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SEC Staff Conducting Broad Analysis of Derivative Use by Registered Funds: Certain ETF Applications Are Temporarily Placed on Hold Until Study Is Concluded

On March 26 at the SEC Speaks 2010 conference, Andrew J. Donohue, the Director of the Securities and Exchange Commission's Division of Investment Management (Division), stated that he has convened a task force to examine the use of derivatives by all funds registered under the Investment Company Act of 1940 (1940 Act). Mr. Donohue indicated that his concerns about derivatives use by registered funds predated the March 25 SEC press release relating to the Division's temporary halt in considering exemptive relief applications submitted by exchange-traded funds (ETFs) that plan to make "significant investments in derivatives to achieve their investment objectives." See http://www.sec.gov/news/press/2010/2010-45.htm (Derivative Study Release). In the spring of 2009, Mr. Donohue asked the American Bar Association to form a task force to look at registered funds' use of derivatives.

Mr. Donohue indicated that a formal review of the use of derivatives by registered funds by SEC staff members (Staff) is "long overdue" and emphasized that it is not a "judgmental" exercise to determine whether derivatives are bad or good for registered funds. Rather, Mr. Donohue stated that an analysis of these new derivative "tools" is warranted because the 1940 Act does not currently deal with derivatives very well. He also stated that he expects to receive the ABA's report on derivatives shortly, which will be utilized by the Staff task force, and has directed the Staff task force to engage in an outreach effort to gather input and comment from persons outside the SEC on issues of disclosure and regulation. Mr. Donohue acknowledged that one of the goals of this effort is to preserve the usefulness of these tools for registered funds.

Elizabeth G. Osterman, Associate Director of the Division charged with oversight of the Division's office of 1940 Act exemptive relief, elaborated on the portion of the Derivative Study Release concerning ETF applications. Ms. Osterman stated that while the Staff task force was considering the use of derivatives by all registered funds, her office would "take a step back." She explained that, contrary to erroneous press reports about the Derivative Study Release, her office is not denying, but only deferring, consideration of certain applications for the 1940 Act relief required for the establishment of ETFs in order to ascertain the appropriate level of protection of investors under the 1940 Act.

Ms. Osterman stated that her office presently is reviewing approximately thirty ETF exemptive relief applications, of which only two or three are expected to be affected by the temporary halt because they propose "using a significant amount of derivatives to get their investment objective." She then explained that two types of ETFs are implicated. The

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first type is transparent, actively managed ETFs, which may have issues under the temporary halt; however, Ms. Osterman stated that their applications can still progress if they reexamine their portfolio strategy and agree to limit their use of derivatives. Second, she said that leveraged and inverse ETFs present a more difficult issue under the temporary halt because such ETFs must use derivatives to achieve their two-times, three-times or inverse performance objectives. Noting that these latter funds have garnered a lot of recent press, Ms. Osterman referred interested parties to the Investor Alert posted on the SEC's website, which contains a general statement on investor concerns in these types of ETFs. See http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm.

Ms. Osterman observed that the Derivative Study Release caused some "panic" in the press and made clear that her office's temporary halt relates only to pending ETF exemptive relief applications. She stated that ETFs operating under existing exemptive orders can continue to issue new leveraged and inverse ETFs and said that the SEC is not issuing "stop orders" to halt the current or future registration and trading of ETFs possessing existing orders.

Ms. Osterman also generally commented on other activities in her office relating to ETFs. She noted that the Staff has received a lot of equity and fixed income ETF applications and some 130/30 ETF applications, as well as applications for ETFs based on what she termed "designer indices," in which the ETF sponsor establishes a portfolio management theory and then engages a third-party index provider to design an index pursuant to that theory. In addition, she mentioned that her office is also working through preliminary issues with respect to proposed ETF applications for nontransparent, actively managed ETFs. Ms. Osterman noted that these ETF applications have not been finalized because the Staff is still working through relevant 1940 Act policy issues as well as the SEC's pending ETF rule proposal.

Neither Mr. Donohue nor Ms. Osterman provided a timetable or an estimated date for the completion of the Staff task force review. It is likely to be a lengthy process, given that the Derivative Study Release outlines a wide-ranging scope of inquiry relating to the use of derivatives by registered funds, including consistency with current leverage, concentration and diversification standards; risk management and compliance procedures; board standards for review of derivative strategies and counterparties; valuation procedures; prospectus disclosures; and reporting requirements.

The Division's response to the Staff task force review will depend upon the findings and recommendations made, together with the input and advice it receives from non-SEC sources. Possible developments include: (i) expanded publication of investor information on the SEC website; (ii) articulation of new registered fund guidelines and/or best practices with respect to the broad use of derivatives; (iii) publication of a concept release or preliminary rule proposals targeting particular types of transactions or instruments; and (iv) proposals to amend existing rules or interpretations regarding the use of derivatives under the 1940 Act. Therefore, it is impossible to speculate what effect the Staff task force review will have on registered funds generally and, in particular, on leveraged and inverse leveraged ETFs or actively managed ETFs that plan to use "significant amounts" of derivatives.

As the Division regulates only investment companies and federally registered investment advisers, Mr. Donohue and Ms. Osterman did not mention exchange-traded vehicles that are not investment companies, such as exchange-traded commodities funds (ETCs). Such vehicles are not affected by the Derivative Study Release because they are not subject to the provisions of the 1940 Act and, therefore, do not apply to the Division for exemptive relief. It remains possible that the Division of Corporation Finance may find the Staff task force findings and recommendations useful when its staff members review registrations and disclosure documents submitted by ETCs and other non-investment company vehicles.

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