Mutual Funds Today: Exchange-Traded Funds

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The number of ETFs may be small but it is growing and shows every indication that the number will keep increasing.

IN 1940, investment companies were divided into three classifications: management companies, unit investment trusts, and face-amount certificate companies. Management companies (**"**funds**"**) were further divided into open-end funds ("mutual funds") and closed-end funds. The significant difference between a closed-end fund and a mutual fund, under the Investment Company Act of 1940, is that a mutual fund issues securities that are redeemable at the option of the shareholder on a daily basis. Thus, a shareholder of a mutual fund can sell shares back to the fund any day, based on the net asset value of the fund. In contrast, a closed-end fund issues shares that are not redeemable. Instead, shares of a closed-end company are often listed and traded on a secondary market or are sometimes repurchased by a fund through a tender offer. Thus, a shareholder of an exchange-traded closed-end fund can sell shares in the secondary market any time that the market is open at a negotiated market price. However, there is no assurance that the market price of a closed-end fund share will be the same as the net asset value per share ("NAV").

A NEW TYPE OF FUND • Exchange-Traded Funds ("ETFs") are relatively new creations that do not fit neatly into the universe of investment companies. ETFs encompass many of the attributes of both mutual funds and closed-end funds. Like mutual funds, ETFs can issue and redeem shares daily. Unlike a mutual fund, however, an ETF will only issue and redeem shares in large blocks, typically 25,000 or 50,000 shares. Single shares of ETFs will trade throughout the day on a stock exchange like shares of a closed-end fund. However, while shares of closed-end funds often sell at a substantial premium or discount, the shares of an ETF trade at a price that generally corresponds to the ETF's.

In order to have traits of both mutual funds and closed-end funds, ETFs rely on exemptions from several sections of the Investment Company Act. Currently, all ETFs exist pursuant to exemptive orders issued by the SEC. In 2008, the SEC proposed a rule that would permit ETFs to operate without obtaining exemptive orders. The proposed rule was well received by the industry, but it has not yet been adopted. Nonetheless, the number of ETFs, and the amount of assets invested in ETFs, continues to grow.

HISTORY OF ETFS •

1. Index Participations

In 1988, the SEC authorized the Chicago Board Options Exchange, the Philadelphia Stock Exchange, and the American Stock Exchange to trade index "participation contracts." Participation contracts were synthetic instruments structured to offer small investors an inexpensive way to trade a security whose value depended on an underlying securities index. In effect, the holder of an index participation unit was in the same position as a holder of shares in a closed-end mutual fund that held a value-weighted portfolio of the securities in the index.

In 1989, as part of the then ongoing turf war between the SEC and the Commodity Futures Trading Commission ("CFTC"), the futures exchanges (both the Chicago Board of Trade and the Chicago Mercantile Exchange) sued the SEC—arguing that the SEC did not have jurisdiction over participation contracts—and won. Ruling in favor of the two Chicago futures exchanges, the Seventh Circuit Court of Appeals, which is located in Chicago, found that index participation contracts were futures contracts within the exclusive jurisdiction of the CFTC, and thus were not tradable on securities exchanges. As a result, the instruments were delisted.

2. SPDR

The first true ETF, the SPDR Trust (pronounced "Spider"), was registered as a unit investment trust, with State Street Bank and Trust Company as the Trustee, and began trading on the American Stock Exchange in early 1993. The SPDR Trust was designed to track the Standard & Poor's 500 Index by holding all the securities of that index in the same proportion as the index. To operate as an ETF, the SPDR Trust received exemptive relief from the SEC that allowed individual shares of the trust to be traded at negotiated prices on a securities exchange, and limited redemptions to "Creation Units" consisting of 50,000 individual shares.

3. ETF Evolution

Since the introduction of the SPDR Trust in 1993, hundreds of ETFs have been created. These ETFs have become a significant part of the market, though still a much smaller part than traditional mutual funds. Two of the most significant events for the growth ETFs were: (1) the 2000 launch of iShares and the corresponding massive marketing campaign, and (2) the entry of Vanguard, a traditional mutual fund company, into the ETF market. Since then, we have seen the SEC approve ETFs based on fixed income, inverse and leveraged, and long/short indices. In 2008, the SEC also approved actively managed (as opposed to index based passively managed) ETFs. Also significant was the 2003 issuance of an exemptive order to iShares permitting unaffiliated mutual funds to invest in the iShares ETFs beyond the limits imposed under Section 12(d)(1) of the Investment Company Act. Since then, most if not all ETFs have received similar exemptive relief, and many mutual funds now invest in ETFs.

STRUCTURE OF EFTs •

1. Overview

To date, ETFs have been organized as either unit investment trusts ("UITs") or open-end funds.[1] In both cases, the ETFs have received exemptive relief from the SEC to allow the ETF to issue and redeem shares only in large blocks, called Creation Units. Creation Units are usually 25,000, 50,000, or 100,000 shares of the ETF. These are sold to "Authorized Participants," such as banks and broker-dealers, that have entered into "participant agreements" with the ETF's distributor.

Typically, although not exclusively, Authorized Participants will purchase and redeem Creation Units in-kind. For example, to purchase a Creation Unit, an Authorized Participant will transfer to the ETF a group of securities called a "creation basket" that consists of all or most of the ETF's portfolio securities, generally in the same proportion as held by the ETF. Similarly, for a redemption, an Authorized Participant will submit a Creation Unit (e.g., 50,000 shares of the ETF) to the ETF and, in exchange, will receive a "redemption basket" that consists of all or most of the ETF's portfolio securities, generally in the same proportion as held by the ETF. In each case, the value of the creation basket or redemption basket will be the same as the value of the Creation Unit.

Because of the in-kind creation and redemption process, ETFs do not incur the same level of brokerage expenses as typical open-end funds, and transactions can be effected quickly with less impact on market prices. Further, because an ETF is not generally buying and selling its portfolio securities, it does not incur capital gains. Thus, the in-kind creation and redemption process effectively reduces capital gains incurred by the ETF and passed on to shareholders.

ETFs typically retain the right to substitute cash in lieu of all or any portion of a creation basket or redemption basket. This flexibility is needed primarily by ETFs that invest in securities that are difficult to transfer in-kind (such as certain foreign securities) or financial instruments (such as swaps). Some ETFs, such as the iShares MSCI Malaysia Index Fund and the Short QQQ® ProShares, carry out creations and redemptions entirely for cash.

2. Unit Investment Trusts

As stated above, the first ETF, the SPDR Trust, was a UIT designed to replicate the Standard & Poor's 500 Index. Since then, a handful of other ETFs have been registered as UITs, each designed to replicate an individual index. Because the ETF replicates the components of the index, there is no need for any management, consistent with the UIT structure.

3. Management Companies

In 1996, the SEC permitted an ETF to register as an open-end mutual fund, rather than a UIT. This was significant in that it permitted ETFs, just like many other index-based mutual funds, to develop an optimized portfolio that matches the performance of an index without necessarily

[1] Some exchange traded products are commonly referred to as ETFs, but are not registered under the Investment Company Act, these include commodity pools, precious metals trusts and currency trusts. For our purposes, these are not ETFs.

holding all of the component securities of the index. Because of the additional flexibility of the open-end structure, most ETFs are now organized as open-end mutual funds.

Passive Management

The SEC has not placed any restrictions on ETFs that would require them to hold any specific percentage of the component securities of their indices, but instead has required that at least 80 percent of the total assets of an ETF be invested in component securities of its underlying index. Thus, an ETF tracking an index with 2000 components may hold only 1500, or 75 percent, of the components of the index, but at least 80 percent of the ETF's assets must be invested in such component securities. The remaining 20 percent of the ETF's assets may be invested in derivatives or other securities that the adviser believes will help the ETF track its underlying index.

Active Management

For the first decade of their existence, tracking an index was considered fundamental to the nature of an ETF. Nonetheless, as the popularity of ETFs began to grow, there was a desire to push the envelope. In 2001, this prompted the SEC to issue a concept release on the subject of actively managed ETFs. Seven years later, the SEC issued several exemptive orders permitting actively managed ETFs after determining that an actively managed ETF did not raise any concerns that were significantly different than those raised by an index-based ETF—provided the actively managed ETF was "fully transparent." In short, the SEC required actively managed ETFs to disclose their full portfolio of securities every day.

CONCLUSION • To date, the number of actively managed ETFs remains relatively small; as of the end of 2014, there were 120 actively managed ETFs with approximately $17.6 billion in total net assets.[2] The bulk of these assets are concentrated in ETFs that invest in fixed income securities, including several that use active management to seek foreign currency exposure by investing in non-U.S. money market-type securities. Generally, it is believed that most active equity managers do not want to disclose their portfolios on a daily basis, so they are reluctant to create fully transparent actively managed ETFs. Nonetheless, several investment advisers known for providing active management have filed for and received relief that would permit them to sponsor fully transparent actively managed ETFs. Other potential ETF sponsors are seeking relief for ETFs that are something less than fully transparent. To date, no such relief has been granted. In one case recently, however, the SEC has granted relief that would permit a new type of non-transparent fund that is a hybrid between a traditional ETF and an actively managed mutual fund, seeking to retain the best attributes of both structures.[3]

[2] AdvisorShares Active ETF Report (January 31, 2015).

[3] See Eaton Vance Management, et al., Investment Company Act Rel. Nos. 31,333 (Nov. 6, 2014) (Notice) and 31,361 (Dec. 2, 2014)(Order).