

December 11, 2012

*Practice Group(s):**Investment
Management*

SEC Lifts Moratorium on Actively Managed ETFs' Use of Derivatives; Moratorium Continues for Leveraged ETFs

By Stacy L. Fuller, Kurt J. Decko

As announced by Norm Champ, the Director of the Division of Investment Management of the Securities and Exchange Commission ("SEC"), in a speech on December 6, 2012,¹ and followed by a no-action letter of the same date,² the SEC will no longer defer consideration of exemptive applications for actively managed exchange-traded funds ("ETFs") that propose to invest in derivatives. The policy change comes more than two and a half years after the SEC first announced that it was reviewing funds' use of derivatives and that it would impose a moratorium on exemptive applications for actively managed ETFs proposing to invest in futures, options or swaps and for leveraged ETFs. The policy change does not apply to leveraged ETFs, about which Champ suggested that the staff continues to have concerns.

Background

In a press release issued in March 2010,³ the SEC announced that the SEC staff was conducting a review of the use of derivatives by mutual funds, ETFs and other investment companies. The press release indicated that pending completion of this review, the SEC staff would defer consideration of exemptive applications for ETFs that would make "significant investments" in derivatives.

The position resulted in a moratorium on the processing of exemptive applications for both actively managed ETFs proposing to use futures contracts, options contracts or swap agreements in their investment strategies and leveraged ETFs. The moratorium was enforced by the staff's refusal to consider all leveraged ETF applications and applications for actively managed ETFs, unless they included an explicit representation that the ETF would not invest in futures, options or swaps.⁴

Lifting the Moratorium

In a significant development for actively managed ETFs and their sponsors, Champ announced lifting the moratorium for actively managed ETFs in his December 6 speech. Specifically, Champ's speech indicated that the SEC staff will once again process exemptive applications for actively managed ETFs that propose to use derivatives, including futures, options and/or swaps, provided that the

¹ See Remarks to the ALI CLE 2012 Conference on Investment Adviser Regulation: Legal and Compliance Forum on Institutional Advisory Services, by Norm Champ, Director, Division of Investment Management, U.S. Securities and Exchange Commission, December 6, 2012, available at <http://www.sec.gov/news/speech/2012/spch120612nc.htm>.

² See Moratorium Lift, dated December 6, 2012, available at <http://www.sec.gov/divisions/investment/noaction/2012/moratorium-lift-120612-etf.pdf>.

³ See SEC Press Release 2010-45, SEC Staff Evaluating the Use of Derivatives by Funds (Mar. 25, 2010), available at <http://www.sec.gov/news/press/2010/2010-45.htm>.

⁴ The moratorium did not impact index-based ETFs, which have continuously been allowed to invest up to 20% of their assets in derivatives that such ETF's adviser believes will help the ETF to track its underlying index

SEC Lifts Moratorium on Actively Managed ETFs' Use of Derivatives; Moratorium Continues for Leveraged ETFs

applications contain the following two specific representations:

- (i) the ETF's board periodically will review and approve the ETF's use of derivatives and how the ETF's investment adviser assesses and manages risk with respect to the ETF's use of derivatives; and
- (ii) the ETF's disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant SEC and staff guidance.

Champ's announcement was promptly followed by a no-action letter from the Division of Investment Management to the 18 applicants that had obtained an actively managed ETF exemption during the moratorium based upon their representation that their ETFs would not invest in futures, options or swaps. The no-action letter provides relief to allow these 18 applicants' ETFs to use futures, options and swaps, notwithstanding statements to the contrary in their applications, provided that they, too, comply with the representations described above. Given these representations, actively managed ETFs are expected to be allowed, at least under their exemptive relief, to invest in derivatives to the same extent as other actively managed, registered open-end funds.⁵

We expect ETFs and their sponsors to be able to make and comply with these representations. For representation (i), it is common even now for fund boards, including ETF boards, to review a fund's usage of derivatives with the investment adviser and monitor how the adviser assesses and manages associated risks. Indeed, the SEC staff has noted on a number of occasions the importance of this dialog between a fund board and investment adviser.⁶ In addition, since 2010, funds' (including ETFs') proxy statements and registration statements have been required to disclose the extent of the board's role in risk oversight.⁷ As a result, processes for reviewing fund investments in derivatives and the risks associated with these investments are already embedded in many boards' existing practices. Further, through other standard board practices, including the approval and/or ratification of fund registration statements, annual advisory agreement reviews, and annual compliance program reviews, ETF boards may already undertake many of the steps required to "approve," at least informally, an ETF's use of derivatives and how the ETF's investment adviser assesses and manages associated risks.

Similarly, representation (ii) does not appear to impose any new substantive disclosure requirements on ETFs. In a July 30, 2010 letter from the Division of Investment Management to the Investment Company Institute,⁸ the SEC staff outlined their expectations for funds' derivatives disclosure in registration statements, stating that funds should avoid generic derivatives disclosures and that their derivatives-related risk disclosures should be tailored to a fund's actual derivatives usage. Representation (ii) does not appear to require anything more of actively managed ETFs.

The difficulty, if any, for ETFs could be that these representations will now be required by the terms of the exemptive relief on which they rely for all of their operations. In this way, the representations could "up the ante" for ETFs by potentially making inadequate board processes or derivatives

⁵ Champ noted that derivatives usage for actively managed ETFs may be limited by relevant listing rules of the ETFs' exchanges or regulatory relief provided by the SEC's Division of Trading and Markets.

⁶ See Speech by SEC Staff: If I Were a Director of a Fund Investing in Derivatives--Key Areas of Risk on Which I Would Focus, by Gene Gohlke, Associate Director, Office of Compliance Inspection and Examinations, U.S. Securities and Exchange Commission, November 8, 2007, available at <http://www.sec.gov/news/speech/2007/spch110807gg.htm>; Speech by SEC Staff: Remarks before the Mutual Fund Directors Forum and the University of Maryland "Oversight of Derivatives" Conference, by Eileen Rominger, Director, Division of Investment Management, U.S. Securities and Exchange Commission, September 9, 2011, available at <http://www.sec.gov/news/speech/2011/spch090911epr.htm>.

⁷ See Form N-1A, Item 17(b)(1).

⁸ Letter from Barry D. Miller, Associate Director, Office of Legal and Disclosure, to Karrie McMillan, General Counsel, Investment Company Institute, dated July 30, 2010.

SEC Lifts Moratorium on Actively Managed ETFs' Use of Derivatives; Moratorium Continues for Leveraged ETFs

disclosure a violation of their exemptive order. Because, however, a material violation of these representations could put the ETF at risk of independently violating the Investment Company Act and/or other Federal securities laws, we do not expect significant controversy surrounding the inclusion of these representations in ETF exemptive applications. In short, we expect actively managed ETFs ultimately to accept both of the newly-required representations if they invest in derivatives.

As noted in Champ's December 6 speech, the staff will continue not to entertain exemptive applications for leveraged ETFs, which generally are ETFs that seek to deliver multiples of the performance, or inverse performance, of an index. Champ noted continuing "concerns" regarding leveraged ETFs, though he did not expand on or explain the nature of these concerns.⁹ Thus, the moratorium remains in place for leveraged ETFs.

Next Steps

ETF applicants currently in the exemptive applications process will be contacted by the SEC staff and offered the opportunity to amend their application to permit the use of derivatives by (a) removing the representation that ETFs operating in reliance on the order will not invest in futures, options or swaps and (b) inserting representations (i) and (ii) at an appropriate place in their applications. The 18 applicants named in the December 6 no-action letter may rely on that relief immediately, provided they comply with representations (i) and (ii) above.

Conclusion

The lifting of the moratorium on derivatives usage by actively managed ETFs is a welcome development for actively managed ETF sponsors and those seeking to enter the space. While it does not mean the end of the SEC staff's review of derivative usage by investment companies generally, it does signal that the staff has not found serious or persistent issues based on ETFs investing in derivatives, and it restores actively managed ETFs' ability to compete largely on an equal footing with other vehicles in many investment strategies.

⁹ In the past, the staff's concerns about leveraged ETFs have tended to focus on the potential for investor confusion about such ETFs' performance objectives. See Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors, SEC-FINRA Investor Alert, available at <http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm>. The Investor Alert notes that leveraged ETFs are typically designed to achieve their stated performance objectives on a daily basis, but that some investors might invest in leveraged ETFs with the expectation that the ETFs meet these goals over the long term as well.

SEC Lifts Moratorium on Actively Managed ETFs' Use of Derivatives; Moratorium Continues for Leveraged ETFs

Authors:

Stacy L. Fuller

stacy.fuller@klgates.com

+1.202.778.9475

Kurt J. Decko

kurt.decko@klgates.com

+1.415.249.1053

K&L GATES

Anchorage Austin Beijing Berlin Boston Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg
Hong Kong London Los Angeles Miami Milan Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh
Research Triangle Park San Diego San Francisco São Paulo Seattle Shanghai Singapore Spokane Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of more than 40 fully integrated offices located in North America, Europe, Asia, South America, and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information about K&L Gates or its locations and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2012 K&L Gates LLP. All Rights Reserved.