Exchange-Traded Funds
Challenging the Dominance of Mutual Funds?

A Deloitte Research Report

Table of Contents

About Deloitte Research

Deloitte Research, a part of Deloitte Services LP, identifies, analyzes, and explains the major issues driving today's business dynamics and shaping tomorrow's global marketplace. From provocative points of view about strategy and organizational change to straight talk about economics, regulation and technology, Deloitte Research delivers innovative, practical insights companies can use to improve their bottom-line performance. Operating through a network of dedicated research professionals, senior consulting practitioners of the various member fi rms of Deloitte Touche Tohmatsu, academics and technology specialists, Deloitte Research exhibits deep industry knowledge, functional understanding, and commitment to thought leadership. In boardrooms and business journals, Deloitte Research is known for bringing new perspective to real-world concerns.

Foreword

Exchange-Traded Funds, or ETFs as they are commonly known, have risen from obscurity to an increased level of prominence. Launched in 1993, they were passively managed (index-based) until early 2008, when actively-managed ETFs were introduced. ETFs have become part of a number of retail and institutional portfolios.

ETFs have become popular with investors due to their fee structure, tax efficiency and increased level of transparency. ETFs have also made it accessible for retail investors to invest in individual commodities such as oil or gold. These are some reasons perhaps why ETFs have weathered the sharp slowdown in markets better than mutual funds. As a result, ETF net assets are nearly half a trillion dollars with a high likelihood that the upward growth slope seen in recent years will return once markets stabilize.

In this report we provide an introduction to ETFs, including how they are formed and a comparison between ETFs and mutual funds. We also look at the proposed changes in ETF regulations and what the near future holds for ETFs. Lastly, we answer the question whether ETFs will challenge the dominance of mutual funds in the future. Mutual funds have a 69-year head start on ETFs and it is unlikely that ETFs will become bigger in terms of net assets anytime in the near to medium term. However, ETFs will increase their share of investment dollars as more investors find them to be an attractive option.

Cary

Cary Stier
Managing Partner
US Asset Management Services
Deloitte & Touche LLP

Executive Summary

The recent emergence of exchange-traded funds (ETFs) has been remarkable. Available in the U.S. since 1993 and in Europe since 1999, they will continue to challenge the dominance of open-ended mutual funds (MFs), the undisputed heavyweight of investment products that first started in 1924. The total net assets of U.S.-based ETFs increased from $72.13 billion in January 2001 to $531.28 billion in December 2008 after reaching a high of 610.31 billion in May 2008.

Historically, ETFs were investment vehicles traded on stock exchanges that generally tracked indices, such as the Dow Industrial Average or the S&P 500. More recently, ETFs have proliferated because they are tailored to an increasingly specific array of regions, sectors, commodities, bonds, futures, and other asset classes. Some ETFs are diversified; others track only a single sector, commodity, or currency. All ETFs were index-based or passively managed until March 2008 when the U.S. Securities and Exchange Commission (SEC) approved the launch of actively managed ETFs. They are primarily traded on the American Stock Exchange, but some are also traded on the NYSE Arca, NYSE AltNext, and NASDAQ, and the SEC regulates them under the Investment Company Act of 1940 (ICA).

Similar to the valuation of MFs and Unit Investment Trusts, ETFs can be purchased at the end of each trading day for its net-asset value (NAV). Additionally, ETFs enjoy the tradability of closed-end funds, which trade throughout the day at prices that may differ from their NAVs. Generally, the advantages of ETFs over traditional, open-ended mutual funds include lower costs, flexibility when buying and selling, tax efficiency, market exposure, diversification, and transparency.

When investors in open-ended mutual funds redeem their shares, the fund may have to liquidate a portion of their underlying positions to fund the redemptions, potentially resulting in realized capital gains at the fund-level. On the other hand, when large redemptions occur, the creation process happens in reverse. Therefore, an ETF does not have to sell any of its holdings to fund large shareholder redemptions. These shareholders are redeemed "in-kind," which should not result in realized capital gains at the fund level (for Federal tax purposes) that must be later distributed to shareholders. Smaller investors redeem their shares by selling them on an exchange instead of transacting directly with the ETF.

The ETF-creation process begins when fund sponsors and index creators target an index to track and then seek permission from the SEC to launch an ETF. Once the SEC grants permission, sponsors enter an agreement with Authorized Participants (APs) to manage the ETF and its shares. Sponsors give APs a portfolio composition file that lists the components and weight of underlying securities that mirror the target index. APs buy or borrow these securities and exchange these baskets for creation units, which are delivered to a custodian. In exchange, the sponsor issues ETF shares to the APs. The total value of these ETF shares equals that of the creation unit. The APs sell these shares almost like stocks on the open market. Unlike stocks, their value depends on the underlying securities and partly on the supply and demand for the ETF.

Every time the SEC approves an ETF, it must exempt it from certain provisions of the ICA ; this can be a time-consuming approval process. The SEC is now proposing a new rule that would hasten this process. Proposed Rule 6c-11 would exempt ETFs from certain provisions of the Act if the ETFs meet conditions set by the SEC. Additional proposals might give investment companies the right to invest more heavily in ETFs.

Current industry trends suggest further developments in the next two to three years:

- Total ETF assets in the U.S. will likely exceed $1 trillion
- Actively managed ETFs are unlikely to become as popular as index-based ETFs
- More closed-end funds will reorganize and become ETFs
- ETFs of ETFs will become popular
- ETFs will predominantly focus on commodities, emerging markets, fixed income and currencies

ETFs are already challenging the dominance of mutual funds, and this trend will continue with greater intensity. In a survey of investment professionals conducted in March 2008, 67 percent called ETFs the most innovative investment vehicle of the last two decades, and 60 percent reported that ETFs have fundamentally changed the way they construct investment portfolios.[1] While ETFs are not expected to surpass open-ended mutual funds' assets under management, they are expected to capture a greater percentage of current and future investment capital. Research suggests that mutual funds will decline approximately 10 percent in a typical portfolio product mix, and most of this reallocation is expected to impact ETFs. There are several reasons for this:

- New SEC rules that will make it easier to launch ETFs
- New disclosure rules that will make ETFs more popular with retail investors
- More 401(k) plan money that will be invested in ETFs
- Greater tax efficiency of ETFs
- Lower costs of ETFs
- Liquidity
- Market-exposure diversification
- Transparency
- An increasing number of mutual fund complexes that enter the ETF business

Mutual funds have a 69-year head-start and are much larger than ETFs. Therefore, ETFs are unlikely to beat mutual funds in terms of net assets in the near future. However, retail and institutional investors and advisors are ensuring that ETFs will be one of the fastest-growing investment products of the future.

The Basics of Exchange-Traded Funds

ETFs are "securities that closely resemble index funds, but can be bought and sold during the day, similar to common stocks. These investment vehicles give investors a convenient way to purchase a broad basket of securities in a single transaction. Essentially, ETFs offer the convenience of a stock along with the diversification of a mutual fund."[2] According to the SEC, ETFs "are investment companies that are legally classified as open-ended companies or Unit Investment Trusts."[3]

ETFs generally track indices, such as the Dow Jones Industrial Average or the S&P 500. Depending on the fund manager's strategy, ETFs also track a wide array of regions, sectors, commodities, bonds, futures, and other asset classes. ETFs were passively managed until March 2008, when the SEC allowed the launch of actively managed ETFs.[4]

ETFs have relatively recent origins: the first was the Standard & Poors Depository Receipt (SPDRs), which tracked the S&P 500 and launched on the American Stock Exchange in January 1993. Its $66 billion in assets makes it one of the largest ETFs. While most U.S.-domiciled ETFs are traded on the American Stock Exchange, some are traded on the New York Stock Exchange Arca and NASDAQ.

The growth of these funds has been remarkably fast. In December 2008, total U.S.-domiciled ETF net assets[5] were $531.28 billion, up from $72.13 billion in January 2001.[6] There were 728 U.S.-domiciled ETFs in December 2008, up from 81 in January 2001. However, only three ETF providers account for approximately 82 percent of ETF assets.[7]

Worldwide, there were 1,499 ETFs with total assets of $765 billion at the end of the third quarter of 2008.[8] By comparison, total open-ended U.S. mutual fund[9] net assets[10] were $10.63 trillion in September 2008, up from $7.23 trillion in January 2001. It reached a high of $12.30 trillion in October 2007 and again came close to the peak in May 2008 when net assets reached 12.29 trillion.[11] Though ETFs may never threaten the dominance of mutual funds, they seem to be giving them a run for their money. (See figure 1 in the appendix for a comparison between ETF and mutual fund net asset trends.)

The Creation of an ETF

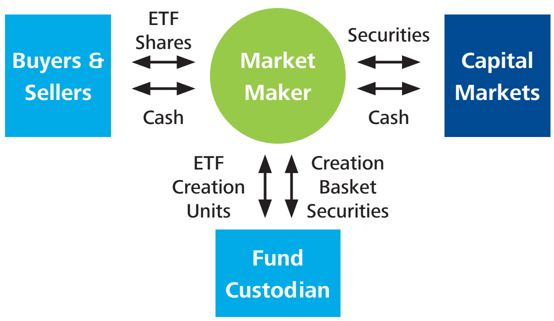
Bringing an ETF to Market

The creation of an ETF is a complex process. First, the fund manager (also referred to as a sponsor or trustee), along with firms that create and maintain indices set procedures for determining the target index. The sponsor then submits a detailed plan for the proposed ETF to the SEC, including its operations and where it will be listed. Once the SEC approves the ETF by exempting it from certain provisions of the ICA — a process that can take up to a year. The provisions of the 1940 Act from which they seek exemption are tailored towards traditional mutual funds. Therefore, from an operational perspective, it would be difficult for ETFs to comply with these particular provisions; this is why they seek exemption. The sponsors then enter into an agreement with APs, which are usually large institutional investors that empower them to create and redeem ETF shares. There are times when the ETF sponsors and APs could be one and the same. There are very few APs; of the few existing ones, all are market makers, and all of them support ETF trading.

Creating ETF Units

The "creation of units" is the daily operational process that is utilized by APs to create ETF units. (See figure 1, which illustrates the process of creating ETF units). A portfolio composition file, created by the sponsor, lists the composition and weights of the underlying securities or commodities that mirror the target index. APs then buy or borrow relatively large amounts of the underlying stocks from the capital markets that would mirror the index. If the proposed ETF tracks a commodity, it buys or borrows certificates of ownership of that commodity. The basket of securities is delivered to the custodian who verifies that it is an approximate mirror of the index. The AP (if they are the sponsor) then subsequently receives a "creation unit" delivered to their account at the Depository Trust Corporation. The creation unit is broken up into ETF shares, which represent a fraction of the creation unit. The number of ETF shares depends on the NAV of the creation unit — a function of the weights assigned to the underlying securities. In the case of commodities, the sponsor will usually have a formula to calculate the NAV. Because this is "in-kind" barter and no cash changes hands, there are no tax implications.

Figure 1: Process of Creation of ETF Units



Source: First Trust Exchange-Traded Funds. "A Guide to Exchange-Traded Funds"

The AP sells the ETF shares on the open market like any publicly traded stock. The AP also has the option of holding shares in their name. The AP process is really the "primary" market for ETF shares. ETF shares are created and/or redeemed by the APs who subsequently sell them to retail investors through the secondary market. Listing of ETFs for trading is done under the Securities Exchange Act of 1934. However, unlike stocks, the value of the ETF shares (NAV) is largely dependent on the value of the underlying securities, but is a market component to the price of ETF shares. Since the ETF trades on the open market, supply and demand is a factor in the market price of retail ETF shares, but it is usually within a small margin since the AP ensures that the arbitrage between the NAV and the value of the underlying securities is minimal by either creating or redeeming shares. However, when an ETF is lightly traded, the NAV can be discounted relative to the value of the underlying assets.[12]

The Different Structures of ETFs

In the United States, there are three legal structures of ETFs: Managed Investment Companies (open-ended index funds), Unit Investment Trusts, and Grantor Trusts. Table 1 illustrates the significant differences between these structures.

Table 1: ETF Structures

	Managed Investment Companies (Open-ended Index Fund)	Unit Investment Trust	Grantor Trust (Exchange Trades Notes)
Reinvests Dividends	Yes (monthly or quarterly basis)	No	No
Replication of Index	May optimize index	Must fully replicate index	Custom-weighted basket
Specific Termination Date	No	Yes	No
Able to hold commodities portfolios	No	No	Yes
Tax Efficient	Yes	Yes	Yes
Registered Under	ICA	ICA	Securities Act of 1933
Registered with SEC	Yes	Yes	No

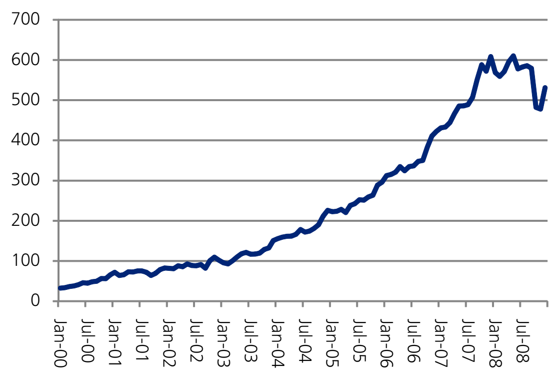
Source: ETFguide.com, Path to Investing

While Unit Investment Trust ETFs are the oldest structure, the majority of ETFs are open-ended index funds because of the flexibility of their structure. It should be noted that Grantor Trusts are typically traded as American Depository Receipts on U.S. stock exchanges.

Accounting for the Popularity of Exchange-Traded Funds

ETFs have been a favorite among institutional investors for some time now, but they have recently become popular with retail investors. Figure 2 depicts the rapid growth of these funds between January 2000 and December 2008, though the market crash in the second half of 2008 put a dent in that growth. While an argument could be made that this growth was because of buoyancy in stock and commodity markets before the crash in both markets — it may have contributed. Mutual fund complexes have also launched ETFs, and others are considering this option. A realistic conclusion is that investors, particularly retail investors (who own over 50 percent of total ETF assets), like the idea of having ETFs as part of their portfolios and many mutual fund managers are aware of this trend.

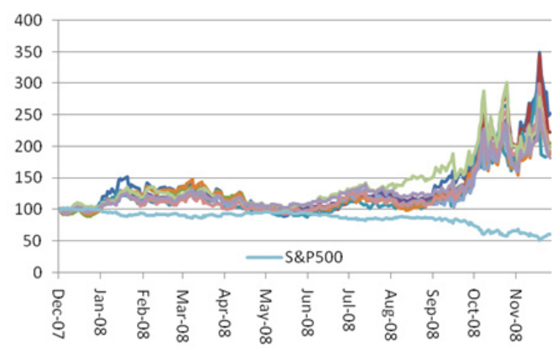
Figure 2: ETF Assets ($ billions) (January 2000 – December 2008)



Source: Investment Company Institute

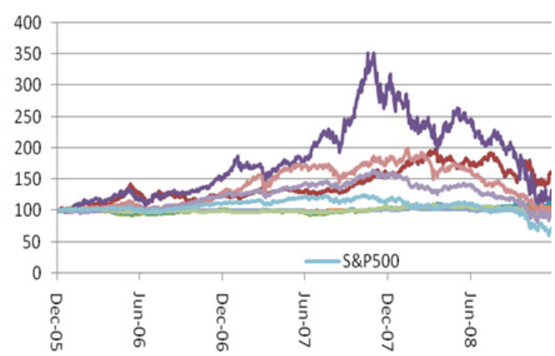
Investors tend to move their money together from one product, asset, or country to another. This "herd behavior" — an always-present market phenomenon — is perhaps another reason why ETF growth has been so rapid. Herd-driven investors' destinations are all typically marked by one characteristic: their performance is comparatively the best. Figures 3 and 4 compare the top performing ETFs and the S&P 500 over one and three years, respectively, and the gap is clear. Granted, comparing returns on the S&P 500 to a Brazil- or Gold-indexed ETF may be a bit like comparing apples and oranges, but these products compete for the same investment dollars, and they are available to all retail and institutional investors. That said, there are many ETFs that underperform the S&P 500, but the limelight is typically reserved for the top performers — hence, the herd behavior.

Figure 3: Indexed Daily Performance of Top-Performing ETFs vs. S&P 500 (December 3, 2007 to November 28, 2008)



Source: Bloomberg
Note: All the ETFs are domiciled in the U.S. and listed on U.S. exchanges

Figure 4: Indexed Daily Performance of Top-Performing ETFs vs. S&P 500 (December 1, 2005 to November 28, 2008)



Source: Bloomberg
Note: All the ETFs are domiciled in the U.S. and listed on U.S. exchanges

The growing popularity of ETFs is also grounded in other reasons:

- **Tax efficiencies**: Generally, ETFs are more tax efficient than open-ended mutual funds. First, unlike open-ended mutual funds, which typically fund shareholder redemptions by selling portfolio securities, ETFs usually redeem investors in-kind. The sale of portfolio securities by open-ended mutual funds may generate taxable gains that can ultimately result in taxable distributions to remaining shareholders. However, as redemptions in-kind by ETFs generally do not generate taxable gains to the ETF, there would be no need for any taxable distributions to the remaining shareholders. Second, ETFs usually only sell portfolio securities when the underlying indices rebalance. This low turnover rate will typically result in fewer taxable distributions to investors. However, it should be noted that tax efficiencies are generally accrued in the case of long-ETFs and not short-ETFs.
- **Low fees**: ETFs generally have a lower expense ratio than their mutual fund counterparts. The reason is twofold: most ETFs are not actively managed, and ETFs are shielded from the costs associated with buying and selling shares to accommodate shareholder purchases and redemptions. ETFs typically have lower marketing, distribution, and accounting expenses and most do not have 12b-1 fees. The ETFs in figure 3 have management fees ranging from 0 to 0.74 percent, while many mutual funds have annual management fees ranging from 1 to 3 percent. The average ETF has approximately a 0.41 percent expense ratio. As actively managed ETFs continue to grow their market share, average ETF fees may increase over time.
- **Diversification**: ETFs are generally more diversified than open-ended mutual funds because they typically seek exposure to broad indices.
- **Allowing investment in commodities**: Investing in commodities is cost-prohibitive for most retail investors because they cannot afford to buy in 'lot-sizes.' ETFs allow retail investors to buy commodity lots in much smaller pieces like a single ETF share. As a result, many retail investors have been able to benefit from the increase in commodity prices over the past few years.
- **Transparency**: The ETF discloses the composition and weights of the underlying base.
- **Pricing and trading**: ETFs are traded on exchanges similar to regular stocks, so their intra day indicative value gets updated every 15 seconds.
- **Flexibility**: ETFs can be customized to track almost any index. There are ETFs that track companies with the best corporate governance and "inverse ETFs" that profit when the value of the underlying index falls. Inverse ETFs can also be used to hedge portfolios. ETFs can also be loaned, sold short, bought on margin, and used for hedging purposes.

Apart from the upside, certain ETFs may present additional risk. It is estimated that over 90 percent of ETFs are narrow-based.[13] Narrow-based ETFs, by definition, have narrow underlying indices, such as commodity-based ETFs, country-focused ETFs, or sector-focused ETFs. They tend to be impacted more dramatically than broad-based ETFs when there is news of poor market conditions. For example, most financial-sector-focused ETFs have been languishing with extensive news coverage of the global financial crisis. Investors can reduce their risk exposure by investing in different types of ETFs.

Comparing Exchange-Traded Funds and Mutual Funds

ETFs are most commonly compared to open-ended mutual funds because of certain similarities they share and the growing competition between them for investment dollars. (See table 2 in the appendix for a comparison of ETFs and closed-end funds). The mutual fund industry currently holds the lion's share of assets under management, but ETF assets are growing at a faster pace. Though index-based mutual funds and ETFs are both open-ended, there are significant differences between them. It is perhaps these differences that were responsible for the genesis of ETFs, as well as their current popularity with investors. The major differences are summarized in table 2.

Table 2: ETFs and MFs Compared

	Exchange-Traded Funds	Open-Ended Mutual Funds
Management Type	There are both actively and passively managed (index-based) ETFs. The latter dominates the former.	There are both actively and passively managed (index-based) mutual funds. The former dominates the latter.
Transparency	Both passively and actively managed ETFs have to disclose their holdings every trading day.	Mutual funds have to disclose their holdings every quarter.
Tax Efficiency	When ETF shareholders redeem their shares, the ETF generally does not have to sell any of its portfolio securities to pay for the redemptions because redemptions are either done in-kind or through the sale of shares on an exchange. As a result, redemptions of ETF shares generally do not contribute to capital gains distributions being paid to shareholders. However, actively managed ETFs may be required to pay larger capital gains distributions because of the ETF's investment objectives.	When shareholders of an open-ended mutual fund redeem their shares, they are transacting directly with the fund. Therefore, the fund must often sell portfolio securities to fund shareholder redemptions. This activity can result in capital gains distributions.
Pricing and Trading	The price of ETFs is "live" throughout the trading day and can be traded similar to any stock. ETFs can be shorted, as well as bought on margin, and investors can trade ETF options. ETFs are traded on exchanges.	The price of an open-ended mutual fund is the NAV that is determined at the end of the trading day; all trading done on a particular day is based on that NAV. Open-ended MFs cannot be shorted, but they can be bought on margin. There are no mutual fund options, and open-ended mutual funds are not traded on exchanges.
Transaction Costs/Fees	ETFs have comparatively low management fees, ranging from 0 to 0.74 percent for the ETFs in figure 3. The average management fee for ETFs is 0.41 percent, and the range of management fees for index ETFs is 0.09 to 0.99 percent. ETFs, like shares, have bid-ask spreads and commissions, have to be paid for each transaction, and the typical brokerage commission is around $10 per trade.	The average management fee for equity MFs is 1.47 percent, while it is 0.61 percent for money-market MFs. The average fee for index or passively managed ETFs is 0.74 percent, but it can be lower than 0.20 percent for S&P indexed MFs. Some MFs charge an early withdrawal fee that typically ranges from 1.5 to 2 percent. Some have front loads and back loads, and in some cases, the front load can be as high as 5.75 percent. MFs have no bid-ask spreads. Unlike ETFs, most index-based MFs have no commissions.
Minimums	ETF shareholders can buy one share.	Some mutual funds have minimum amounts that investors have to purchase.

There are also some operational difference between ETFs and MFs, and these differences are summarized in table 3:

Table 3: Operational differences between ETFs and MFs

	Exchange-Traded Funds	Mutual Funds
Structure	There are three main structures of ETFs: open-ended index, Unit Investment Trust, and Grantor Trust. Open-ended ETFs dominate.	There are both open-ended and closed-end mutual funds.
Purchase/sale options	ETFs are traded only through brokers.	MFs are traded directly with sponsors, as well as brokers.
Dividends	Generally, dividends are paid annually.	Income can be paid monthly, quarterly, or annually, but capital gains are generally paid annually.
Commissions/ sales load	Investors pay standard brokerage commissions to buy and sell ETFs.	Some MFs carry a sales load as an adjustment to the purchase price.
Tax Structure	Regulated Investment Company (Corporation) or Grantor Trust.	Regulated Investment Company (Corporation).
Registered under	Security-based ETFs are registered under the ICA, while commodity-based ETFs are regulated by the Commodity Futures Trading Commission.	MFs are regulated under the ICA .

Inside ETFs and MFs

While figure 1 gives a general overview of the ETF creation unit process, figure 5 illustrates the key players involved and their key operational responsibilities.

Figure 5: Operational Responsibilities of ETF Key Players

Fund Sponsors identify the target benchmark of the fund, which can be a specific index, as well as the number of shares that will equate to a creation unit to be traded for the specific ETFs. Also dessiminates daily fund NAV.

Fund Distributor is responsible for approving all creation orders of the ETF fund shares and signing-off on the orders to create shares of the ETF fund. The fund sponsor can choose to be distributor or engage third party service provider.

Custodian is responsible for the safe-keeping of assets, trade processing, settlement and clearance.

Authorized Participant (AP) places orders to create or redeem ETF shares in large blocks and execute transactions to investors.

Investment Managers are responsible for all securities trading decisions as well as trade execution of the underlying securities. They may have an approval role with regard to dividend payments on ETF shares.

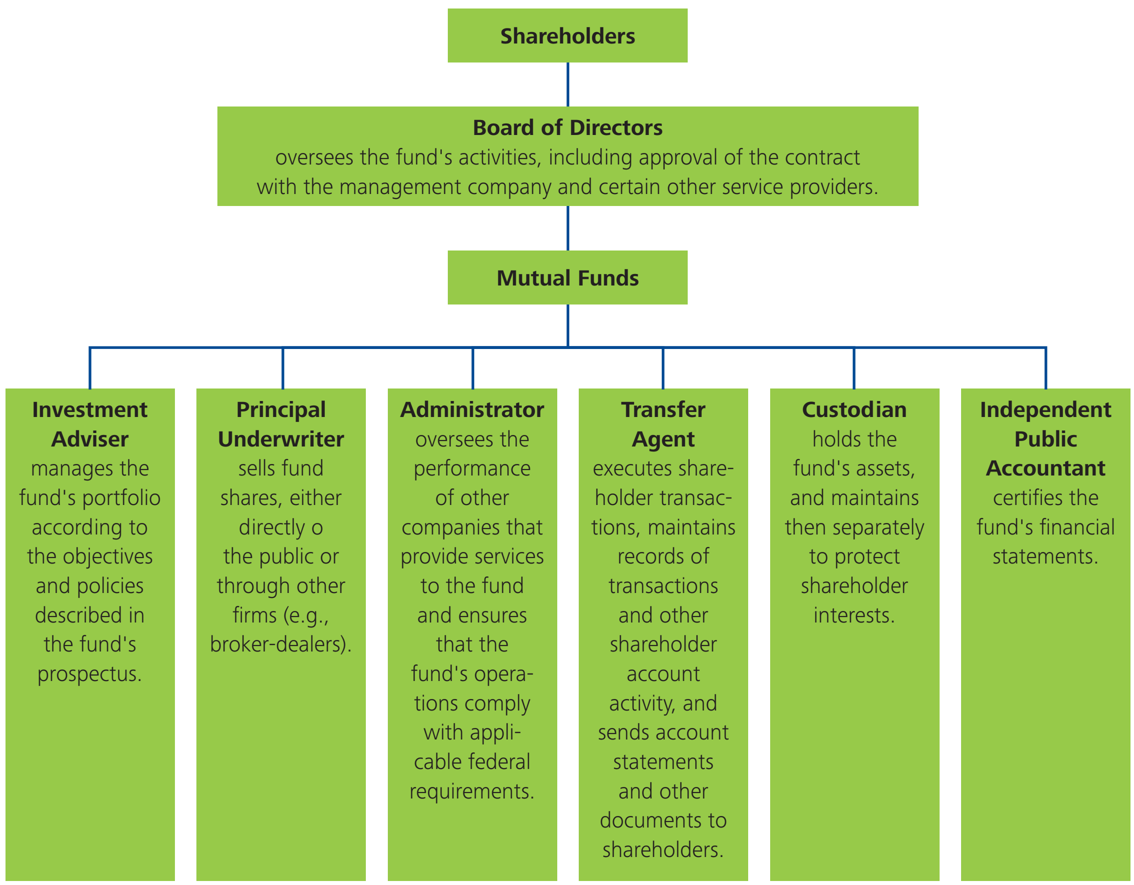
Transfer Agents provide maintenance of AP activity records, processing of fund establishments and terminations, creation of ETF shares, dividend payment distributions, and automated ETF share reconciliation.

Source: Bank of New York Mellon

Mutual Funds

Typically, mutual funds have no employees, and their operations are conducted by other organizations and independent contractors, including an investment manager. Figure 6 illustrates the structure of a mutual fund and the operational responsibilities of its organizations and independent contractors.

Figure 6: Structure of a Mutual Fund



Source: Investment Company Institute. "A Guide to Understanding Mutual Funds"

The Emergence of Actively Managed Exchange-Traded Funds

Sponsors have recently launched actively managed ETFs (AME) to generate alpha.[14] The SEC indicates that an AME "does not seek to track the return of a particular index. Instead, an actively managed ETFs investment adviser, like an adviser to any traditional actively managed mutual fund, generally selects securities consistent with the ETF's investment objectives and policies without regard to a corresponding index."[15]

The concept of AMEs has been around for some time now; the SEC sought public comment on AMEs by issuing a 'concept release'[16] in 2001. However, the idea of AMEs was not approved because of skepticism. The first approval (Invesco's PowerShares Capital Management unit) happened in March 2008, and the first AME to launch was Bear Stearns' Current Yield Fund on March 25, 2008. Since AMEs are a relatively new concept, the jury is still out on their success.

There are several key differences between passively and actively-managed ETFs:

- **Costs**: Historically, investors have been fascinated with ETFs because of their relatively low costs, due in large part to the reduced role of the portfolio manager. The average management fee for ETFs is 0.41 percent, and the range of management fees for index ETFs is 0.09 to 0.99 percent. The expense ratio of the first actively managed ETF, Bear Stearns Current Yield, was 0.35 percent. PowerShares' actively managed funds have expense ratios between 0.29 and 0.75 percent.[17] Compared to their passively managed counterparts, management fees for AMEs may increase as the roles and responsibilities of the portfolio manager increase.
- **Transparency**: ETFs are transparent products; investors typically know the composition of the underlying securities. AMEs, on the other hand, may not be able to communicate their intra-day composition and prices to investors, especially if the composition is changing regularly; they are only required to disclose their holdings once a day. According to the SEC, "This potential for less transparency in the portfolio holdings of an actively managed ETF may make the process of creating and redeeming Creation Units more difficult or present greater investment risk for arbitrageurs. As a result, an actively managed ETF could have a less efficient arbitrage mechanism than index-based ETFs, which could lead to more significant premiums or discounts in the market price of its shares."[18]
- **Tax efficiency**: ETFs are also popular among investors because of the tax efficiency that results from the fact that they only sell portfolio securities when indices rebalance. AMEs are generally less tax efficient than passively managed ETFs because of their higher turnover rate.
- **Flexibility**: AMEs offer more flexibility than index-based ETFs because securities that fail to perform well can be removed from the portfolio. AMEs will also have access to complex and diverse strategies.

Changes in Exchange-Traded Fund Regulations

The SEC regulates ETFs that are registered under the ICA. However, the ICA does not actually account for the ETF structure. Therefore, the SEC has to issue an "exemptive" order for each ETF proposal and give relief from certain provisions of the Act.[19] Commodity ETFs, which do not invest in securities, are not regulated by the SEC. However, commodity ETFs are subject to SEC review, and the SEC has to issue a "no-action" letter.[20] Commodity ETFs are subject to oversight by the Commodity Futures Trading Commission.

On March 11, 2008, the SEC issued several ETF-related proposals for comment. The SEC is proposing new rules under the ICA. The summary of the proposed rule changes as outlined in the original concept release is:

The SEC is proposing a new rule under the ICA that would exempt ETFs from certain provisions of that Act and our rules. The rule would permit certain ETFs to begin operating without the expense and delay of obtaining an exemptive order from the Commission. The rule is designed to eliminate unnecessary regulatory burdens, and to facilitate greater competition and innovation among ETFs. The Commission also is proposing amendments to our disclosure form for open-ended investment companies, Form N–1A, to provide more useful information to investors who purchase and sell ETF shares on national securities exchanges. In addition, the Commission is proposing a new rule to allow mutual funds (and other types of investment companies) to invest in ETFs to a greater extent than currently permitted under the ICA.[21]

Exemptions Permitting Funds to Form and Operate as ETFs

The SEC is proposing Rule 6c-11[22] under the ICA that would "codify much of the relief and many of the conditions of orders that we have issued to index-based ETFs in the past, and more recently to certain actively managed ETFs. The proposed rule is designed to enable most ETFs to begin operations without the need to obtain individual exemptive relief from the Commission." [23]

Scope of Rule 6c-11

- **Index-based ETFs** – The new rule would not limit the type of indices that an ETF may track or the types of securities that may comprise the index.
- **Actively managed ETFs** – The rule would be applicable to AMEs that disclose the identities and weights of the securities and other assets each business day on their Web site.
- **Organization of an open-ended investment company** – The new rule would be applicable only to ETFs that are organized as open-ended investment companies and not as Unit Investment Trusts (UITs). Currently, the SEC defines ETFs as, "investment companies that are legally classified as open-ended companies or unit investment trusts."[24] This does not appear to be an issue because there has not been an ETF that has applied to be a UIT since 2002 because of the comparative flexibility of an open-ended investment structure.[25] Also, as of December 2007, 99 percent of the ETFs in existence were open-ended.

Conditions

ETFs would have to meet the following conditions to rely on the proposed Rule 6c-11:

- **Transparency of index and portfolio holdings** – ETFs would have to disclose the names and weights of securities, as well as other assets on their websites. Alternatively, they could state an investment objective, for example, listing the index the ETF tracks so long as the provider of that index releases the names and weights of the securities on its website.
- **Listing on a national securities exchange and dissemination of intra-day value** – All shares that are issued by an ETF would have to be approved for listing and trading on a national exchange. Listing on a stock exchange would facilitate the publication and dissemination of the intra-day value. This intra-day value is not a single price, but rather a continuous publication of the price. The SEC indicated that exchanges typically report these prices every 15 seconds; this dissemination would prevent any significant premium or discount between the market price of the ETF share and its intra-day value.

- **Marketing** – To help assure that retail investors are not confused between ETFs and mutual funds, APs could not advertise or market their ETFs as either open-ended funds or mutual funds. In addition, APs would have to explain that ETF shares are not individually redeemable. ETFs also would have to state in their literature that they do not sell or redeem individual shares and that investors can buy or sell ETF shares in the secondary market (through brokers-dealers) without any involvement from the ETF.

Exemptive relief

The relief that proposed Rule 6c-11 would give, provided all conditions are met, include:

- **Issuance of redeemable securities** – The proposed rule would deem all securities that are issued by an ETF as "redeemable securities," according to Section 2(a)(32) of the ICA.[26] This would then permit an ETF to register as an open-ended fund directly with the SEC. The Act recognizes open-ended funds as investment companies that issue and redeem redeemable securities.
- **Trading of ETF shares at negotiated prices** – Part of Section 22(d) of the ICA says, "No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus." Rule 22c-1 requires that a dealer selling, redeeming, or repurchasing a redeemable security must use its NAV-based price. Proposed Rule 6c-11 would exempt a dealer in ETF shares from both Section 22(d) and Rule 22c-1. Thus, dealers would be able to buy and sell ETF shares at market prices in the secondary market.
- **In-kind transactions between ETFs and certain affiliates** – Proposed Rule 6c-11 would grant exemptions from Sections 17(a)(1) and 17(a)(2)[27] of the ICA that would allow first- and second-tier affiliates of an ETF to purchase and redeem creation units through in-kind transactions. First-tier affiliates are "those affiliated because they own 5 percent or more, and in some cases more than 25 percent, of the ETF's outstanding securities." Second-tier affiliates are "persons who are affiliated with the first-tier affiliates or who own 5 percent or more, and in some cases more than 25 percent, of the outstanding securities of one or more funds advised by the ETF's investment adviser."[28]
- **Additional time for delivering redemption proceeds** – Section 22(e) prohibits "a registered open-ended investment company from suspending the right of redemption, or postponing the date of satisfaction of redemption requests more than seven days after the tender of a security for redemption."[29] However, ETFs that invest in foreign securities are often faced with external factors, such as foreign holidays and delivery cycles that may prevent them from meeting the seven-day deadline. Provided ETFs follow a set of conditions, such as disclosing foreign holidays, they will be given no more than 12 days after the tender of shares.

Exemption for Investment Companies Investing in ETFs

Section 12(d)(1)(A) of the ICA limits the amount that one fund may invest in another fund's shares and it prohibits a fund (and the companies or funds it controls) from:

- Acquiring more than 3 percent of the total outstanding voting stock of another fund
- Having securities issued by another fund that have an aggregate value in excess of 5 percent of the value of the total assets of the acquiring fund
- Having securities issued by all other funds (other than treasury stock of the acquiring fund) that have an aggregate value in excess of 10 percent of the value of the total assets of the acquiring fund

The SEC's proposed Rule 12d1-4 to help acquirers increase their limits in excess of Section 12(d)(1) (A) is subject to four conditions.[30] They are control, redemptions, complex structures, and layering of fees. The SEC has imposed these conditions to address "historical abuses that result from pyramiding and the threat of large-scale redemptions and may arise in connection with investments in ETFs."[31] If the rule is adopted, acquirers will be able to invest up to 25 percent of outstanding ETF shares. However, the SEC has included provisions in the rule, so acquiring funds will not be able to threaten large-scale redemptions to coerce ETFs. In addition to investment companies, the SEC is also requesting comments on whether to allow fund of funds to invest in ETFs.

The Near Future

Growth of the ETF sector

Between March 2001 and March 2008, total U.S.-domiciled ETF assets grew at a compounded annual rate of 44 percent. At that pace, it was expected that they would likely exceed $1 trillion before the end of 2009. However, given current volatile market conditions, at a conservative growth rate of 20 percent compounded annually, total ETF assets will exceed $1 trillion in mid 2011. The ETF sector is likely to continue to grow at a rapid pace over the next two to three years. The drivers for this growth are primarily a result of the following:

- **Proposed SEC rules will make it easier to launch ETFs**. Proposed Rule 6c-11 could simplify the creation of new ETFs. Firms will likely launch new ETFs to meet demand. Additionally, the proposed SEC rules will give greater flexibility to ETFs to consider new indices.
- **Proposed SEC rules will allow funds to buy more ETF shares**. If the SEC approves proposed Rule 12d1-4, ETF investments may increase as acquiring funds, such as mutual funds, will be allowed to invest up to 25 percent of their portfolio in the outstanding shares of ETFs. Mutual funds already invest some of their money in ETFs and will likely take advantage of the increased limits, particularly since many index funds outperform managed funds. That said, the tax efficiency of ETFs may be lost for MF investors if the fund decides to sell the ETF.
- **More MF companies will enter the ETF business**. Several years ago, Vanguard began marketing ETFs after observing State Street Global Advisors' success in attracting significant investment capital into their new ETF products. The Wall Street Journal writes: "Vanguard's 37 ETFs have attracted $41 billion since their launch in 2001. That is a sliver of the company's $1.3 trillion in assets, but the business is growing at a faster clip than Vanguard's traditional funds. For mutual fund companies across the country, the challenge today is largely the same: Should they, like Vanguard, compete with ETFs by getting in the game? Or should they stick with what they know, offering a wide variety of index and actively managed funds?"[32] The answer is that it does seem other mutual fund complexes want to launch their own ETFs. A Dow Jones Newswires article says: "More of the big kids want to play after all. Spurred by the march of investor dollars into exchange-traded funds as new types continue to be launched, more giants from the mutual-fund world have decided to try their hand at running them."[33] A news report suggests that MF companies are indeed planning to enter the ETF space.[34]
- **Greater retail investor inflow**. To date, institutional investors have been the primary investors in ETFs. Retail investors historically account for only a small percentage of total ETF investors due, in large part, to the lower commissions they offer brokers. However, trends suggest a change could be coming. The Wall Street Journal writes that, "After years of shying away from index funds, brokerage firms have embraced their cousins, exchange traded funds, to such an extent that they are building entire portfolios out of them."[35] A survey by Cogent Research suggests that mutual fund assets will likely decline approximately 10 percent in their portion of a portfolio product mix and most of this money will go to ETFs.[36] This, along with new disclosure requirements that the SEC is contemplating, will likely make ETFs even more attractive. In November 2007, the SEC proposed amendments to Form N-1A[37] and Rule 498 under the Securities Act of 1933[38] to increase disclosure requirements.[39] According to the SEC: "The proposed amendments, if adopted, would require key information to appear in plain English in a standardized order at the front of the mutual fund prospectus."[40] Although it states mutual funds, it refers to open ended funds. According to proposed Rule 6c-11, all ETFs will become open-ended funds, which will benefit retail investors.
- **More 401(k) money will come into ETFs**. As of September 30, 2007, 401(k) plan total assets amounted to $3.06 trillion. Of this, investments in mutual fund assets totaled $1.68 trillion, while less than 1 percent of 401(k) assets ($30.6 billion) were in ETFs. A study estimates that 401(k) assets will increase to between $7.5 and $8.5 trillion in 2015.[41] Thus far, ETFs have faced stiff headwinds in trying to crack the 401(k) market because of costs, as well as operational challenges. ETFs can become costly because of charge commissions for every trade, and this can add up over time. The operational challenges, among others, are that 401(k)s were designed around end-of-day MF batch transactions and MFs allow purchase of fractional shares, while ETFs don't. As a result, they are not part of many employer-sponsored plans. However, recent demands from regulators might make plan fees more transparent, meaning

MFs will have to disclose revenue-sharing agreements with plan providers. This might give ETFs, which don't have revenue-sharing agreements, the opportunity to gain a larger foothold. ETF companies are now creating ETFs specifically designed for 401(k) plans, and increased investments in ETFs from 401(k) contributions are likely.[42] Also, once 401(k)s overcome their operational challenges, there will be a greater adoption of ETFs.

Actively Managed ETFs Will Probably Not Challenge the Dominance of Index-Based ETFs — Their Targets will be Mutual Funds

On the face of it, AMEs theoretically offer a better strategy than regular index-based ETFs because they have people to manage them. The obvious inference is that access to better research will give managers the ability to offer better returns. However, studies suggest that this is not the case. Investment advisor Mike Burnick writes in his blog: "There are more than 10,000 conventional mutual funds in existence today. The vast majority of these are actively managed funds, with fund managers collecting fees in return for their investment skills. Sadly, over 90 percent of these actively managed mutual funds cannot beat the market index return; most fall well short in fact."[43]

Since the first AME appeared in 2008, the launch of subsequent funds has been largely anticlimactic. The *Wall Street Journal* writes: "The most anticipated exchange-traded funds in years are finally here -- but so far nobody seems to have alerted investors… The first active fund has been around for only about eight weeks, so it is too early to draw hard conclusions. But early results suggest the ETF industry will have to work hard to popularize the new funds by outperforming stock-market benchmarks and marketing them to financial advisers."[44] At the end of December 2008, there were 13 active ETFs with approximately $240 million in assets.[45] However, the weight of history is against managed funds and they will probably not displace index based ETFs from the top position or make a big dent in their dominance.

That said, it is likely that some future AMEs may be looking to compete with actively-managed mutual funds and not index-based ETFs. When initially introduced, AMEs were structurally different from MFs, but in January 2009 an AME was introduced that would function more like a traditional actively-managed MF.[46] Given their higher transparency and lower fees, these type of AMEs could compete aggressively with actively-managed MFs.

Increased Reorganization of Closed-end Funds to ETFs

Like ETFs, closed-end funds (CEFs) also trade on exchanges. However, there are some key differences. Absent a rights offering, CEFs cannot issue additional shares, while ETFs can. Additionally, while an ETF's value is usually close to the value of its underlying securities because of the arbitrage mechanism, the value of a CEF is determined by the markets, which can differ — sometimes significantly — from its NAV. It has been estimated that most CEFs in the United States trade at approximately a five percent discount to their NAV. Obviously, this may not be advantageous for investors, and CEF sponsors may look at different ways of reducing this discount by reorganizing as an ETF. As of the first quarter of 2008, the assets of closed-end funds totaled $293.3 billion.

The big advantage of this conversion is that it can potentially be tax-free. In a letter written to shareholders in March 2007 regarding the reorganization of a closed-end fund to an ETF, James Bowen, the CEO of First Trust Value Line, wrote, "Through the Reorganization, your shares of FVL[47] would be exchanged, on a tax-free basis for federal income tax purposes, for shares of FVL ETF[48] with an equal aggregate NAV, and you will become a shareholder of FVL ETF."[49] However, if shareholders in the CEF decide not to convert their holdings into the ETF, they can redeem their shares, but this may be subject to capital gains tax.

It has been reported that after reorganization to ETFs, the trading discount has reduced tremendously. In the case of the FVL conversion, the discount was 8 percent before the conversion, and it fell to 1.5 percent on the first day of trading as an ETF and to 0.03 percent six months after that.[50] The key reason for reduced post-reorganization discounts is that a CEF cannot issue new common shares, while an ETF can create new shares when investors invest. Lower expense ratios represent another significant benefit for converting CEFs to ETFs. The financial crisis too has played havoc with CEF discounts. It has been reported that at the end of September 2008, the median discount to NAV for CEFs was 16.06 percent.[51]

However, the caveat here is that it is likely that only quantitative CEFs will convert to ETFs because it is easier for them to convert to index-based ETFs. (See table 1 in the appendix for a comparison between ETFs and CEFs).

ETF Wraps will Become Popular

In June 2007, Claymore Investments launched the Claymore Global Balanced Income ETF and the Claymore Global Balanced Growth ETF in Canada, making them the world's first ETF wrap portfolios. The fund consists of 13 ETFs and gives investors exposure to many different sectors.

On May 20, 2008, the first ETF wrap in the United States, PowerShares Autonomic Global Asset Portfolios, was launched on the American Stock Exchange. It consists of three ETFs of ETFs: PowerShares Autonomic Growth NFA Global Asset Portfolio (PTO), PowerShares Autonomic Balanced Growth NFA Global Asset Portfolio (PAO), and PowerShares Autonomic Balanced NFA Global Asset Portfolio (PCO). These three ETFs of ETFs will "represent three different asset allocation strategies and risk levels, with differing amounts assigned to several different asset classes. The equity allocation encompasses domestic stocks, foreign stocks, and real estate, while the fixed-income bucket covers fixed income, commodities, and currency."[52] PTO has 30 underlying ETFs, PAO has 27 underlying ETFs, and PCO has 27 underlying ETFs.[53] The underlying indices must be rebalanced every quarter, but this can happen on a monthly basis, if warranted.

There are several characteristics that will contribute to the anticipated success of ETFs of ETFs, including low fees, tax efficiencies, exposure to a wide variety of asset classes that can potentially negate the dangers of narrow-based ETFs, and the promising track record of tried and-tested, index-based ETFs.

The Future Focus of ETFs

According to The *Wall Street Journal*, in October 2008, ETF providers in the U.S. had more than 500 ETFs in development.[54] ETF sponsors can be extremely creative. Some of the ETFs that are currently in the market testify to this. The reality, however, is that only select types will be successful. While ETF sponsors may try to differentiate themselves by offering exotic ETFs, investors will probably invest solely in funds they believe will be successful — and that list is usually fairly short. Since the whole process is demand driven, ETF sponsors will probably focus on their investors' desires. Typically, the rule of thumb that most investors use when evaluating potential investment opportunities is to see what performed best over the past one to three years, though more seasoned investors look at three to five years.

Going forward and looking beyond the subprime crisis, it is likely that new ETFs will tend to focus on commodities and emerging markets. Though commodities took a beating towards the end of 2008, the reality is that the demand-supply equation for a lot of commodities, particularly oil, is still tight and prices will likely firm up as the economic situation gets better. Equity markets in the United States are in flux, and it will likely continue well into 2009. As a result, inverse ETFs that 'short' the market will likely become popular. 'Short' ETFs will also likely be popular because they have proven to be effective as hedging mechanisms.

Along with commodity and emerging market ETFs, demand for fixed-income ETFs will also increase. The demand for fixed-income assets always usually tends to grow when there is volatility in equity markets or a high probability of an economic slowdown, as is now the case. Conservative investors will likely gravitate in droves toward fixed-income ETFs, which generally tend to offer some level of protection against bearish economic conditions.

A potential future focus for ETFs is the real estate sector, which was badly hit in the sub-prime crisis, so valuations look quite affordable. In the same vein, a potential future focus for ETFs is the financial sector. Another possible focus could be alternative energy and fuels. Obviously, having a future focus doesn't mean abandoning tried and tested strategies, and ETFs will continue to be linked to things like currencies, etc.

The Characteristics of Successful ETFs

Pinpointing the characteristics of ETFs that will likely succeed will become increasingly critical as they become more popular with both institutional and retail investors. This is necessary because the number of ETFs in the market — 698 at last count — create obvious competitive pressures. Some aspects like low costs and high transparency are common across ETFs, so they are not distinguishing features. Several factors could enable funds to attract additional capital:

- **Link to less exotic indices**. Some of the best performing ETFs are linked to less exotic indices, such as commodities and equities. The data shows that exotic funds, on average, have not performed as well as regular ETFs. This is not to say that exotic funds haven't performed well, but exotic ETFs are difficult for regular investors to understand. In other words, the simpler, the better. Also, simpler betas are cheaper than their more exotic counterparts.
- **Focus on indices with long-term appeal**. There are a number of ETFs that are launched to benefit from a current market situation. Inverse financial sector ETFs, for example, profit from the ailing financial sector. However, most investors recognize that these ETFs have a limited shelf life. Being linked to an index with a long-term appeal is usually more attractive to investors, particularly retail investors.
- **Increase appeal to 401(k) investors**. The barrier for 401(k) funds investing in ETFs is its higher costs compared to index mutual funds. Given that 401(k) assets will probably reach $7.5 to 8.5 trillion in 2015, ETF sponsors need to make themselves 401(k) friendly to tap into this huge pool of assets that primarily invests in mutual funds.
- **Become more retail-investor-friendly**. When small investors buy ETFs, they incur commission costs, as well as the bid-ask spread. These costs usually make the difference between small investors putting their money in index mutual funds or ETFs. While commissions and bid-ask spread may not have a large impact on big investors, it is significant for investors who put in small but consistent sums of money. In essence, ETFs will have to maintain their 'good' characteristics but mimic index MFs.
- **Keep it institution-friendly**. The rise of ETFs has been mainly attributable to institutional investors, such as hedge funds and pension funds. These funds were drawn to ETFs because of their low cost, risk diversification, and efficient beta. Another reason for large investors to be drawn to certain ETFs is their strong liquidity.
- **Ensure low tracking error**. The tracking error is the difference between the NAV of an ETF and its benchmark. Typically, the simpler the benchmark, the lower the tracking error. A lower tracking error is also one of the primary determinants of choosing an ETF.

These are not necessarily characteristics for improving performance. While these attributes could help in that regard, their real strength is the ability to attract increased investment into a fund. The *Wall Street Journal* reports that a fund should have at least $50 million in assets to be profitable. However, as of August 2008, over 350 ETFs contained assets less than $50 million.[55]

Will ETFs Challenge the Dominance of Mutual Funds?

Mutual funds have a 69-year head start on ETFs; ETFs are thus unlikely to have more assets under management than MFs anytime soon. However, ETFs are likely to increase their share of investment dollars and become the fastest-growing investment product as funds from declining mutual funds transition to ETFs. A research report suggests that ETFs are a threat to mutual funds because advisors, both strategic-asset allocators and 'tactical-asset allocators, are increasingly using ETFs as part of investors' portfolios.[56] Data show that between ETFs, index MFs and Active MFs, ETFs accounted for 37.6 percent of net sales in 2007 compared to 21.5 percent in 2006. Active MFs accounted for 67.5 percent in 2006, but declined to 45.6 percent in 2007.[57]

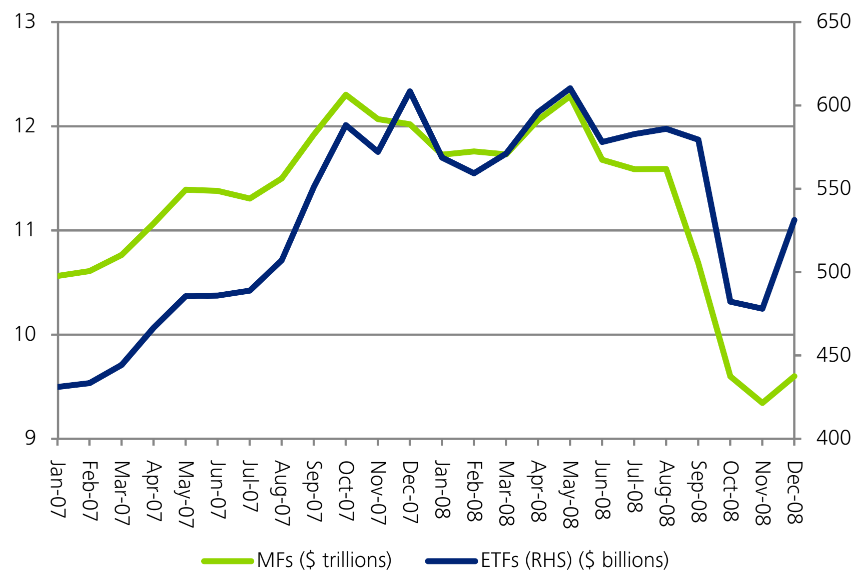
Since their launch, ETFs have experienced profound growth because characteristics like tax efficiency and transparency made them popular with investors. There are several reasons to expect a continued upward trajectory:

- New SEC rules will make it easier to launch ETFs and for funds to invest more in ETFs
- New disclosure rules will make ETFs more popular with retail investors
- More 401(k) plan money will be invested in ETFs
- More mutual fund complexes will enter the ETF business

In addition to investors, Wall Street's largest brokerage firms are also getting into the act by building portfolios made entirely out of ETFs.[58] Perhaps, if there is one guide to the future of ETFs, it is that brokerage houses tend to follow the money.

Appendix

Figure 1: ETF Assets vs. Mutual Fund Net Asset Trends
(January 2007 – December 2008)



Source: Investment Company Institute,

Table 1: ETFs and Closed-End Funds Compared

	ETFs	Closed-End Funds
Continuous trading and pricing throughout the day?	Yes	Yes
Can be bought on margin?	Yes	Yes
Can buy/sell options?	Yes	No
Sold by prospectus?	Yes	Yes
Can use in an IRA, 401(k), or another retirement plan?	Yes*	Yes*
Can be purchased through a traditional or online broker?	Yes	Yes
Minimum investment or share amount required?	No~	No
Traded on what exchanges?	Amex, NYSE Arca, Nasdaq	Amex, NYSE Arca, Nasdaq

Source: www.etfguide.com
* For employer-sponsored retirement plans, ETFs and closed-end funds may not be available as an investment option. Self-directed retirement plans may offer a broader menu of investment choices which may include ETFs and closed-end funds.
~ Exception is Merrill Lynch's HOLDRs, which can only be bought and sold in 100-share increments.

Endnotes

1. State Street Global Advisors and Knowledge @Wharton "The Impact of Exchange Traded Products on the Financial Advisory Industry," June 10, 2008.
2. "Exchange Traded Fund," Streetauthority.com, <http://www.streetauthority.com/terms/e/etf.asp> [accessed on September 2, 2008].
3. Securities and Exchange Commission, "Exchange Traded Fund,", <http://www.sec.gov/answers/etf.htm> [accessed on September 2, 2008].
4. ETFs should not be confused with Exchange Traded Notes (ETNs). According to ETNCenter.com, ETNs are: "Exchange Traded Notes (ETNs) are senior, unsecured debt securities that are designed to match the returns of a specific market index, minus fees. ETN holders do not receive any coupon payments during the life of the note, and there is no principal protection for the investment." Differences between ETFs and ETNs can be found at http://www.investopedia.com/articles/06/ETNvsETF.asp
5. All ETFs registered as investment companies with the SEC are included in the statistical release. The different types of ETFs whose assets are included in the total are: Domestic Equity, Global/International Equity, Hybrid and Bond.
6. "Exchange-Traded Fund Statistics," Investment Company Institute, <http://www.ici.org/stats/etf/index.html>.
7. John Spence, "ETFs suffer asset declines, closures," MarketWatch, November 2, 2008.
8. John Spence, "Market Downturn Poses Threat to ETFs — Funds Had Thrived, But Will Investors Back Latest Offers?" The *Wall Street Journal*, October 9, 2008.
9. Any future reference to 'mutual funds' or 'MFs' refers to both actively managed and passively managed (index) open-ended mutual funds, unless explicitly stated otherwise.
10. The different types of open-ended MFs are: Stock Funds, Hybrid Funds, Taxable Bond Funds, Municipal Bond Funds, Taxable Money market Funds and Tax-free Money Market Funds.
11. "Mutual Fund Statistics," Investment Company Institute, <http://www.ici.org/stats/mf/index.html#TopOfPage>.
12. Ian Salisbury, "Some ETFs Fall Short on Pricing — Certain Trades Slip Below Value of Holdings," The *Wall Street Journal*, November 21, 2008.
13. "ETFs Evolve – For Better or Worse?" *Knowledge @ Wharton*, March 19, 2008.
14. According to Wikipedia, "Alpha is a risk-adjusted measure of the so-called active return on an investment. It is a common measure of assessing an active manager's performance as it is the return in excess of a benchmark index".
15. Securities and Exchange Commission, "Exchange Traded Funds: Proposed Rules," *Federal Register*, Vol. 73, No. 53, March 18, 2008, Page 14621.
16. According to the SEC, they publish "concept releases to solicit the public's views on securities issues so that we can better evaluate the need for future rulemaking".
17. Heather Bell, "PowerShares Launches 4 Active ETFs: Only the Beginning?," *Seeking Alpha*, April 13, 2008, < http://seekingalpha.com/article/72095-powershares-launches-4-active-etfs-only-the-beginning> [Accessed on Novermber 28, 2008].
18. Securities and Exchange Commission, "SEC Concept Release: Actively Managed Exchange Traded Funds," November 8, 2001. <http://www.sec.gov/rules/concept/ic-25258.htm> [accessed on December 3, 2008].
19. The provisions that ETFs need to seek exemption from are
    - 2(a)(32) – Mutual fund securities must be redeemable
    - 22(d) and 22(c)-1- Every investment company security transaction must receive the NAV next determined
    - 24(d) – Prospectus delivery requirement for every secondary market trade
    - 17(a)(1) and 17(a)(2) – Investors who own more than 5% of a RIC are affiliates and cannot invest or redeem in kind
20. According to the SEC: "An individual or entity who is not certain whether a particular product, service, or action would constitute a violation of the federal securities law may request a "no-action" letter from the SEC staff. Most no-action letters describe the request, analyze the particular facts and circumstances involved, discuss applicable laws and rules, and, if the staff grants the request for no action, concludes that the SEC staff would not recommend that the Commission take enforcement action against the requester based on the facts and representations described in the individual's or entity's original letter. The SEC staff sometimes responds in the form of a no-action letter to requests for clarification of the legality of certain activities." <http://www.sec.gov/answers/noaction.htm> [accessed on October 12, 2008].
21. Securities and Exchange Commission, "Exchange Traded Funds: Proposed Rules," *Federal Register*, Vol. 73, No. 53, March 18, 2008, Page 14618.
22. Section 6-c of the Investment Company Act of 1940 is: "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 title or of any rule or regulation there under, 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 title."

23. Securities and Exchange Commission, Ibid, Page 14621.
24. Securities and Exchange Commission, "Exchange Traded Fund,", <http://www.sec.gov/answers/etf.htm> [accessed on September 2, 2008].
25. A UIT portfolio is fixed, and substitution of securities may take place only under certain circumstances.
26. Section 2(a)(32) of the Investment Company Act of 1940 states that "''Redeemable security'' means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."
27. Section 17(1) and (2) of the Investment Company Act of 1940 - It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof; (2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer);
28. Securities and Exchange Commission, Ibid, Page 14629.
29. Ibid.
30. Ibid, Page 14637.
31. Ibid.
32. Rob Wherry, "To ETF or Not to ETF?" The *Wall Street Journal*, January 3, 2008.
33. Ian Salisbury, "Big Fund Firms Eye ETFs," *Dow Jones Newswires*, October 2, 2008.
34. Mariana Lemann, "ETF Market Poised for Growth," *Ignites*, February 17, 2009.
35. Ian Salisbury, "Brokerage Firms Show ETFs Some Love — New Portfolios Are a Departure for Wall Street," The *Wall Street Journal*, March 31, 2008.
36. ETF Trends, "Advisors Will Continue Shift to ETFs Over Next Two Years," <http://www.etftrends.com/2007/12/mutual-fund-dec.html> [accessed on September 21, 2008].
37. Form N-1A is to be used by open-end management investment companies, except insurance company separate accounts and small business investment companies licensed under the United States Small Business Administration, to register under the Investment Company Act of 1940 and to offer their shares under the Securities Act of 1933. <http://www.sec.gov/about/forms/formn-1a.pdf> [accessed on May 23, 2008].
38. Rule 498 of the Securities Act of 1933 refers to profiles for certain open-end management investment companies.
39. Securities and Exchange Commission, "Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies," File No.: S7-28-07, November 21, 2007.
40. Securities and Exchange Commission, Ibid, Page 14631.
41. Joe Morris, "Unprecedented Growth Ahead for 401(k)s," *Ignites*, June 27, 2008.
42. Eleanor Laise, "ETFs Make Inroads in 401(k) Plans," The *Wall Street Journal*, October 21, 2008.
43. Mike Burnick, ""Holy Grail" of ETFs Looks Like a Dead-End to Me," <http://burnickblog.sovereignsociety.com/2008/04/holy-grail-of-1.html> [accessed on September 23, 2008].
44. Ian Salisbury, "'Active' ETFs Get a Passive Response," The *Wall Street Journal*, May 22, 2008.
45. Sonia Mata and Loren Fox, "ETFs: Growth, Innovation, Competition," Strategic Insight, February 2009.
46. *Marketwire*, "Grail Advisors to Launch First Actively-Managed Exchange Traded Equity Funds," *Marketwire*, Jan 15, 2009. <http://www.marketwire.com/press-release/Grail-Advisors-938204.html> [Accessed on February 20, 2009].
47. FVL - First Trust Value Line100 Fund (closed-end fund)
48. FVL ETF - First Trust Value Line100 Exchange-Traded Fund
49. On page 26 of the letter to shareholders, the opinion of the tax adviser is "the acquisition by FVL ETF of all of the assets of FVL solely in exchange for Creation Units representing Reorganization Shares and the assumption by FVL ETF of all of the liabilities of FVL, followed by the distribution by FVL to its shareholders of Reorganization Shares in complete liquidation of FVL, all pursuant to the Plan, constitutes a reorganization within the meaning of Section 368(a) of the Code, and FVL and FVL ETF will each be a 'party to a reorganization' within the meaning of Section 368(b) of the Code."
50. *Seeking Alpha*, "On the First Trust Value Line 100 ETF Conversion: Advantages and Drawbacks," *Seeking Alpha*, June 19, 2007. < http://seekingalpha.com/article/38722-on-the-first-trust-value-line-100-etf-conversion-advantages-and-drawbacks> [Accessed on November 25, 2008]
51. David Hoffman, "Discount gap widens on closed-end funds," *Investment News*, October 12, 2008.
52. Heather Bell, "New PowerShares are ETFs of ETFs," *Indexuniverse.com*, May 20, 2008. <http://www.indexuniverse.com/component/content/article/10/4131.html?Itemid=19> [accessed on September 23, 2008].

53. The prospectus is available at <http://www.invescopowershares.com/pdf/P-052008-PRO-1.pdf> [accessed on December 2, 2008].
54. John Spence, “Market Downturn Poses Threat to ETFs — Funds Had Thrived, But Will Investors Back Latest Offers?” The *Wall Street Journal*, October 9, 2008.
55. Jason Zweig, “What to Do When Your Fancy ETF Goes R.I.P.,” The *Wall Street Journal*, August 2, 2008.
56. Cerulli Associates, “Pension and Investment Consulting: Insight for Asset Managers in DB and DC,” August 2008: Article in David Hoffman, “ETFs a Threat to Mutual Funds,” *Investment News*, Aug 29, 2008. < http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080829/REG/808299987> [accessed on September 5, 2008].
57. Eric Rosenbaum, “Forecast: ETFs To Eclipse Index Funds,” *Indexuniverse.com*, November 17, 2008.
58. Ian Salisbury, “Brokerage Firms Show ETFs Some Love — New Portfolios Are a Departure for Wall Street,” The *Wall Street Journal*, March 31, 2008.

Sponsors

Cary Stier
Managing Partner
U.S. Asset Management Services
Deloitte & Touche LLP
+1 312 486 3274
cstier@deloitte.com

Baruch Cohen
Partner
Deloitte Tax LLP
+1 212 436 5577
bcohen@deloitte.com

About the Author

Sunil Rongala
Deloitte Research
Deloitte Support Services India Private Limited
Tel: +1 615 718 2430
Email: srongala@deloitte.com

Sunil Rongala is a Manager with Deloitte Research, Deloitte Support Services India Private Limited. He holds a Ph.D. in Economics (International Economics) from Claremont Graduate University, California and a Post-Graduate Diploma in Economics from the London School of Economics. Prior to joining Deloitte, Sunil was the economist for a large manufacturing conglomerate in India.

Acknowledgements

The author is grateful for feedback, comments and assistance from the following individuals from the Deloitte & Touche U.S. Firms: Ryan Alvanos, Deloitte Services LP; Michael Bacharz, Deloitte & Touche LLP; Eric Brynes, Deloitte Tax LLP; Baruch Cohen, Deloitte Tax LLP; Robert Fabio, Deloitte & Touche LLP, Brian Gallagher, Deloitte & Touche LLP; Elizabeth Krentzman, Deloitte & Touche LLP; Nicole Maggio, Deloitte & Touche LLP; Vikram Mahidhar, Deloitte Services LP; Abigail May, Deloitte & Touche LLP; Jean Paulsen, Deloitte Services LP; Prithi Rajagopalan, Deloitte Services LP; Satish Raghavendran, Deloitte Support Services India Private Limited, Cary Stier, Deloitte & Touche LLP; Mitchell Wolfe, Deloitte LLP.

Industry Leader
Cary Stier
Managing Partner
U.S. Asset Management Services
Deloitte & Touche LLP
+1 312 486 3274
cstier@deloitte.com

Leadership Team
Donna Glass
Partner
National Private Equity, Hedge Funds & Mutual Funds AERS Leader
Deloitte & Touche LLP
+1 212 436 6408
dglass@deloitte.com

Jim Calvin
Partner
National Private Equity, Hedge Funds & Mutual Funds Tax Leader
Deloitte Tax LLP
+1 617 437 2365
jcalvin@deloitte.com

Adam Weisman
Partner
National Private Equity, Hedge Funds & Mutual Funds FAS Leader
Deloitte & Touche LLP
+1 212 436 5276
aweisman@deloitte.com

Adam Broun
Principal
National Private Equity, Hedge Funds & Mutual Funds Consulting Leader
Deloitte Consulting LLP
+ 617 437 2367
abroun@deloitte.com

Jean Paulsen
Senior Manager
National Private Equity, Hedge Funds & Mutual Funds Marketing Leader
Deloitte Services LP
+1 617 437 2463
jepaulsen@deloitte.com