). Shares in closed-end funds usually are not redeemable, such that closed-end funds are not subject to the same liquidity requirements as open-end funds. *Id.*

20. As Stacy L. Fuller explains, exemptive relief from the Investment Company Act requires that regulators deviate from the letter of the statute: "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." Fuller, *supra* note 7, at 91.

21. *See infra* Part II.D (discussing transparency and the arbitrage system).

22. The proposition that arbitrage has informed exemptive relief for ETFs is not a controversial one. In its Proposed Rules, the SEC requested comment on the following question: "Does the requirement that an ETF establish creation unit sizes the number of

If an efficient arbitrage mechanism is critical to investor protection, and if arbitrageurs require transparency to perform their stabilizing function, then what is to be said of non-transparent actively managed ETFs? Some commentators focus on the risk of front-running,[23] and how it may raise concerns about openness by fund managers.[24] Depending on the financial innovations underway to counteract this situation, actively managed ETFs may indeed provide investors with less transparency than the index-tracking variety.[25] Nonetheless, this Article does not predict whether the SEC will eventually approve non-transparent actively managed ETFs, but instead aims to shed light on why the SEC has approved the existing class of transparent funds. By subjecting the evolution of SEC approval of transparent ETFs to the harsh gaze of hindsight, this Article intends to help clear a path for future structures by navigating the often-tangled maze of values that has produced the first two generations of ETF products.

II. FINANCIAL STRUCTURE

A. *The Indexing Tradition*

Despite the SEC's recent approval of actively managed ETFs, most existing ETFs remain passive[26] instruments that track an underlying securities index,[27] such that the portfolio changes only in response to a

which is reasonably designed to facilitate arbitrage provide the sponsor or advisor of the ETF with sufficient guidance in setting appropriate thresholds?" SEC Proposed Rules, *supra* note 3, at 14,627. This Article seeks to advance the discussion of the role arbitrage plays in the regulation of ETFs, by exploring the nuances and specific justifications behind its importance in the regulatory setting.

23. *See* Thao Hua, *Bear Stearns Could Land 1st Active ETF on U.S. Shores*, PENSIONS & INVESTMENTS, Apr. 30, 2007 (noting that transparency is one of the biggest challenges facing actively managed ETFs, because managers must fully disclose the underlying portfolio and run the risk that other managers may front-run their strategies); Raquel Pichardo, *Solving Puzzle of Active ETFs*, PENSIONS & INVESTMENTS, Oct. 1, 2007 (explaining that transparency is the most daunting regulatory hurdle facing fund managers who are trying to launch the next wave of ETFs, because "[m]anagers worry that full transparency of their trades will betray their investment processes and open the door to front-runners").

24. Pichardo, *supra* note 23.

25. See sources cited in *supra* note 23 (discussing risks of transparency to fund managers).

26. Here, "passive" indicates a lack of active trading by fund managers.

27. *See e.g.*, SEC, Exchange-Traded Funds (ETFs), http://www.sec.gov/answers/etf.htm (last visited Oct. 23, 2008) (noting, in 2007, that "all ETFs seek to achieve the same return as a particular market indexes [sic]").

change in the index.[28] Equity index ETFs "closely mirror" their underlying indices, making portfolio turnover rare.[29] Traditional securities indices[30] typically include equities based on capitalization weighting,[31] which is partially explained by the relationship between high capitalization and liquidity.[32] Early ETFs strove to replicate the performance of traditional stock indices such as the Dow Jones Industrial Average and the S&P 500 Index.[33]

Before actively managed structures emerged, the ETF industry began to develop new indices for the purpose of launching equity index ETFs.[34] Fueled by the growing popularity of ETFs as investment vehicles, sector-specific and fund-specific indices have produced increasingly narrow benchmarks.[35] The demand for increasingly diverse offerings has created a situation where "more indices are being developed to form the basis of new ETFs,"[36] marking a change from the time when ETFs were built around then-existing, traditional indices.[37] While "fund-friendly" indices may use the same capitalization method of traditional benchmark indices, they differ

28. *See* Anthony Ragozino & Charlie J. Gambino, *Actively-Managed Exchange Traded Funds: Coming Soon to a Market Near You?* 8 INVESTMENT LAWYER 3 (2001) (explaining that an ETF is designed to track a particular stock index, such that the ETF's portfolio changes only if the benchmark index changes).

29. Vipul K. Bansal & Archana Somani, *Exchange Traded Funds: Challenge to Traditional Mutual Funds*, REV. OF BUS., Fall 2002, at 41.

30. Indices such as the Dow Jones Industrial Average, the S&P 500 Index, and the NASDAQ Composite Index were not "originally created with the idea that a fund portfolio replicating the structures and rules of the index would be a popular investment. These indexes were developed to serve as market indicators and/or as a standard for comparison with actual portfolios managed by active portfolio managers." GARY L. GASTINEAU, THE EXCHANGE-TRADED FUNDS MANUAL 131 (John Wiley & Sons, Inc. 2002).

31. *See, e.g.*, *id.* at 131 (noting that, with the exception of the original Dow Jones Industrial Average and the Nikkei Average, most popular indices are capitalization weighted).

32. *See id.* at 132 (correlating market capitalization and liquidity).

33. *See, e.g.*, Diya Gullapalli, *Why Hot Funds are Tripping Up Some Investors–ETFs, Which are Meant to Track Benchmarks, Increasingly Go Astray*, WALL ST. J., Apr. 19, 2007, at A1 (explaining that ETFs "were designed to match the performances of various market benchmarks, such as the Standard & Poor's 500-stock index").

34. *See* GASTINAEU, *supra* note 30, at 132-33 (discussing reasons for the development of new indices that depart from the capitalization weighted approach); *see also* SEC Proposed Rules, *supra* note 3, at 14,619 (explaining that many newer ETFs are based on more specialized indices, including some designed specifically for a particular ETF).

35. *Exchange Traded Funds Growing in Popularity*, INVESTMENT ADVISER, June 4, 2007, http://www.ftadviser.com (search "Exchange Traded Funds Growing in Popularity"; then follow article hyperlink).

36. *Id.*

37. *See, e.g.*, Authers & Knight, *supra* note 5, at 11 (observing that while ETFs traditionally were based on conventional indices and weighted by market capitalization, ETF providers recently have launched funds that incorporate alternative weighting strategies).

by considering "the structural requirements of funds, the economics of trading, the investment objectives of funds, and the presence of other investors in the marketplace."[38] Others use alternative weighting methodologies[39] that depart from capitalization weighting to incorporate factors such as cash flow, dividends, sales, and book value.[40] Sampling strategies, in which ETFs track a limited array of securities from a given index based on a wide array of selection strategies, are also common.[41] For example, the benchmark index might be limited to securities that come out favorably in a dividend weighting evaluation.[42] These new indices "convert an established stock selection process into an index which serves as the template for a portfolio."[43] Unsurprisingly, given the demand for increasingly specialized sector exposure, recently-developed indices have led to ETFs "of virtually every flavor,"[44] including those that track private equity, gold, vaccines, intellectual property, nanotechnology, and renewable energy.[45] Demand for greater sector exposure has also led to commodities ETFs that, unlike mutual funds that hold equity in publicly-traded commodities companies, attempt to track the prices of the underlying commodities themselves, typically through direct ownership or futures contracts.[46]

38. GASTINAEU, *supra* note 30, at 132.

39. Authers & Knight, *supra* note 5, at 11.

40. *ETFs Growing in Popularity*, *supra* note 35; *see also* Rob Carrick, *The Case for Blending Passive, Active Indexing*, GLOBE & MAIL UPDATE, May 19, 2007 (describing the new paradigm of fundamental indexing as a refinement of traditional indexing).

41. *See* Paul F. Roye, Dir., Div. of Inv. Mgmt., SEC, Speech by SEC Staff: Regulatory Issues Involving Exchange Traded Funds at the American Stock Exchange Symposium on Exchange Traded Funds, (Jan. 14, 2002), http://www.sec.gov/news/speech/spch534.htm (explaining that "rather than holding securities that replicate an entire index, [an ETF] could instead use 'sampling techniques' to track the performance of an index . . . . By 'sampling' the stocks in an index, the exchange traded fund can seek to replicate the performance of the index without actually owning all the component stocks in the index.").

42. *See, e.g.*, Rob Garver, *The ETF Evolution*, BANK INV. CONSULTANT, Mar. 2007, at 25 (citing ETFs issued by WisdomTree Investments as an example).

43. GASTINAEU, *supra* note 30, at 165.

44. Chuck Jaffe, *ETFs v. Mutual Funds: Winner Depends on You*, THOMSON FIN. NEWS, July 30, 2006.

45. *Revolution or Pollution? Exchange-Traded Funds*, ECONOMIST, Apr. 21, 2007, at 83-84; *see* David E. Stout & Huaiyu Chen, *A Primer on Exchange Traded Funds: Purpose, Operation, and Risk*, THE CPA J., Sept. 2006, at 56 (commenting that the list of ETFs is comprehensive enough that today's investors "can use ETFs to cover all the sectors, styles, and market capitalization options associated with ordinary mutual fund investments").

46. *See, e.g.*, Philip McBride Johnson, *The CFTC and Commodity-Based Exchange-Traded Funds*, 11 DERIVATIVES USE, TRADING & REG. 303, 304 (2006) (noting that ETFs commonly are tied in value to the price of gold or other commodities trading on a futures exchange); *see also* Robert S. Bernstein, *Oil, Currency, and Silver Commodities Come to the Securities Market*, 33(4) CORP. TAXATION 40 (2006) (noting the emergence of commodity-based ETFs).

B. *Actively Managed, Transparent ETFs*

The new structures that the SEC approved in early 2008 differ from their predecessors in that fund managers are no longer bound by the confines of a particular securities index. Nevertheless, all actively managed ETFs approved by the SEC must disclose their portfolio holdings daily, just like the traditional index-tracking variety that preceded them.[47] The commonality between the first actively managed ETFs and traditional equity index ETFs is that both are "fully transparent."[48] The first generation of actively managed ETFs provides disclosure in largely the same manner as index-tracking funds[49] with the main difference concerning an enhanced freedom to select and trade portfolio securities. While ETF fund managers are no longer confined to a particular index, the SEC nonetheless limits its approval "to transparent actively managed ETFs,"[50] which must fully disclose their holdings.[51] All existing ETFs may therefore be characterized as transparent.

C. *Creation and Redemption*

In most cases, an authorized participant[52] creates an ETF by depositing a block of securities, called a portfolio deposit,[53] with a custodian in exchange for shares of equivalent value.[54] The authorized participant receives from the ETF sponsor a block of shares called a

47. *See* WisdomTree Trust, Notice of Application, *supra* note 1, at 7780 ("On each Business Day, before the commencement of trading in Shares on the Fund's listing Exchange, the Fund will disclose on its Web site the identities and quantities of the money market securities and other assets held by the Fund that will form the basis for the Fund's calculation of NAV at the end of the Business Day.").

48. SEC Proposed Rules, *supra* note 3, at 14,623.

49. *Id.*

50. *Id.* at 14,642.

51. As the SEC explains, "[a]n 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." *Id.* at 14,642-43.

52. Authorized participants are institutional investors that create ETFs by acquiring the necessary portfolio securities. *See, e.g.*, CHRISTINE BRENTANI, PORTFOLIO MANAGEMENT IN PRACTICE 167 (Elsevier Ltd. 2001) (2004) (explaining that, when demand for an ETF is expected, a large intermediary broker/dealer or authorized participant buys securities representing an underlying index).

53. Portfolio deposits "essentially need to match the index underlying the fund and be acceptable to the fund's adviser." Reg. of Inv. Companies, *supra* note 15, § 26.02[1][a].

54. *See* Bansal & Somani, *supra* note 29, at 40 (discussing ETF formation); Phyllis J. Bernstein, *A Primer on Exchange-Traded Funds*, J. ACCT., Jan. 1, 2002, at 39-40 (discussing the ETF share-creation process).

creation unit, which typically contains 50,000 or more shares of the ETF.[55] Because the value of a creation unit will equal that of its corresponding ETF shares,[56] portfolio deposits may include a small amount of cash to balance differences between the value of the deposit and the shares' NAV.[57] Investors also may acquire creation units on the secondary market by purchasing a sufficient number of shares.[58] As a result, ETFs operate in two markets; creations and redemptions define the primary market, while investors who trade shares on an exchange create the secondary market.[59]

ETF shares are redeemed through "in kind" transfers, which exchange creation units for their underlying portfolio securities.[60] ETF shares are not redeemable individually,[61] a feature that distinguishes them from most open-end funds.[62] Redemptions are priced by the end-of-day NAV and thus protect shares from dilution.[63] In-kind redemption also shelters ETF shareholders from the tax consequences of cash-redeemable mutual funds,[64] as in-kind redemption uses a direct securities transfer rather than a

55. Stuart M. Strauss, *Exchange Traded Funds—the Wave of the Future?* 7 INVESTMENT LAWYER 1, 15 (2000).

56. Actively Managed Exchange-Traded Funds, Investment Act Release No. IC-25258, 66 Fed. Reg. 57,614, 57,616 (Nov. 8, 2001).

57. *Id.*

58. *See, e.g.*, Bernstein, *supra* note 54, at 39 (noting that broker-dealers often break up creation units and offer ETF shares on the exchanges where individual investors can buy them).

59. *See* Ragozino & Gambino, *supra* note 28, at 3 (explaining that there are really "two markets" for ETFs); *see also* DOUGLAS S. ROGERS, TAX AWARE INVESTMENT MANAGEMENT 106 (Bloomberg Press 2006) (listing the two types of markets for ETFs as a primary market of authorized participants and a secondary market of individual investors); Ira P. Shapiro, *An Introduction to U.S. ETFs*, *in* PRACTISING LAW INST., NUTS & BOLTS OF FIN. PRODUCTS 2008 357, 361 (2008) (stating that most investors buy and sell ETF shares on the exchange, instead of making direct purchases and redemptions from the fund itself as they would do with index mutual funds); Letter from Philippe El-Asmar, Managing Dir., Barclays Capital Inc., to Nancy M. Morris, Sec'y, Sec. & Exch. Comm'n 2 (May 8, 2008) (on file with author), http://www.sec.gov/comments/s7-07-08/s70708-4.pdf (noting transactions with ETFs are limited to Authorized Participants, whereas "retail investors purchase and sell ETF shares in secondary market transactions").

60. BRENTANI, *supra* note 52, at 167.

61. *See, e.g.*, Actively Managed ETFs, *supra* note 56, at 57,621 ("Because ETF shares are not individually redeemable, an ETF requests relief to permit the ETF to register and operate as an open-end fund and to issue shares that are redeemable in Creation Units only.").

62. *See* Investment Company Act, 15 U.S.C. § 80a-5(a)(1) (2000) (indicating that open-end funds traditionally redeem all shares).

63. American Stock Exchange LLC, Explanation of ETFs, http://www.amex.com/?href=/etf/eductn/etf_edu_instit.html (last visited Oct. 16, 2008).

64. The following is a summary of the two primary tax advantages of ETFs over mutual funds:

> First, because retail investors go directly to the market to obtain cash for their shares, the fund manager does not have to sell shares that would trigger capital-

sale yielding taxable gains.[65] Capital gains taxes are deferred until investors sell the securities,[66] which in turn controls costs for the remaining shareholders[67] and supports the claim that in-kind creation and redemption provide for "relatively frictionless portfolio turnover."[68]

D. The Arbitrage Mechanism

ETF shares trading on secondary exchanges can experience deviations between share price and the NAV of their underlying portfolio securities.[69] While ETF share prices track the NAV of the fund's portfolio securities,[70] short-term differences between the two prices nonetheless occur.[71] The trading environment causes this deviation, marking a critical difference between an ETF and an open-end mutual fund. The share price of an open-end mutual fund "always equals its NAV,"[72] which, coupled with the

> gain distributions for the remaining shareholders. Second, creation unit holders can redeem their shares for the underlying stock rather than cash, thus deferring the gain or loss until the distributed shares are sold by the investor.

See, e.g., Randy Gardner & Julie A. Welch, *Increasing After-Tax Returns with Exchange Traded Funds*, J. FIN. PLANNING, June 2005, at 31, *available at* http://www.fpanet.org/journal/articles/2005_Issues/jfp0605-art4.cfm.

65. *See* Kathleen Moriarty, *Exchange-Traded Funds: Legal and Structural Issues Worldwide*, 29 INT'L BUS. L. 346, 349 (2001) ("[T]he ETF satisfies redemptions by providing the redeeming party with the actual basket of designated stocks, rather than cash proceeds resulting from the sale of such stocks . . . ."); *see also* Svea Herbst-Bayliss, *Fidelity Opens Magellan Fund to New Investors*, REUTERS, Jan. 14, 2008, http://www.reuters.com/article/companyNews/idUSN1441753420080114 (reporting that Fidelity re-opened its Magellan mutual fund to new investors following increasing withdrawals by retirees, which frequently forced the fund manager "to sell stocks he liked in order to have enough cash on hand to meet redemptions").

66. *See* Gardner & Welch, *supra* note 64, at 31 (citing this as a tax advantage); *see also* Stout & Chen, *supra* note 45, at 57 (explaining in regard to the in-kind redemption process: "According to the IRS, this exchange of essentially identical items does not trigger capital gains. Thus, ETF shares allow an investor to delay payment of capital gains tax until the final sale of the ETF shares.").

67. *See* Gardner & Welch, *supra* note 64 (contrasting the relatively high capital gains taxes associated with regular mutual funds with those associated with ETFs).

68. Moriarty, *supra* note 65, at 348.

69. Plante Moran Fin. Advisors, Exchange-Traded Funds Revisited 1 (2006), http://www.plantemoran.com (search "Exchange-Traded Funds Revisited"; then follow "full article" hyperlink).

70. Stuart Strauss & Scott M. Zoltowski, *Exchange Traded Funds*, *in* A.L.I.-A.B.A., INVESTMENT MGMT. REG. 67, 70 (Aug. 2006).

71. *See* John Demaine, *Exchange Traded Funds for the Sophisticated Investor*, 7 DERIVATIVES USE, TRADING & REG. 354, 355 (2002) ("While both ETFs and futures tend to track underlying cash indices tightly over a period of time, in the short term they can trade significantly away from 'fair value.'").

72. Plante Moran Fin. Advisors, *supra* note 69, at 1.

absence of intraday trading, precludes a significant arbitrage opportunity available to ETF investors.[73]

In practice, arbitrage profits are constrained by the market responses they create; high awareness of premiums and discounts motivates quick transactions that remove the spread between NAV and share price,[74] and provides ammunition to those who claim that "arbitrage is always a case of diminishing returns."[75] Nevertheless, arguments that arbitrage profits quickly evaporate tend to support the notion that arbitrage opportunities "discipline"[76] ETF share prices and prevent them from trading "at a material discount or premium in relation to their NAV."[77] For instance, if the ETF share price rises above the NAV of the securities in the portfolio basket, arbitrageurs have an incentive to quickly tender the necessary securities to purchase a creation unit, which can then be broken up and sold as individual ETF shares on an exchange.[78] Alternatively, if the NAV of the portfolio basket exceeds the share price, arbitrageurs will redeem creation units and sell the underlying portfolio securities.[79] As a result, if the share price trades at a premium, arbitrageurs may quickly purchase creation units and flood the secondary market with shares, which drives the share price down toward conformity with NAV.[80] A similar result may occur if ETF shares trade at a discount, as the incentive to purchase and redeem shares for the higher-value portfolio securities will reduce share supply and drive the price upward.[81] The resulting stability provided to ETF markets is significant, as "the close correspondence between NAVs and market prices of U.S. ETFs appears to be due largely to the feature of in-kind purchases and redemptions, which historically has facilitated price-

73. *See* Strauss, *supra* note 55, at 1 (explaining investment opportunities available with ETFs that are not available with mutual funds).

74. *See* Bansal & Somani, *supra* note 29, at 41 ("Investors can redeem ETF shares for shares of the underlying portfolio, and vice versa. This enables large investors to take advantage of any disparity between the market price and the underlying Net Asset Value (NAV), which in turn keeps the two trading close to one another.").

75. Daniel P. Collins, *Shrinking World Opens Arbitrage Window*, FUTURES, Dec. 2001, at 66.

76. Bernstein, *supra* note 54, at 39.

77. *Id.*

78. *See* James M. Poterba & John B. Shoven, *Exchange-Traded Funds: A New Investment Option for Taxable Investors*, 92 AM. ECON. REV. 422, 423 (2002) ("If the ETF share price rises too far above the NAV for the underlying assets, the creating institutions will buy the associated securities, deposit them in the trust, and create new ETF shares.").

79. *See id.* ("If the ETF share price falls below the NAV of the underlying assets, institutions will purchase ETF shares and redeem them for the underlying securities.").

80. *See* Actively Managed ETFs, *supra* note 56, at 57,616 ("As the supply of individual ETF shares available in the secondary market increases, the price of the ETF shares may fall to levels closer to NAV.").

81. *See id.* ("In purchasing the ETF shares, arbitrageurs create greater market demand for the shares, which may raise the market price to a level closer to NAV.").

correcting arbitrage activity."[82]

While some question the profit potential of arbitrage,[83] such challenges often validate the efficiency and speed of the arbitrage system in the ETF context.[84] Arbitrage profits for particular institutional investors may be thin, because the system works efficiently to respond quickly to profit opportunities created by premiums and discounts. Gary L. Gastineau and others argue that "[r]eal arbitrage opportunities, where the arbitrageur covers his costs and earns a trading profit are not common."[85] Nevertheless, the fact that U.S. domestic ETFs "are priced very close to their true NAVs with only brief excursions any significant distance away"[86] supports the view that arbitrage quickly stabilizes and adds liquidity[87] to the ETF market. In other words, market stability does not indicate that short-term profit opportunities for arbitrageurs are lacking per se,[88] but that they simply may be reaped too quickly to create significant wealth opportunities for a given arbitrageur.[89] Indeed, short-term profit opportunities, and the fierce competition to exploit them, explain why arbitrage has succeeded at stabilizing U.S. ETF markets. A fleeting profit opportunity motivates quick transactions that prevent premiums and discounts from lingering or growing.

Profit aside, arbitrage is possible only because investors know precisely what they are transacting in when they trade ETF shares and acquire or redeem creation units. For most ETFs, indexing provides the

82. Kathleen H. Moriarty, *Outline of Legal and Structural Issues Pertaining to Issuing and Trading Exchange Traded Funds*, *in* PRACTISING LAW INST., THE INVESTMENT MGMT. INST. 2002: A SEMINAR FOR '40 ACT LAWYERS 7, 30 (2002).

83. *See, e.g.*, GASTINEAU, *supra* note 30, at 237 (arguing that arbitrage opportunities in ETFs are rare).

84. For a discussion of how the spread of information and ease of trading increases competition and thus makes arbitrage profits more difficult to achieve, *see* Collins, *supra* note 75, at 66–68.

85. GASTINEAU, *supra* note 30, at 237.

86. Robert Engle & Debojyoti Sarkar, *Premiums-Discounts and Exchange Traded Funds*, J. DERIVATIVES, Summer 2006, at 27, 41.

87. *See* Shapiro, *supra* note 59, at 363:

> By engaging in such arbitrage transactions throughout the trading day whenever an ETF's share price varies significantly from the value of its underlying holdings, the Authorized Participants quickly provide "liquidity" whenever there is an imbalance of buy or sell orders for ETF shares that would otherwise cause the shares to trade at a premium or discount. By supplying such liquidity, the Authorized Participants close the premium or discount and ensure that the exchange price generally tracks the value of the ETF's holdings closely, which benefits all investors.

88. *See* Demaine, *supra* note 71, at 355 (noting that ETFs can trade significantly away from "fair value" in the very short-term).

89. *See generally* Collins, *supra* note 75 (discussing diminishing returns of arbitrage opportunities).

first layer of transparency by publishing the benchmark that an ETF seeks to track.[90] A fund's redemption baskets may change in response to index modifications, but these changes are published at the beginning of the day, usually through the National Securities Clearing Corporation,[91] and "generally reflect the contents of the portfolio of the ETF on that day and do not change during the day."[92] Changes to the underlying indices that equity index ETFs track are infrequent and therefore conducive to transparency and stability.[93] In addition, "the listing exchange makes available the current value of the Portfolio Deposit on a per ETF share basis at 15 second intervals throughout the day and disseminates intra-day values of the relevant index."[94] Sponsors of the first actively managed ETFs have worked within this framework of transparency and argue that "fully transparent portfolios, liquid portfolio securities and dissemination of the ETF's intraday indicative value permits arbitrage opportunities for actively managed ETFs to the same extent as index-based ETFs . . . ."[95]

Indeed, "[i]dentifying specific securities held in an ETF is much easier than determining the holdings of mutual funds," which "often delay or provide outdated information about holdings periodically throughout the year,"[96] much in contrast to fully transparent[97] ETFs that provide updated portfolio holdings daily.[98] The SEC lauds ETFs' frequent portfolio disclosures for their "high degree of transparency,"[99] which provides arbitrageurs with the necessary information for informed transactions.[100] The ability to determine the securities held in an ETF's portfolio[101] has

90. *See, e.g.*, Actively Managed ETFs, *supra* note 56, at 57,619 n.36 ("Because an index-based ETF seeks to track the performance of an index, often by replicating the component securities of the index, the ETF investment advisor or sponsor has no reservations about informing the marketplace of the contents of the ETF's portfolio.").

91. *See, e.g.*, Gary L. Gastineau, *The Benchmark Index ETF Performance Problem*, J. OF PORTFOLIO MGMT., Winter 2004, at 96, 99 (noting that ETFs post their baskets to the NSCC).

92. Actively Managed ETFs, *supra* note 56, at 57,619.

93. Bernstein, *supra* note 54, at 39; *see* Bansal & Somani, *supra* note 29, at 41 (noting general stability of index-linked ETFs); Gastineau, *supra* note 91, at 100 (discussing the infrequent changes to an ETF's underlying index).

94. Actively Managed ETFs, *supra* note 56, at 57,619.

95. Ropes & Gray, SEC Issues Notices for Actively Managed ETFs 1 (Feb. 20, 2008), http://www.ropesgray.com/secactivelymanagedetfs.

96. Plante Moran Fin. Advisors, *supra* note 69, at 3.

97. *See* Anne Papmehl, *Exchange-Traded Funds: Something for Everyone*, CMA MGMT., Oct. 2001, at 48 (explaining that intraday transmittal of valuation and related information makes ETFs fully transparent).

98. Fuller, *supra* note 7, at 90 ("ETFs disclose to the market the entire contents of their portfolio every single day, including on their websites.").

99. Actively Managed ETFs, *supra* note 56, at 57,619.

100. *Id.*

101. *See* Letter from Ira P. Shapiro, Assoc. Gen. Counsel, Barclays Global Fund Advisors, to Nancy M. Morris, Sec'y, Sec. & Exch. Comm'n 4 (May 16, 2008) (on file with

been central to arbitrage transactions, as the ability of arbitrageurs and others "to maintain [an ETF] price that tracks NAV is directly related to the transparency of the fund's portfolio."[102] When institutional investors know the contents of an ETF's portfolio, they "can determine at any time on any trading day the approximate NAV of an ETF"[103] and then compare that figure to the market price to facilitate an arbitrage transaction where imbalance exists.[104] Simply, "[f]or it all to work, big investors must be able to calculate the value of the underlying stocks" that an ETF holds.[105]

III. REGULATORY STRUCTURE

A. *Fund Types*

The Investment Company Act provides for two primary ETF structures: unit investment trusts (UITs)[106] and open-end investment companies.[107] Shares in a UIT[108] represent an undivided interest in a fixed basket of unmanaged securities.[109] These fixed portfolios are controlled

author), http://www.sec.gov/comments/s7-07-08/s70708-14.pdf ("Portfolio transparency is a means for permitting professional trading firms to readily ascertain the value of an ETF's portfolio relative to its current secondary market price . . . .").

102. Letter from Amy B.R. Lancellotta, Senior Counsel, Inv. Co. Inst., to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (Jan. 14, 2002) (on file with author), http://www.ici.org/statements/cmltr/02_sec_etfs_com.html.

103. Fuller, *supra* note 7, at 90.

104. *Id.*

105. John Waggoner, *New Breed of ETFs Offer a Half-Hidden Manager*, USA TODAY, Mar. 31, 2007, at 3B.

106. The Investment Company Act defines a unit investment trust as follows:

> [A]n investment company which (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-4(2) (2000).

107. *See, e.g.*, Moriarty, *supra* note 82, at 13 ("Currently, all U.S. ETFs are structured either as UITs or open-end funds that invest in a portfolio of equity securities designed to provide returns generally corresponding to the performance and dividend yield of a specific stock index."); *see also* Letter from Rita Dew, President, Nat'l Compliance Serv., to Douglas J. Scheidt, Assoc. Dir. & Chief Counsel, Div. of Inv. Mgmt., Sec. & Exch. Comm'n (Mar. 10, 2005) (on file with author), http://www.sec.gov/divisions/investment/noaction/ncs113005.htm (noting most ETFs are registered as open-end companies).

108. *See* SEC, Unit Investment Trusts (UITs), http://www.sec.gov/answers/uit.htm (last visited Oct. 16, 2008) (explaining that UITs usually offer a limited number of shares through a one-time public offering).

109. Consider the following description of the UIT structure:

> Typically the holder of a share in [a unit investment trust] has merely an

"with little or no change"[110] for the duration of the investment.[111] The vast majority of equity index ETFs and all actively managed ETFs use the open-end investment company structure.[112] Actively managed ETFs cannot use the UIT structure, which does not provide for active portfolio trading.[113] Sampling techniques, which ETFs registered as open-end companies often use, are unavailable to the UIT structure.[114]

Open-end investment companies, such as mutual funds, continually issue shares redeemable at NAV.[115] Unlike non-redeemable closed-end funds,[116] investors typically do not trade shares of open-end companies on an exchange,[117] but purchase them from an issuer or broker at NAV.[118] Although ETFs are often structured as open-end investment companies,[119] they are distinct from traditional open-end funds; ETFs limit redemption[120]

> undivided interest in a package of specified securities that are held by a trustee or custodian. There is no board of directors, and management discretion in the management of the portfolio is entirely eliminated or reduced to a minimum.

LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 48 (Aspen Publishers 5th ed. 2004).

110. SEC, Unit Investment Trusts, *supra* note 108.

111. *Id.*

112. *See* Letter from James E. Ross, Senior Managing Dir., State St. Global Advisors, to Nancy Morris, Sec'y, Sec. & Exch. Comm'n 3 (May 19, 2008) (on file with author), http://www.sec.gov/comments/s7-07-08/s70708-7.pdf (noting ETF sponsors prefer the open-end fund structure).

113. *See* SEC, Unit Investment Trusts (UITs), *supra* note 108.

114. Peter A. Ambrosini, *Exchange Traded Funds*, *in* A.L.I.-A.B.A., INVESTMENT COMPANY REG. & COMPLIANCE 427, 429 (2002).

115. Nora M. Jordan, *United States Regulation of Funds*, *in* PRACTISING LAW INST., INT'L SEC. MARKETS 2004 BEST PRACTICES & CHANGING REQUIREMENTS IN GLOBAL MARKETS 633, 636 (2004); *see* Letter from Dixie L. Johnson, Chair, Comm. on Fed. Regulation of Secs., & John T. Bostelman, Chair, Subcomm. on Secs. Registration, Am. Bar. Ass'n, to Sec. & Exch. Comm'n 81 (Feb. 11, 2005) (on file with author), http://www.sec.gov/rules/proposed/s73804/dljohnson021105.pdf (providing more detail on open-end investment companies' operation and regulation).

116. Closed-end funds do not redeem shares, such that investors must rely on secondary market trading to liquidate holdings. *See, e.g.*, LOSS & SELIGMAN, *supra* note 109, at 49 ("Closed-end companies do not have redeemable securities; they may occasionally offer new securities to the public as any industrial company does, but the usual way to acquire shares is on the open market.").

117. *See, e.g.*, SEC Div. of Investment Mgmt., Protecting Investors: A Half Century of Investment Company Regulation 423 (May 1992), http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf [hereinafter SEC Protecting Investors] (explaining differences between open-end and closed-end investment companies).

118. SEC, Mutual Funds, http://www.sec.gov/answers/mutfund.htm (last visited Oct. 26, 2008); SEC, Invest Wisely: An Introduction to Mutual Funds, http://www.sec.gov/investor/pubs/inwsmf.htm (last visited October 26, 2008).

119. Letter from Rita Dew to Douglas J. Scheidt, *supra* note 107.

120. ETF shares may only be redeemed in creation unit aggregations. Exchange-Traded Funds, *supra* note 56.

and list shares for intraday trading,[121] which are features usually associated with closed-end funds.[122] As Gastineau explains, ETFs "are a unique hybrid of closed-end and open-end investment companies," as they "trade like common stocks or closed-end funds"[123] but can also be "redeemed like open-end funds," albeit only in large aggregations of shares.[124]

B. *Specific Regulatory Provisions*

As instruments that blend elements of open-end and closed-end structures, ETFs traditionally require exemptive relief from various provisions of the securities laws before they may operate.[125] In addition to relief from the Investment Company Act, all ETFs must seek exemptions from certain provisions of the Securities Act and the Securities Exchange Act (although this Article does not focus on these statutes). Exemptive relief is available under § 28 of the Securities Act where it "is necessary or appropriate in the public interest, and is consistent with the protection of investors."[126] Section 36 of the Securities Exchange Act provides a power of limited exemptive authority, consistent with the parameters for relief under the Securities Act.[127]

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121. *See id.* (discussing sales of ETF shares).

122. *See* Mutual Funds, *supra* note 118 (describing how ETFs differ from open-end investment companies like mutual funds).

123. Gary L. Gastineau, *Is Selling ETFs Short a Financial "Extreme Sport"? in* FRANK J. FABOZZI, SHORT SELLING 37, 38 (Frank J. Fabozzi ed., John Wiley & Sons, Inc. 2004).

124. *Id.*; *see* EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKET 12-13 (Aspen Publishers 8th ed. 2005) ("ETFs are a hybrid of open-end and closed-end funds—they are traded on the secondary market (mostly on the AMEX) like shares of stock and their shares are redeemable, although only in very large blocks, which provides certain efficiencies in the operation of the funds.").

125. *See, e.g.*, Moriarty, *supra* note 82, at 43 ("[T]he hybrid nature of ETFs does not fit neatly into the existing U.S. regulatory regime. A variety of exemptions, interpretive and no-action relief is required to accommodate the structure and trading features of ETFs . . . ."); *see also* Shapiro, *supra* note 59, at 366:

> Because ETFs are a hybrid between mutual funds and closed-end funds that developed after the adoption of the 1940 Act, they are not directly authorized by the statute and, under existing SEC positions, must be granted an exemption by the SEC from complying with certain technical sections of the statute that do not otherwise diminish the need to comply with the investor protections of the statute.

The SEC has proposed relieving transparent ETFs from the need to acquire individual exemptions. *See* SEC Proposed Rules, *supra* note 3, at 14,618 ("The [proposed] rule would permit certain ETFs to begin operating without the expense and delay of obtaining an exemptive order from the Commission.").

126. 15 U.S.C. § 77z-3 (2000).

127. *See* 15 U.S.C. § 78mm (2000) ("[T]he Commission [may provide exemptive relief] . . . to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.").

This Article focuses on relief from certain provisions of the Investment Company Act that support a general theory of regulation in the ETF market. Pending the SEC's proposal to streamline ETF registrations,[128] ETFs must seek individual exemptive relief from Investment Company Act §§ 2(a)(32)[129] and 5(a)(1)[130], to permit ETFs to register as open-end investment companies while limiting redemption to creation units.[131] Relief from § 22(d)[132] and rule 22c-1[133] is similarly necessary to allow secondary market trading in ETF shares at negotiated prices that may not conform to NAV.[134] Furthermore, the SEC generously has granted orders for exemptive relief from § 17(a),[135] thus permitting "affiliates" to acquire and redeem creation units in-kind.[136] As a condition for exemptive relief, ETFs may not market themselves as mutual funds and must disclose that shares are not individually redeemable.[137] Actively managed ETFs must disclose their status.[138]

Until very recently, the SEC granted exemptive relief only to ETFs that were "structured primarily to track various domestic or foreign indices."[139] The SEC's recent proposed rule 6c-11 would exempt index-tracking and fully transparent actively managed ETFs from the need to

128. *See* SEC Proposed Rules, *supra* note 3, at 14,618 (stating that the SEC designed the rule "to eliminate unnecessary regulatory burdens").

129. 15 U.S.C. § 80a-2(a)(32) (2000).

130. 15 U.S.C. § 80a-5(a)(1) (2000).

131. Actively Managed ETFs, *supra* note 56, at 57,620-21.

132. 15 U.S.C. § 80a-22(d) (2000).

133. 17 C.F.R. § 270.22c-1 (2005).

134. *Id.*; *see also* Strauss, *supra* note 55, at 17 (explaining that compliance with § 22(d) and rule 22c-1 does not affect transactions in ETF shares, and thus makes applications for exemptions necessary).

135. Aside from the general provision for exemptive relief in § 6(c), 15 U.S.C. § 80a-6(c) (2000), § 17(b) permits the SEC to issue an order granting relief from § 17(a), 15 U.S.C. § 80a-17(a) (2000), provided three criteria are met: (1) the terms of the proposed transaction are reasonable and fair and do not involve overreaching by anyone involved; (2) the terms are consistent with the policy of each registered investment company involved; and (3) the proposed transaction is consistent with general purposes of the Act. 15 U.S.C. § 80a-17(b) (2000).

136. *See* Actively Managed ETFs, *supra* note 56, at 57,621-22 (addressing ETF exemptions); *see also* Strauss, *supra* note 55, at 17 (discussing the issues that arise when ETFs request exemptions from § 17(a)).

137. *See, e.g.*, Actively Managed ETFs, *supra* note 56, at 57,621 (explaining that the prospectuses and advertising materials for ETFs prominently disclose that their shares are not individually redeemable).

138. *See* WisdomTree Trust, Notice of Application, *supra* note 1, at 7777 (Complying with disclosure provisions by stating, "Neither the Trust nor any individual Fund will be marketed or otherwise held out as an 'open-end investment company' or a 'mutual fund.' The Prospectus for each Fund will prominently disclose that the Fund is an 'actively-managed exchange-traded fund.'").

139. Reg. of Inv. Companies, *supra* note 15, § 26.02[1][c].

acquire individual exemptive orders.[140] The SEC also will entertain petitions for individual exemptive orders filed by non-transparent actively managed funds.[141] Section 6(c) of the 1940 Act provides that the SEC may, either on its own motion or upon application, exempt securities and transactions from any provision of the Act or any rule established under it, provided that such exemption be "necessary or appropriate in the public interest and consistent with the protection of investors . . . ."[142] The SEC may impose conditions on exemptive relief.[143]

Financial innovators welcome the SEC's proposed streamlining process, as obtaining individual exemptive orders is not an easy prospect and forces many ETF sponsors to "innovate at the margins—meaning within parameters that are close to those previously approved by, or otherwise apparently acceptable to, [the Division of Investment Management]."[144] Indeed, securing individual exemptive orders requires significant time[145] and money,[146] as explained by Barry P. Barbash, a former Director of the Division of Investment Management:

> In my judgment, an indirect and unintended consequence of the Commission's recent spate of regulations in the mutual fund area has been to bog down the efforts of the SEC staff in approving new investment management products and services. Many of those products and services raise issues, sometimes of a highly technical nature, under the Investment Company Act of 1940 and necessitate the obtaining of an exemptive order issued by the

140. SEC Proposed Rules, *supra* note 3, at 14,642 ("Proposed rule 6c-11 would exempt ETFs from certain provisions of the [Investment Company] Act, permitting them to begin operating without obtaining an exemptive order from the Commission.").

141. *Id.* at 14,624.

142. 15 U.S.C. § 80a-6(c) (2000) provides the following:

> The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation thereunder, 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 this subchapter.

143. *See, e.g.*, Moriarty, *supra* note 82, at 45 (explaining that an ETF's application for exemptive relief is subject to comment by the Division of Investment Management, and depending on the issues raised, other divisions and offices of the SEC); *see also* 6-83 Sec. L. Techs. (MB) § 83.07[1][a][i] (2008) (noting that the SEC can impose conditions on an ETF before providing relief).

144. Fuller, *supra* note 7, at 92.

145. *Id.* ("At present, the exemptive process in [the Division of Investment Management] can take as little as six months for routine index-based ETFs or several years for more novel ETFs.").

146. The SEC estimates that it costs about $75,000 to $350,000 for an ETF to submit an application for exemptive relief. SEC Proposed Rules, *supra* note 3, at 14,646 n.301.

> Commission under section 6(c) of the 1940 Act. Regardless of whether the product is entirely new to the marketplace or based on existing products, the process of obtaining an exemptive order is time-consuming, and can be a significant disincentive to product development. Obtaining an order relating to a novel product or service, for example, can take eighteen months or more. Nothing frustrates my clients, and I submit the clients of other practitioners, more than the time needed to obtain exemptive orders.[147]

1. Share Pricing and NAV

One prerequisite to transparent ETF registration has been exemptive relief from the Investment Company Act's requirement that shares issued by registered investment companies must be offered, traded, and redeemed at NAV.[148] Section 22(d) of the Investment Company Act contains this requirement, and rule 22c-1 promulgates it thereunder. Section 22(d) restricts the sale of redeemable securities issued by investment companies to "a current public offering price described in the prospectus," unless such securities are sold to or through a principal underwriter for distribution.[149] Similarly, rule 22c-1 limits the sale price of redeemable securities issued by investment companies to NAV.[150] Rule 2a-4, which governs the calculation of NAV, requires that "[p]ortfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company."[151] That market price and NAV are intertwined is not a controversial proposition, as "[t]he [1940] Act also made net asset value, based upon the market prices of an investment company's portfolio securities, the fundamental valuation criterion of registered investment companies."[152]

Despite these provisions, the SEC permits ETFs, with shares trading on secondary markets at "negotiated" prices determined by market forces,

147. *Mutual Funds: A Review of the Regulatory Landscape: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 109th Cong. 48 (2005) (statement of Barry P. Barbash, Partner, Shearman & Sterling LLP).

148. *See, e.g.*, Moriarty, *supra* note 82, at 43 ("[T]he hybrid nature of ETFs does not fit neatly into the existing U.S. regulatory regime.").

149. 15 U.S.C. § 80a-22(d) (2000).

150. 17 C.F.R. § 270.22c-1 (2008).

151. 17 C.F.R. § 270.2a-4(a)(1) (2008).

152. Harriman v. E.I. du Pont De Nemours & Co., 411 F. Supp. 133, 160 (D. Del. 1975).

to register as investment companies despite § 22(d) and rule 22c-1.[153] An examination of these provisions' objectives is key to understanding why the SEC has been willing to grant ETFs exemptive relief from § 22(d) and rule 22c-1.[154] Both provisions respond to abuses in the mutual fund industry; section 22(d) aims to prevent "riskless trading" schemes,[155] while the "primary purpose"[156] of rule 22c-1 similarly is to prevent dilution-based abuses related to "backwards pricing."[157] These regulations particularly respond to situations where traders, knowing a mutual fund's closing price on the current day and its next-day opening price, have purchased shares at the first price to resell them at a guaranteed higher price the next day.[158] Solomon Freedman, Director of the SEC's Division of Corporate Regulation in 1968, explained how such transactions functioned:

> You all remember that the President, during the evening of March 31 (a Sunday), announced that the bombardment of North [Vietnam] would be curtailed and that he would not accept renomination. During the morning of Monday, April 1, the general market rose sharply—the highest single day increase in some 4-1/2 years. Some individuals placed large orders for the purchase of fund shares at about 1:30 p.m. and obtained the 3:30 p.m. price of the previous Friday. In fact, in one no-load fund, a million dollar purchase was entered—and, about 4:00 p.m. those shares were 'redeemed' upon the basis of the 3:30 p.m. price—thereby making a very handsome profit.[159]

153. See sources cited *supra* note 134 (explaining the relationship between transactions in ETF shares, § 22(d), and rule 22c-1).

154. At least with respect to § 22(d), some argue that "there is little legislative history" to inform how the provision functions. SPA ETF Trust and SPA ETF Inc., Notice of Application, Investment Company Act Release No. 27,963, 72 Fed. Reg. 51,475, 51,478 (Aug. 31, 2007); *see* 1 Reg. of Inv. Companies (MB) § 9.03[1] (2008) (noting that § 22(d) has little legislative history regarding its purpose and an ambiguous administrative history).

155. *See, e.g.*, SEC Protecting Investors, *supra* note 117, at 429 ("Paragraph (d) of section 22 requires that open-end securities be sold only at the current offering price described in the prospectus. This subsection, designed at least in part to prevent insider riskless trading and the resulting dilution, has resulted in a system of retail price maintenance that fixes open-end share prices and prevents dealers from making a secondary market.").

156. Reflow Fund, LLC, SEC No-Action Letter, 2002 WL 1493234 (July 15, 2002).

157. *Id.*; *see* Letter from Craig S. Tyle, General Counsel, Inv. Co. Inst., to Paul F. Roye, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm'n (Nov. 13, 2002) (on file with author), http://www.sec.gov/divisions/investment/guidance/tyle111302.htm ("The SEC adopted Rule 22c-1 to address its concern that backward pricing could lead to significant dilution of the investments of existing fund shareholders.").

158. *See, e.g.*, U.S. v. Nat'l Ass'n of Secs. Dealers, 422 U.S. 694, 707 (1975) (explaining that the "interim period" between the calculation of a fund's closing price on the previous day and the next-day opening price based on NAV at the current day's closing, provided opportunities to "engage in 'riskless trading'" by exploiting the price difference).

159. Solomon Freedman, Dir., Div. of Corporate Regulation, SEC, Projections, Forward

Traders who knew both the current and next-day share price not only cleansed their transactions of risk,[160] but also watered down the value of remaining shareholders' investments where the cash value paid to redeem shares exceeded the shares' NAV.[161] Similarly, an investor who bought shares in a fund could wait until the first price moved higher than the second, thus indicating that share value was declining.[162] The investor could wait for the price drop to hit bottom and buy on the next uptick, thereby diluting the value of the outstanding shares by acquiring more shares than when the original intent to purchase was formed.[163]

ETF shareholders do not face the same threat of dilution that once plagued the mutual fund industry because ETFs redeem in-kind instead of exchanging cash for shares.[164] Moreover, deviations from NAV in secondary market transactions are contained between parties to the transaction and do not draw down the fund's assets.[165] Given these barriers to dilution, a legitimate question is why § 22(d) and rule 22c-1 are relevant in the ETF context, particularly given that "[t]he SEC's apparent concern is primarily with positive distortions of NAV."[166] Positive distortions of NAV can be dangerous for investors, and the SEC takes them seriously because they dilute the wealth of non-redeeming shareholders by drawing cash out of funds when shares are redeemed.[167] While this threat does not apply to the in-kind redemption process used by ETFs, § 22(d) and rule 22c-1 remain relevant to a discussion of exemptive relief in the ETF context, as they may provide inroads into explaining why ETFs are permitted to function as they do. Alternatively, § 22(d) and rule 22c-1 may

Pricing, and Group Purchasing, Remarks before the 20th Annual International Mutual Fund Dealers' Conference 4 (Oct. 22, 1968), http://www.sec.gov/news/speech /1968/102268freedman.pdf.

160. *See, e.g.*, *id.* (discussing unfortunate strategic behavior resulting from the pricing mechanism).

161. *Nat'l Ass'n of Sec. Dealers*, 422 U.S. at 707-08 (explaining that the "immediate appreciation" made possible by backwards pricing "was obtained at the expense of the existing shareholders, whose equity interests were diluted by a corresponding amount").

162. Freedman, *supra* note 159, at 4.

163. *Id.*

164. *See, e.g.*, Moriarty, *supra* note 65, at 349 ("[T]he close correspondence between NAVs and market prices of US ETFs appears to be due largely to the feature of in-kind purchases and redemptions, which historically has facilitated price-correcting arbitrage activity.").

165. At least one fund company seeking approval of a new ETF has made the argument that "market trading in [ETF shares] does not involve the [ETF] as parties and cannot result in dilution of an investment in [the ETF]." SPA ETF Trust, *supra* note 154, at 51,478.

166. Janet Kiholm Smith et al., *The SEC's 'Fair Value' Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Assets* (Claremont Economics, Working Paper No. 2000-39), *available at* http://ssrn.com/abstract=249317.

167. *See* U.S. v. Nat'l Ass'n of Secs. Dealers, 422 U.S. 694, 707-08 (1975) (discussing problems with the pricing system).

not be relevant to ETF investors who remain invested in a fund, but are nevertheless important to those who seek to convert shares into cash through transactions in the secondary market.

Granting ETFs exemptive relief from § 22(d) and rule 22c-1 appears to be a consequence of the belief that the market will act as a surrogate for fair-value redemption by supplying retail investors with a value close to the NAV of the portfolio securities underlying their shares. As a result, the market protects non-selling ETF shareholders—analogous to the non-redeeming mutual fund shareholders in the dilution example—from artificially crumbling share values caused by below-NAV sales in the secondary market. Exemptive relief from § 22(d) and rule 22c-1 for ETFs is based, in part, on the assumption that the market itself will stand in for regulation to ensure that trading does not occur at deep discounts to NAV.

While § 22(d) and rule 22c-1 necessarily apply to mutual funds, ETFs receive exemptions from these regulations precisely because, unlike mutual funds, they are traded in a market that performs the regulations' value-protecting function naturally. Based on its historical treatment of these provisions, the SEC notes in the March 2008 proposed rules that "[o]ur 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."[168]

2. Lessons from Closed-End Funds

At a recent workshop sponsored by the Investment Company Institute concerning closed-end funds, Andrew Donohue stressed the importance of accurate NAV valuations for shares in those funds.[169] In response to the argument that NAV valuations are less important for closed-end funds, which are traded at market price rather than redeemed at NAV, Donohue explained that "closed end fund market prices correlate, at least to some extent, with closed end funds' NAVs," such that NAV can influence trading prices.[170] Donohue implies that inaccurate NAV calculations could disrupt efficient trading by transmitting false signals to the market.[171] At first glance, ETFs, which follow closed-end funds by relying on secondary

168. SEC Proposed Rules, *supra* note 3, at 14,624.

169. Andrew J. Donohue, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm'n, Luncheon Address at the 2007 ICI Closed End Fund Workshop (Oct. 11, 2007), http://www.sec.gov/news/speech/2007/spch101107ajd.htm; *see* Jacquelyn Lumb, *Donohue Outlines Staff Concerns with Closed-End Funds*, 2007-198 SEC TODAY, Oct. 15, 2007, at 1 (summarizing Donohue's remarks about accurate valuation and closed-end funds).

170. Donohue, *supra* note 169.

171. *See id.* (concluding that a closed end fund's NAV must be accurate because "NAVs can affect the market prices at which closed end fund investors trade shares").

market trading as the de facto liquidation method for the retail investor,[172] appear vulnerable to inaccurate NAV calculations. If erroneous NAV calculations by a fund alter the market price of closed-end funds, it follows that inaccurate NAV calculations provided by an ETF could affect the ETF's share price. However, such a view is correct only at the skeletal level, as transparent ETFs offer investors unique, market-based protections.

Specifically, equity index ETFs contain a built-in check on serious or persistent miscalculations of NAV. Equity Index ETFs create an ideal arbitrage situation by tracking publicly-available indices and trading in transparent markets.[173] These ETFs do not simply transmit NAV to the market; instead, market makers have the necessary information to determine NAV[174] based on the component securities that the ETF tracks.[175] When arbitrageurs detect an imbalance between share price and the NAV of portfolio holdings, they smooth the jagged edges by bringing the two prices into balance.[176] The same is true for the recently-approved actively managed ETFs, which provide arbitrageurs with the same transparency.[177]

But, if § 22(d) and rule 22c-1 explicitly intend to protect existing shareholders in mutual funds from discounted redemptions that deplete

172. The ETF market permits redemption with the fund, but limits redemption to "authorized participants" with a sufficient block of shares to constitute a creation unit. *See* Accelerated Approval of a Proposed Rule Change Relating to ETFs, 67 Fed. Reg. 51,916, at 51,918 n.14 (Aug. 9, 2002) ("The Commission notes that unlike typical open-end investment companies, where investors have the right to redeem their fund shares on a daily basis, investors in ETFs can redeem them in creation unit size aggregations only."); *see also* Reg. of Inv. Companies, *supra* note 15, § 26.02[1] (explaining that large institutional investors, arbitrageurs, and other market professionals may acquire shares directly from the ETF by tendering securities); *id.* § 26.02[1][a] ("[P]rior to any redemption, the redeeming shareholder (which is almost always an institution, broker-dealer, arbitrageur or other market professional) must accumulate enough shares to make up a Creation Unit."); Trang Ho, *Actively Managed ETFs: The Next Frontier*, INVESTORS BUS. DAILY, Mar. 17, 2008, http://www.thefreelibrary.com (search "Title" for "The Next Frontier"; then follow article hyperlink) (quoting Patrick Daugherty as stating that "mutual funds allow redemptions of even a single share of the fund every day; ETFs do not. You can't redeem a single share, but you can redeem a block of shares, called a creation unit. That's typically a multimillion dollar amount. So you can redeem it wholesale, but not retail.").

173. *See, e.g.*, Waggoner, *supra* note 105 (linking transparency with arbitrage for active managers).

174. *See id.* (explaining that ETFs typically show the value per share of their holdings every fifteen seconds).

175. *See, e.g.*, Plante Moran Fin. Advisors, *supra* note 69, at 3 (noting it is easier to determine on a daily basis the holdings of ETFs rather than mutual funds).

176. *See* discussion *infra*, Part III.B.3 (noting arbitrageurs limit chaotic pricing and correct price discrepancies by responding to new information about NAV and share price imbalances).

177. *See* SEC Proposed Rules, *supra* note 3, at 14,620 n.27 (discussing proposed transparency requirements for streamlined approval of actively managed ETFs).

fund assets,[178] what do these regulations say about future shareholders who are immune from redemption-based equity drains until they buy into a fund? History may provide the best explanation,[179] as shadows of early Investment Company Act enforcement reveal "spirit of the Act" goals that have become obscured by the more common justification of preventing the dilution of existing shareholders' assets. The repurchase schemes in the years preceding the enactment of the Investment Company Act are particularly instructive.

Closed-end funds became dangerous during the 1930's in part because the absence of a redemption requirement forced liquidating investors to seek value in deteriorating secondary markets. Closed-end fund share values were not only declining, but would also trade below NAV.[180] Such a result was possible because, "[u]nlike shareholders of open-end funds, closed-end fund shareholders who sell their stock may receive more or less than the net asset value of the shares."[181] One especially troubling effect of these discounts was the reaction of some closed-end companies facing powerful incentives[182] to engage in extensive repurchase operations.[183]

The repurchase schemes of the 1930's were possible in large part because illiquid assets held in closed-end funds[184] were subject to murky valuations that prevented investors from accurately pricing NAV. Pricing trouble in the secondary markets particularly damaged investors in closed-end funds, and spurred regulation under the Investment Company Act, based, in part, on the need to "prevent discriminatory repurchases of their own securities by investment companies whose security holders do not have the right to require redemption . . . ."[185] The difficulty in valuing

178. *See, e.g.*, Letter from Craig S. Tyle to Paul F. Roye, *supra* note 157 (stating that the SEC adopted rule 22c-1 to protect mutual fund shareholders from significant dilution of their investments).

179. *See* Harriman v. E.I. du Pont De Nemours & Co., 411 F. Supp. 133, 159 (D. Del. 1975) (explaining that the Investment Company Act of 1940 was "designed to protect shareholders of investment companies from a variety of sharp practices that had become widespread during the 1930's"); *see generally* William K. Sjostrom, *Tapping the Reservoir: Mutual Fund Litigation Under Section 36(a) of the Investment Company Act of 1940*, 54 U. KAN. L. REV. 251, 258 (2005) (summarizing how the Investment Company Act arose from the historic context of the stock market crash of 1929 and subsequent threats to investors).

180. SEC Protecting Investors, *supra* note 117, at 426.

181. Letter from Dixie L. Johnson & John T. Bostelman to Sec. & Exch. Comm'n, *supra* note 115, at 82.

182. SEC Protecting Investors, *supra* note 117, at 426.

183. *Id.*

184. Closed-end funds can invest in illiquid assets because they do not need to meet the redemption obligations of their open-end counterparts. COMMITTEE ON FEDERAL REGULATION OF SECURITIES, FUND DIRECTOR'S GUIDEBOOK 88 (3rd ed. 2006).

185. 86 Cong. Rec. 2844, 2846 (1940) (daily ed. Mar. 14, 1940) (statement of Sen. Wagner), *reprinted in* IV Federal Securities Laws: Legislative History 1933-1982 (BNA) 3827 (1983).

assets held by closed-end funds allowed for persistent discounts and prevented an efficient, market-driven price correction, leaving investors vulnerable to discounted repurchases. As the SEC explained,

> After the crash, repurchases often were made for different reasons. As the price of closed-end shares fell to a discount, repurchases at discount prices became a source of book profits for closed-end companies. Many times, however, the profits were made at the expense of selling shareholders who had no way of knowing the extent of the discount and, therefore, the extent to which they were liquidating their shares at prices that did not reflect their true value. This was possible because closed-end companies did not disclose the net asset value of their shares.[186]

While the SEC subsequently enacted § 23 of the Act to regulate repurchase transactions directly,[187] an important issue that currently surrounds ETFs is whether and to what extent transparency arms the market with sufficient information to correct inefficient pricing. Closed-end funds still face persistent discounts today, a situation often explained by the illiquid assets they hold.[188] ETFs have avoided a similar fate through high liquidity and transparent portfolios that facilitate price-correcting arbitrage.[189]

While the closed-end fund discount problem affects selling shareholders, other regulations—especially § 22(d) and rule 22c-1—help protect shareholders that remain invested in funds by targeting discounted redemptions.[190] Thus, § 23(c) on the one hand, and § 22(d) and rule 22c-1 on the other, collectively protect two classes of investors. While § 22(d) and rule 22c-1 protect investors who remain invested in a fund by preventing cash-based redemptions at prices above NAV from diluting

186. SEC Protecting Investors, *supra* note 117, at 427.

187. *See generally id.* at 427-28 (discussing § 23 and its mechanism to allow closed-end investment companies to repurchase their shares from investors on the open market).

188. The small number of hedge funds listed as closed-end funds on exchanges have proven vulnerable to the same discounting problem common to the closed-end structure. Brynn D. Peltz & Joseph J. Muscatiello, *Hedge Fund Stock Exchange Listings: Considerations and Developments*, 41 REV. OF SECS. & COMMODITIES REG., Feb. 6, 2008, at 25, 28 ("[H]edge funds listed on liquid exchanges as closed-end funds have typically traded at a discount to net asset value.").

189. *See* Fuller, *supra* note 7, at 91 (explaining that "[arbitrage] keeps an ETF's shares from consistently trading at a significant discount to NAV," unlike many closed-end funds' shares); *see also* William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 104 (2008) ("ETFs avoid the perils of unfair valuation by trafficking in publicly traded investments.").

190. *See* discussion *supra* notes 155, 157 (noting the SEC's actions to protect existing mutual fund shareholders from dilution).

their assets,[191] § 23(c) protects sellers by placing limitations on the repurchase of closed-end fund shares.[192] Yet, this is only half of the puzzle, as shares can also trade at a premium to NAV, which benefits the seller at the buyer's expense. While this other side of the coin has been addressed less frequently,[193] at least one account suggests that the SEC may be concerned with premiums *above* NAV, albeit in the limited context of an offering rather than during the course of subsequent trades:

> While there are no statutory prohibitions on issuance of shares of a closed-end company at a price above net asset value during the course of an offering, the SEC staff has taken no-action positions on this point. The staff has taken the position that it would not be consistent with the Investment Company Act for a closed-end company to offer its common stock to the public at a price that is significantly in excess of its net asset value.[194]

Situating this passage within the context of § 23(c) and the policy undercurrent of § 22(d) and rule 22c-1[195] suggests a broad approach to investor protection that spans existing shareholders as well as buyers and sellers in the secondary market. Protecting buyers and sellers in the secondary market is a strong consideration for ETFs, as in-kind redemption precludes the problem of artificially high cash payments that dilute fund assets. If the SEC finds it desirable to protect buyers and sellers from premiums or discounts by keeping secondary market prices close to NAV, an immediate question is why the SEC frequently grants ETFs exemptive relief from the requirements of § 22(d) and rule 22c-1 to permit trading at negotiated prices, as these prices are not guaranteed to approximate NAV.

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191. *Id.*; *see* In the Matter of Heartland Advisors, et al., Order Instituting Administrative Cease-and-Desist Proceedings, Securities Act Release No. 8884, Exchange Act Release No. 57,206, Investment Company Act Release No. 28,136 (Jan. 25, 2008), *available at* 2008 SEC LEXIS 174, at *4 (alleging that certain mutual funds priced municipal bonds "at prices above their fair values," such that "the Funds' Net Asset Values ('NAVs') were incorrect, the Funds' shares were incorrectly priced, and investors purchased and redeemed Fund shares at prices that benefited redeeming investors at the expense of remaining and new investors").

192. *See generally* SEC Protecting Investors, *supra* note 117, at 427-28 (discussing the protections offered by § 23).

193. While there are few specific references to offering an investment company's securities to the public at a price above NAV, the SEC is concerned with protecting potential investment company shareholders. *See, e.g.*, Comment, *The Investment Company Act of 1940*, 50 YALE L.J. 440, 446 (1941) (claiming, in regard to the disclosure requirements of the 1940 Act, that "[a]ll of these disclosure provisions are designed as much to safeguard the potential purchaser of investment securities as the individual who is already a stockholder").

194. PRACTISING LAW INST., FINANCIAL PRODUCT FUNDAMENTALS § 7:6 (Clifford E. Kirsch ed., 1999).

195. *See supra* text accompanying notes 155, 157 (discussing the SEC's actions to protect existing mutual fund shareholders from the effects of dilution).

If investor protection in the course of secondary market transactions is a valid concern, then the SEC must base exemptive relief from § 22(d) and rule 22c-1 on the premise that some other element at play reduces the need for direct regulation.

3. Arbitrage and Regulation

One explanation for exemptions from § 22(d) and rule 22c-1 is that transparent ETFs protect retail investors naturally from large premiums and discounts in the secondary market.[196] Specifically, arbitrageurs limit chaotic pricing by quickly responding to new information about NAV and share price imbalances, thus smoothing away pricing discrepancies. The following account is noteworthy:

> A key distinction between ETFs and closed-end investment companies, however, is the ability to continually purchase and redeem shares of the ETF at net asset value per share ("NAV"). This feature is intended to create an arbitrage pricing discipline which minimizes the occurrence of discount and/or premium pricing historically experienced by closed-end investment companies.[197]

By "ensur[ing] smooth trading on the stock exchange,"[198] arbitrage naturally corrects inefficient pricing and indirectly protects retail investors from the perils of information disparity. Arbitrage—while providing immediate profits only to institutional investors engaged in direct transactions with a fund[199]—also keeps prices efficient by leveling price discrepancies in the secondary market.[200] This leveling process uses the

196. *See, e.g.*, Stout & Chen, *supra* note 45, at 57 (arguing that one benefit of ETFs, as compared to closed-end funds, is that "[c]losed-end fund investors often find their shares trading at a discount or premium . . . . For ETFs, however, any inconsistency between trading price and NAV should be slim and short-lived, and perhaps nonexistent once transaction costs are considered.").

197. FINANCIAL PRODUCT FUNDAMENTALS, *supra* note 194, § 16-2.

198. Deutsche Börse Group, Opportunities for Institutional Investors 39 (2003), http://www.eurexchange.com/download/documents/publications/DB_AM_Final.pdf.

199. Arbitrage is conducted almost exclusively by institutional investors. *See* Reg. of Inv. Companies, *supra* note 15, § 26.02[1][a] ("If the ETF's NAV is *higher* than the ETF's share price on the exchange, institutional investors, broker-dealers and other arbitrageurs or market professionals will redeem Creation Units for portfolio securities."); DAVID LOGAN SCOTT, INVESTING IN MUTUAL FUNDS 139 (Houghton Mifflin Co. 2004) ("A disparity between the value of ETF shares and the underlying basket of securities that represent the index will result in arbitrage by broker-dealers until the disparity in values is eliminated."); Stout & Chen, *supra* note 45, at 57 ("The institutional investor (or market specialist) may, at its discretion, obtain the return of its deposited securities by redeeming with the ETF an equivalent number of the shares it received originally from the ETF.").

200. *See* Bansal & Somani, *supra* note 29, at 41 (explaining that large investors can redeem ETF shares of the underlying portfolio and vice versa to take advantage of

creation and redemption processes to protect the retail investor, even though retail investors do not participate in creation or redemption.[201]

The SEC has explained that closed-end investment companies that engaged in discounted repurchases reaped profits by exploiting investors' inability to accurately price the shares they held.[202] Such a scenario does not threaten investors in index-tracking or newly-approved actively managed ETFs,[203] as transparency provides the information necessary for arbitrageurs to control premiums and discounts, and thus reduces the risk that retail investors will purchase shares above NAV or sell them below NAV.[204] This is the case even if most investors cannot or do not identify deviations between share price and NAV.[205] The current arbitrage regime for transparent ETFs corrects price spreads even if the retail investor is unaware of a premium or discount and does nothing to protect his or her investment from it.[206]

The SEC has provided ETFs with exemptive relief from § 23(c) and § 22(d) at least in part because arbitrage transactions animate the secondary market and provide price stability to retail investors. As long as the ETF market remains transparent, arbitrageurs will possess the necessary information to capitalize on profit opportunities and thus correct premiums and discounts, thereby removing the need for direct regulation and justifying exemptions from the share pricing restrictions of the 1940 Act. Without tracking published securities indices, transparent actively managed ETFs are expected, like their predecessors, to "provi[de] institutional

disparities between the market price and the NAV, which in turn keeps the two trading closely).

201. *See* Stout & Chen, *supra* note 45, at 57 (explaining that the creation and redemption processes prevent institutional investors from engaging in strategic large-block trading practices that would harm ordinary investors).

202. SEC Protecting Investors, *supra* note 117, at 427.

203. Although persistent discount problems that have affected some closed-end funds have not affected ETF investors, ETFs are not entirely safe. There is always a risk that ETF investors will have difficulty selling shares in a declining market. *See* Ragozino & Gambino, *supra* note 28, at 4 (explaining that, because common investors cannot redeem ETF shares, "in a rapidly declining market, where both institutional and retail purchasers of ETFs are likely to be scarce, retail investors may have difficulty selling their ETF shares"). Nonetheless, while selling ETF shares, like any security, may be difficult in a falling market, ETFs are unlikely to trade below the NAV of the underlying portfolio securities.

204. *See* Strauss, *supra* note 55, at 15 (noting that arbitrage generally has allowed ETFs to trade at prices materially similar to NAV, in marked contrast to closed-end funds that frequently trade at discounts to NAV).

205. The arbitrage system adequately protects ETF investors from discounts or premiums because it naturally corrects price defects without requiring any action by the average investor. *See, e.g.*, Stout & Chen, *supra* note 45, at 57 ("[O]ne advantage of ETFs is a built-in mechanism to ensure that they are priced according to the market value of the underlying securities in the fund.").

206. *See id.* (explaining that ETFs price near NAV and provide high liquidity).

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."[207] As a result of readily-available data and the natural profit incentives of arbitrageurs, investors in transparent ETFs "can feel confident that the shares they're buying are as close to the true value of the index as possible."[208]

By granting transparent ETFs exemptive relief from certain provisions of the 1940 Act, the SEC implicitly recognizes the limits of regulation in the context of transparent ETFs. In many ways, exemptive relief from the share pricing provisions of the 1940 Act represents the exclusion of regulatory intervention where markets naturally correct inefficiencies. By ceding to natural forces that supplant the need for regulatory intervention, the SEC may have advanced quietly, or at least deferred to, a normative constraint on unnecessary market intervention with respect to transparent ETFs. The remaining issue is whether this constraint will remain viable for opaque actively managed ETFs, which would aspire to be free from both index-tracking and full transparency.

This section of the Article has addressed the role of transparency and NAV valuation as core investor protections in the ETF market. Equity index ETFs have received exemptive relief from various provisions of the Investment Company Act because the high levels of transparency surrounding share prices and NAV convey sufficient information for arbitrageurs to naturally correct market imbalances by eliminating premiums and discounts. Furthermore, this section has argued that the SEC has allowed arbitrage in the ETF market to shape the contours of regulation. In granting exemptive relief from § 22(d) and rule 22c-1 under the 1940 Act, the SEC has deferred to arbitrage in the transparent ETF market as a process of natural correction that controls pricing imbalances and protects retail investors without the need for direct regulation.

To further situate ETFs within this schema, the next section focuses on exemptive relief from the requirement that investment companies must issue redeemable securities. If closed-end funds are problematic because they force investors to confront risks attendant to difficult valuations by confining liquidation opportunities to the secondary market, then it is interesting that modern ETFs, particularly when organized as open-end investment companies, have been able to limit redemption to creation unit holders. The next section provides a simple explanation of why this has been the case.

207. SEC Proposed Rules, *supra* note 3, at 14,623.

208. ARCHIE M. RICHARDS, ALL ABOUT EXCHANGE TRADED FUNDS 57 (McGraw Hill 2003).

4. Redeemable Securities

The limited right of redemption[209] for ETF shareholders is unique because ETFs are usually registered as open-end investment companies.[210] This is more than a mere structural curiosity because the right of redemption common to open-end funds "leads to many differences in the regulatory treatment of open-end and closed-end companies under the [Investment Company] Act."[211] While limiting redemption to creation unit holders[212] is less restrictive than excluding redemption altogether, comparisons of redemption rights between ETFs and traditional closed-end funds form the basis for numerous discussions about ETFs' "hybrid" structure,[213] which incorporates elements of both the open and closed-end fund models. A criticism of registering ETFs as open-end investment companies may have some appeal, given the de facto exclusion of retail investors from the right of redemption, as "trading ETF shares through a broker is the only way for small investors to redeem their shares because they are not financially able to perform . . . 'in-kind' transactions."[214]

This limitation raises questions about the justification for providing open-end ETFs with exemptive relief from § 2(a)(32) and § 5(a)(1) of the 1940 Act. Section 2(a)(32) defines a "redeemable security" as one that entitles the holder, upon presentment to the fund, to the approximate proportionate share of the fund's assets or the cash equivalent represented by the presented securities.[215] Section 5(a)(1) adds the provision that an open-end investment company may offer for sale "any redeemable security of which it is the issuer."[216] This is an important point because, although closed-end funds are registered as investment companies, they do not issue redeemable securities.[217] The distinction between open and closed-end

209. Shareholders may redeem ETF shares only in creation unit aggregations, typically of at least 50,000 shares. Because individual shares are not redeemable, "there is an issue as to whether ETFs can be viewed as issuing redeemable securities and therefore entitled to register as a UIT or as an open-end company." Strauss, *supra* note 55, at 16-17; *see* Laurin Blumenthal Kleiman, *The Nuts and Bolts of Unit Investment Trusts (or Why a UIT is Not a Mutual Fund)*, *in* PRACTISING LAW INST., NUTS & BOLTS OF FIN. PRODUCTS 2005 631, 674 (2005) ("ETFs issue and redeem blocks of shares (typically called 'creation units') consisting of a specific number (*e.g.*, 50,000) of non-redeemable individual shares which, in turn, trade on an exchange.").

210. *See* Letter from Rita Dew to Douglas J. Scheidt, *supra* note 107 (stating that most ETFs are open-end registered investment companies).

211. SEC Protecting Investors, *supra* note 117, at 422.

212. *See* discussion *supra* note 209 (citing the need to redeem ETF shares in creation unit aggregations).

213. Gastineau, *supra* note 123, at 38.

214. Stout & Chen, *supra* note 45, at 57.

215. 15 U.S.C. § 80a-2(a)(32) (2000).

216. 15 U.S.C. § 80a-5(a)(1) (2000).

217. 15 U.S.C. § 80a-5(a)(2) (2000).

funds is based on the type of assets that each holds. Closed-end funds often invest in illiquid assets and thus make it burdensome and impractical to cover redemptions.[218] Hence, closed-end funds are not subject to the liquidity requirements of open-end funds,[219] a feature consistent with the offering of non-redeemable securities that represent interests in illiquid assets.

The right of redemption ensures that shares in a fund can be converted into NAV, even if secondary market prices are significantly discounted, as often occurs with the shares of closed-end funds.[220] Redemption can also provide some insurance against low liquidity situations, as shareholders have a predictable means of converting holdings to cash or securities. In the ETF market, trading replaces the need for universal redemption common to most open-end funds because the market naturally protects value and liquidity. Transparency, coupled with intra-day trading, creates a situation where shares in ETFs are both highly liquid and, as a result of arbitrage, trade at or near NAV.[221] Together, these factors create an instrument with the investor protections common to universally-redeemable securities, with the added liquidity of intra-day trading absent in mutual funds. As such, an implied basis for granting ETFs exemptions from the redemption requirement for open-end investment companies may be that transparency creates a natural market environment that substantially approximates the protections of NAV-based redemption. The incentive for arbitrage profits naturally draws institutional investors into the ETF market and creates the functional equivalent of a universal right to redeem by

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218. *See* David Jackson, *ETF Investing Guide: Why Use Closed-End Funds?* SEEKING ALPHA, July 1, 2006, http://seekingalpha.com/article/15270-etf-investing-guide-why-use-closed-end-funds (noting that closed-end funds, which often invest heavily in illiquid assets, are better-equipped than open-end funds to buy and sell assets in response to inflows and outflows of capital); *see also* MARK J.P. ANSON, HANDBOOK OF ALTERNATIVE ASSETS 372-73 (Frank J. Fabozzi ed., John Wiley & Sons, Inc. 2003) ("A close-end fund can also invest in less liquid assets without the 15% limitation [on illiquid assets] that is imposed on open-end funds.").

219. Mutual funds are subject to significant liquidity requirements:

> [A]n open-end mutual fund must offer its shareholders daily liquidity equal to the cash value of each share's net asset value. Consequently, the fund's manager must adjust her investment strategy to cope with unexpected cash inflows and outflows. Usually, open-end mutual funds maintain a certain amount of cash to fund redemptions. Last, an open-end mutual fund cannot invest more than 15% of its total assets in illiquid investments (*i.e.*, assets that are not readily marketable within seven days).

ANSON, *supra* note 218, at 372.

220. *See, e.g.*, ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 53 (Oxford Univ. Press 2000) (describing the perplexity of persistent discounting in closed-end funds).

221. *See* discussion *supra* Part III.B.3 (covering the relationship between arbitrage and NAV).

steering trading prices toward NAV.[222]

To explain how current ETFs petition for relief from § 2(a)(32) and § 5(a)(1), Paul F. Roye, former Director of the SEC's Division of Investment Management, noted that ETF shares "typically trade at or near NAV because of arbitrage opportunities," such that investors "generally should be able to sell their shares in the secondary market for a price at, or near, NAV—even if they cannot redeem shares directly from the fund."[223] Secondary market price stability explains why ETFs have not experienced the problem of persistent discounts that many closed-end funds face.[224] Arbitrage ensures that secondary markets price ETF shares to NAV, such that the market provides the investor with "approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."[225] The closeness between share price and NAV ensures that retail investors not in possession of creation units will nonetheless be protected,[226] as shares can be sold on secondary exchanges for prices close to the underlying NAV of an equivalent interest in the ETF's portfolio.

5. Transactional Mechanics and Section 17

Exemptive relief from NAV-based transactions and universal redemption are meaningless unless the SEC also grants exemptions necessary for a functioning arbitrage system in the ETF market. Exemptions from § 17(a) of the Investment Company Act have long served this purpose by accommodating the necessary transactional mechanics for effective primary and secondary market transactions in ETFs. Section 17(a)(1) places significant restrictions on the ability of an "affiliated person or promoter of or principal underwriter for a registered investment

222. Fund companies have pushed for SEC approval of new ETFs through arguments such as the following: "Applicants further state that because the market price of Shares will be disciplined by arbitrage opportunities, investors should be able to sell Shares in the secondary market at prices that do not vary substantially from their NAV." SPA ETF Trust, *supra* note 154, at 9.

223. Roye, *supra* note 41.

224. Some commentators propose that closed-end funds consistently trade at discounts because redemption is unavailable. *See* ANSON, *supra* note 218, at 373 (explaining that post-IPO discounts in the trading prices of closed-end funds may be caused by "the inability to tender shares back to the mutual fund issuer").

225. 15 U.S.C. § 80a-2(a)(32) (2000).

226. *See* Letter from Anthony Dudzinski, Chief Executive Officer, Xshares Advisors LLC, to Nancy Morris, Sec'y, Sec. & Exch. Comm'n (May 20, 2008) (on file with author), http://www.sec.gov/comments/s7-07-08/s70708-15.pdf ("We believe that transparency and disclosure are the keys to effective arbitrage that benefits all fund shareholders. An effective arbitrage leads to lower spreads and more efficient trading, effectively lowering costs to shareholders.").

company"[227] to sell or purchase securities in the company or in an entity "controlled"[228] by the company. Section 12(d)(1) is a related provision that governs one registered investment company's ability to obtain shares or voting rights in another.[229]

Section 2(a)(3)(A) defines an "affiliated person" as "any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities"[230] of an investment company.[231] Section (2)(a)(9) defines "control" as ownership of twenty-five percent of an investment company's outstanding voting securities either directly or through ownership of a controlled company.[232] This definition can bring transactions under the purview of § 17, or, if the entities at issue are registered investment companies, under that of § 12(d).

Without exemptive relief, § 17 in particular could pose a threat to arbitrage transactions in the ETF market, because purchases and redemptions of creation units could create new "affiliated" persons in those who acquire a sufficient percentage of securities, thus prohibiting transactions found to constitute "sales" under the Act.[233] The risk of a violation is centered on primary market transactions, as § 17(a)(1) governs sales of securities "to" registered investment companies or their controlled entities.[234] Section 17(a)(2) bars purchases by affiliated purchasers "from" registered investment companies.[235] Most secondary market transactions, which do not involve issuing companies as parties, are not problematic under § 17.[236] Nonetheless, for ETFs to function, the SEC must permit

227. 15 U.S.C. § 80a-17(a) (2000).

228. 15 U.S.C. § 80a-17(a)(1) (2000).

229. 15 U.S.C. § 80a-12(d)(1) (2000).

230. 15 U.S.C. § 80a-2(a)(3)(A) (2000).

231. Section 2(a)(3)(A) uses the term "person." 15 U.S.C. § 80a-2(a)(3)(A) (2000). Section 2(a)(3)(E) makes the appropriate connection by applying the restriction as follows: "[I]f such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof" is bound by the limitations of §17(a). 15 U.S.C. § 80a-2(a)(3)(E) (2000).

232. 15 U.S.C. § 80a-2(a)(9) (2000).

233. *See* Actively Managed ETFs, *supra* note 56, at 57,621 ("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. Because purchases and redemptions of Creation Units may be in-kind rather than cash transactions, section 17(a) may prohibit affiliated persons of an ETF from purchasing or redeeming Creation Units."); 1 Reg. of Inv. Companies (MB) § 8.01[1][a][ii] (2008) ("Although arguably permitted by Sections 2(a)(32) and 17(a)(1) of the Act, in the past the SEC has required exemptive relief for affiliates to redeem fund shares on an 'in kind' basis (*i.e.*, the distribution of portfolio holdings) because such a transaction *may constitute a purchase of securities from the fund prohibited by Section 17(a)(2)*.") (emphasis added).

234. 15 U.S.C. § 80a-17(a)(1) (2000).

235. 15 U.S.C. § 80a-17(a)(2) (2000).

236. *See* BLDRS Index Funds Trust, et al., Notice of Application, Investment Company Act Release No. 26,386, 69 Fed. Reg. 54, at 13,074 (Mar. 15, 2004) (explaining the caveats

"affiliated persons" to engage in direct transactions with ETFs organized as investment companies,[237] and in particular must permit "affiliated persons" to deposit securities into an ETF and to receive portfolio securities from the ETF.[238]

In March 2008, the SEC proposed exemptions for transparent ETFs from § 17(a)(1), § 17(a)(2), and § 12(d)(1).[239] This is especially noteworthy because the transactions that these provisions otherwise prohibit are precisely the transactions necessary for a functioning arbitrage mechanism. The SEC previously granted relief from § 17 if several criteria are satisfied, including that "the redemption in kind is effected at approximately the affiliated shareholder's proportionate share of the distributing fund's current net assets,"[240] and that "the securities distributed in-kind are valued in the same manner as they would be for calculating the fund's NAV."[241] In light of the purpose of § 17 as a means "to prevent insiders from using an investment company to benefit themselves to the detriment of the company and its shareholders,"[242] it follows that the SEC will permit only those affiliate transactions that are based on NAV, thus preventing affiliates from receiving favorable treatment at the expense of fund shareholders. This approach places ETFs comfortably within the historic context of regulation under the Investment Company Act, as the SEC "has consistently utilized net asset value as the controlling factor in section 17 proceedings."[243] The SEC advanced a similar justification in support of the March 2008 proposed exemptions from § 17(a)(1), § 17(a)(2), and § 12(d)(1).[244]

It may be an oversimplification, however, to limit the justification for relief from § 17 and § 12(d)(1) to the assurance of a practical check on overreaching affiliates. A less articulated, but additional explanation for

of § 17).

237. *See id.* (describing the need for such an exception).

238. *See* Moriarty, supra note 82 (noting that ETFs have needed to secure exemptive relief from the Invesment Company Act with respect to "Sections 17(a) and 17(b) to permit affiliates to deposit securities into, and receive Portfolio Securities from, the ETF").

239. SEC Proposed Rules, *supra* note 3, at 14,640.

240. Signature Financial Group, Inc., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 981, at *17 (Dec. 28, 1999) (listing requirements for relief from an enforcement action under § 17(a)).

241. Reg. of Inv. Companies, *supra* note 233, § 8.01[1][a][ii].

242. *Id.* § 8.01.

243. Harriman v. E.I. du Pont De Nemours and Co., 411 F. Supp. 133, 160 (D. Del. 1975).

244. SEC Proposed Rules, *supra* note 3, at 14,640 (noting, in regard to the proposed exemption from § 12(d)(1), that "[p]ermitting 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").

the granting of relief from § 17 in particular is that ETF transactions between investment companies and affiliates may be necessary to protect the investments of non-affiliate shareholders, by ensuring that such shareholders may convert shares into the cash equivalent of NAV. In other words, there is a need to protect retail investors who are unable to acquire enough shares to form creation units, and thus lack the market power to temper ETF share prices in light of the underlying portfolio securities' actual value.[245] This need collides with the reality that arbitrage through strategic creation and redemption remains essential to quickly level share discounts and premiums. The only actors with the institutional competence to perform this task are large investors who, absent exemptive relief, might become "affiliated" with an ETF when transacting in creation units.[246]

Put another way, "[d]esignated Sponsors of ETFs *are the crucial link between the primary and secondary markets*. Besides being market makers, Designated Sponsors create and redeem ETF shares in the so-called 'creation/redemption process.'"[247] As such, primary market actors are the entities that participate in creations and redemptions,[248] which are the very transactions necessary for a functioning arbitrage regime.[249] Arbitrage, in turn, controls premiums and discounts to ensure that retail investors can expect trades to occur at or near NAV.[250] Hence, it is likely that part of the motivation[251] for granting ETFs exemptive relief from § 17

245. *See, e.g.*, Michael Sackheim et al., *DB Commodity Index Tracking Fund: An Innovative Exchange-Traded Fund*, FUTURES INDUSTRY, May/June 2006, at 24 ("As with other ETFs, baskets of shares [in a particular commodity ETF] may be created or redeemed on any business day but only in integral multiples of 200,000 shares and only by certain qualified financial institutions called 'authorized participants.'").

246. JIM WIANDT & WILL MCCLATCHY, EXCHANGE TRADED FUNDS 87 (John Wiley & Sons, Inc. 2002); *see supra* text accompanying note 59 (discussing creation units in the "primary" ETF market).

247. Deutsche Börse Group, *supra* note 198, at 39 (emphasis added).

248. *See, e.g.*, Demaine, *supra* note 71, at 357 ("The primary marketplace is the realm of the large securities dealers whose index basket trades can be made on a large scale at low cost.").

249. *See* Deutsche Börse Group, *supra* note 198, at 40 (explaining that "arbitrage opportunities exist" because of "high transparency and the creation/redemption process").

250. *See* RICHARDS, *supra* note 208, at 57 (explaining how arbitrage diminishes price variance between ETF shares and their underlying portfolio securities).

251. Of course, transparency serves as a primary check on the abuses that the rules governing affiliates intend to prevent. One commentator explains as follows:

> [T]he highly transparent nature of ETFs should operate to reduce, if not minimize, the risk that any Authorized Participant, whether affiliated or not with the ETF's adviser, would be in a position to manipulate either the contents of the purchase and redemption baskets or the pricing of ETF securities. Any such manipulation would be reflected in the ETF's portfolio holdings and NAV and would be readily transparent to other market participants.

Letter from Philippe El-Asmar to Nancy M. Morris, *supra* note 59, at 5.

is that such exemptions are necessary for the arbitrage system to function. Otherwise, the nature of creation units as large aggregations of shares would place an inherent regulatory hurdle in front of direct transactions between affiliated persons and ETFs. If rules governing affiliates constrain institutional investors' ability to engage in creation or redemption, they could seriously compromise the arbitrage mechanism.[252] Were this to occur, retail investors would be vulnerable to pricing inefficiencies, as the resulting constraints on arbitrage would remove the assurance that share prices and NAV remain similar. Exemptive relief from § 17 recognizes that transactional flexibility for institutional investors may be necessary to protect the retail investor.[253]

IV. FUTURE CHALLENGES OF REDUCED TRANSPARENCY

The SEC frequently has granted exemptive relief from various provisions of the Investment Company Act to equity index ETFs, which offer a high degree of transparency as the foundation for a price-correcting arbitrage system. The SEC's recent approval of fully transparent actively managed ETFs comports with its treatment of index-tracking funds, as the new structures also provide the necessary information for stabilizing arbitrage.[254] However, transparent structures may not represent the full potential of actively managed ETFs. Speculation about future SEC approval of opaque ETF structures began almost immediately after the SEC provided a green light for the first transparent actively managed ETFs.[255]

252. Exemptive relief that permits affiliates to transact with ETFs "is potentially beneficial to fund investors by increasing competition at the Authorized Participant ("AP") level which, in turn, would theoretically increase the efficiency of the arbitrage mechanism." Letter from Anthony Dudzinski to Nancy Morris, *supra* note 226, at 9.

253. The SEC recently granted relief from § 17(a)(2) to permit a fund affiliate to purchase securities from an investment company. The following account explains the basis of the decision: "The staff agreed with the parties' assessment that this purchase transaction [while normally barred by the Act] would nevertheless be in the best interests of the fund's shareholders." Affiliate May Purchase Securities from Fund, 2310 Fed. Sec. L. Rep. (CCH) 6 (Jan. 16, 2008).

254. Issuers devoted substantial attention to the feasibility of an arbitrage regime in seeking approval for transparent actively managed ETFs. *See, e.g.*, WisdomTree Trust, Notice of Application, *supra* note 1, at 7777 ("Applicants expect that the price at which the Shares trade will be disciplined by arbitrage opportunities created by the ability to continually purchase or redeem Creation Units at their NAV, which should ensure that the Shares will not trade at a material discount or premium in relation to their NAV."); *see also id.* at 7778 ("[A]pplicants contend that the proposed distribution system will be orderly because arbitrage activity will ensure that the difference between the market price of Shares and their NAV remains narrow.").

255. *See, e.g.*, Press Release, Foley & Lardner, *supra* note 10 (quoting George Simon, a senior member of Foley & Lardner LLP's team in charge of designing one such fund: "All of the products being processed now are fully transparent, but we have no doubt that the

Such speculation is consistent with the current regulatory climate, particularly in light of the SEC's comment that, "[b]y 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."[256] Donohue added that "[p]ermitting most ETFs to come directly to market without the cost and delay of obtaining an exemptive order would also allow staff to focus on more novel and difficult requests."[257] Despite the potential implications of these statements, actively managed ETFs with reduced transparency will remain distant for some time. Recent approvals notwithstanding, financial innovation and regulatory scrutiny remain combatants, and actively managed ETFs will face more difficult regulatory challenges than their index-tracking counterparts, especially those that intend to operate with reduced transparency.[258] While the SEC did not foreclose the possibility of granting individual exemptive orders for actively managed ETFs with reduced transparency, such an event would represent a significant departure from all previous SEC approvals.

Of course, history has already been rewritten in part, as a once-paralyzing concern surrounding the registration of actively managed ETFs has been resolved:

> The feasibility of actively managed ETFs has been the subject of much debate. A key concern in this regard is the extent to which the arbitrage process, which keeps market prices in line with NAV, can effectively function without a fully transparent portfolio. Absent real time disclosure of the composition of the underlying portfolio, an arbitrageur will be hindered in its ability to compare intraday NAV and market prices and to evaluate the risk/rewards of an arbitrage transaction.[259]

SEC will move to less transparent funds next.").

256. SEC Proposed Rules, *supra* note 3, at 14,623.

257. Press Release, U.S. Sec. & Exch. Comm'n, SEC Proposes to Streamline ETF Approval Process (Mar. 4, 2008) (on file with author), http://www.sec.gov/news/press/2008/2008-30.htm (quoting Andrew J. Donohue, Director of the SEC's Division of Investment Management).

258. The words of former SEC Commissioner Paul S. Atkins are telling:

> The [ETF] proposal does not include all actively-managed ETFs—only those with full transparency. Are there ways to expand the scope of the proposal? The intent is to consider broadening the rule as we see more actively managed ETFs. But, we have seen how tortuous it seems to be to adopt rules or rule changes—witness the soft-dollar issue for the buy-side, e-mail retention, BDC reform, and changes to Form ADV.

Paul S. Atkins, Comm'r, U.S. Secs. & Exch. Comm'n, Remarks Before the Investment Company Institute's 2008 Mutual Funds and Investment Management Conference 6 (Mar. 17, 2008), http://sec.gov/news/speech/2008/spch031708psa.htm.

259. FINANCIAL PRODUCT FUNDAMENTALS, *supra* note 194, §§ 16-5, 16-17.

Indeed, the SEC has limited its recent approval of actively managed ETFs to those funds that, like the equity index variety, provide a "unique arbitrage mechanism that is fueled by full portfolio transparency."[260] In addressing its 2001 concept release on actively managed ETFs, the SEC notes that it was "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."[261] The SEC alleviated this concern not through an innovative new disclosure regime, but by simply requiring that actively managed ETFs retain full transparency.[262] In this way, any new era of the ETF market may provide enhanced structural freedom, but will not significantly deviate from traditional foundations.

For the near future, actively managed ETFs are likely to remain in the family of transparent funds that includes the equity index structure.[263] A transition away from transparency would require convincing the SEC that opaque actively managed ETFs—through either internal structural design or natural market forces—somehow can replicate the investor protections that existing ETFs offer. While such an outcome is possible, the length of time between SEC approval of equity index and actively managed ETFs, as well as the SEC's consistent emphasis on transparency, suggests that non-transparent ETFs will face especially difficult regulatory challenges. Rather than representing a new structure within an overarching framework of transparency, opaque actively managed ETFs would step beyond the framework entirely. The SEC has granted existing ETFs exemptive relief from various requirements of the Investment Company Act because the market has sufficient information to naturally correct dangerous price imbalances through arbitrage. While there will likely be plenty of innovation directed toward overcoming regulatory concern,[264] it remains

260. Stacy L. Fuller & Richard M. Phillips, SEC Green-Lights First Actively Managed ETFs, K&L Gates Newsstand (Feb. 20, 2008), http://www.klgates.com (search "green light"; then follow article hyperlink).

261. SEC Proposed Rules, *supra* note 3, at 14,622.

262. *See, e.g.*, Judith Burns, *SEC Proposes Faster ETF Path to Market*, WALL ST. J., Mar. 5, 2008, at C13 ("Actively managed ETFs that don't provide daily information about their portfolio holdings wouldn't be covered by the SEC's proposal. SEC investment management director Andrew Donohue said the agency has yet to make any decisions on how to handle ETFs whose holdings aren't fully transparent and omitted them from the proposal.").

263. Although significant, the advent of actively managed ETFs does not represent a radical break with the past, as "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.". Fuller, *supra* note 7, at 92.

264. *See* Birdthistle, *supra* note 189, at 110 ("The existing pattern of ETF growth, when combined with the possibility of successfully gaining entrance to retirement accounts and the market for active management, suggests that the ETF industry will continue its

unclear how less transparent ETFs will fare before regulators.

V. CONCLUSION

This Article has argued that multiple grounds may justify exemptive relief from various provisions of the Investment Company Act, but a strong consideration is that arbitrage transactions can protect the retail investor naturally, by exploiting profit opportunities created when the share price of an ETF and the NAV of its underlying portfolio securities are mismatched. As the SEC stated in its 2001 concept release on actively managed ETFs, "[b]ecause of arbitrage opportunities inherent in the ETF structure, ETF shares generally have not traded in the secondary market at a significant premium or discount in relation to NAV."[265] Survival prospects for this mechanism of natural correction require "constant price discovery in the public securities market,"[266] which provides arbitrageurs with the necessary information to perform their stabilizing function. Indeed, the SEC has recognized that "[t]his high degree of transparency in the investment operations of an ETF helps arbitrageurs determine whether to purchase or redeem Creation Units."[267] While the exemption process for transparent structures has been crucial to the ETF industry, perhaps its broader importance lies in what the process reveals about the SEC and its role in financial markets. A common theme emerging from the various exemptions discussed in this Article is that the SEC—at least in the ETF context—has not over-protected investors by implanting regulatory restraints where the market does not require them. The subtext of the explicit justifications in support of exemptive relief from the Investment Company Act seems to be that regulatory intervention simply is unnecessary where the market naturally creates that which regulators could impose. An arbitrage profit potential, made possible through free-flowing information, has built a self-correcting market for transparent ETFs. Exemptive relief for these products represents an area where market forces

breakneck expansion."); Fuller, *supra* note 7, at 95 (stating that, after SEC approval of the first actively managed ETFs, "there are powerful incentives at work in the ETF space that make continued innovation likely"); Letter from David B. Smith, Executive Vice-President, Mutual Fund Dirs. Forum, to Nancy Morris, Sec'y, U.S. Secs. & Exch. Comm'n (May 21, 2008) (on file with author) ("[U]ltimate adoption of [the Proposed Rules] should not be the endpoint of innovation with respect to exchange-traded products. While the proposal provides a template for many standard types of ETFs, it certainly does not exhaust the range of potentially beneficial products that could be offered.").

265. Actively Managed ETFs, *supra* note 56, at 57,616.

266. Letter from R. Sheldon Johnson, Managing Dir., Morgan Stanley & Co., Inc., to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (May 3, 2002) (on file with author), http://sec.gov/rules/concept/s72001/johnson1.htm.

267. Actively Managed ETFs, *supra* note 56, at 57,619.

receive substantial deference. The issue of whether this deference can survive the emergence of less transparent or opaque ETF structures will define future battles between financial innovation and regulatory oversight.