OnPoint Dechert LLP

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A legal update from Dechert's Financial Services Group

SEC Lifts Moratorium on Active ETF Use of Derivatives

On December 6, 2012, the staff of the Securities and Exchange Commission (the "SEC") announced that it was lifting its moratorium on the use of derivatives by actively-managed exchange-traded funds ("ETFs"). Below, we summarize the SEC staff's actions to date and discuss the ramifications for ETFs and their sponsors.

I – Background

The SEC's moratorium was publicly announced in March 2010[1] (though the SEC staff had been informally imposing the moratorium for several months prior to that time). In its press release announcing the moratorium, the SEC stated that the staff would defer consideration of exemptive requests under the Investment Company Act of 1940, as amended (the "1940 Act") relating to actively-managed and leveraged ETFs that would make significant investments in derivatives. As a practical matter, though, in order for ETF sponsors to obtain exemptive relief to offer actively-managed ETFs following the imposition of the moratorium, the SEC staff required ETF sponsors to represent that their actively-managed ETFs would not make *any* investments in options, futures or swaps. ETF sponsors who had obtained exemptive relief to offer actively-managed ETFs before the moratorium was imposed were, however, allowed to continue offering actively-managed ETFs which utilized derivatives.

II – Lifting of the Moratorium for Active ETFs

In a speech delivered in New York on December 6, 2012,[2] the SEC's Director of the Division of Investment Management ("Investment Management"), Norm Champ, stated that the staff would no longer defer consideration of exemptive requests under the 1940 Act regarding actively-managed ETFs that utilize derivatives, provided that exemptive applicants make the following two representations in their requests for relief:

"(i) that 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) that the ETF's disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant Commission and staff guidance."[3]

Mr. Champ also stated that the SEC was not changing the existing moratorium on requests for exemptive relief to offer leveraged ETFs due to the SEC's continuing concerns regarding such products.

Notably, Mr. Champ's speech only specified that the moratorium was being lifted with respect to requests for exemptive relief. Mr. Champ's statements did not specify whether the moratorium was also being lifted with respect to actively-managed ETFs offered pursuant to exemptive relief obtained while the SEC's moratorium was in force (and thus required to represent that they would not invest in options, futures or swaps). However, we expect the SEC staff to provide additional guidance in this regard and we will advise you of any such developments.

In addition, Mr. Champ's statements did not address whether the lifting of the moratorium would affect the standards imposed by the SEC's Division of Trading and Markets ("Trading & Markets") with respect to actively-managed ETFs' investments in order for a listing exchange to obtain the rule change required under Rule 19b-4 under the Securities Exchange Act of 1934, as amended, for such active ETFs to be listed on the exchange. We will advise as soon as we learn of any impact of the moratorium lifting on the Rule 19b-4 process for active ETFs.

We look forward to discussing these issues with you in greater detail. Please feel free to contact Stuart Strauss, Jeremy Senderowicz, Allison Fumai or the Dechert attorney with whom you work if you have any questions.

Footnotes

1. *See* SEC Staff Evaluating the Use of Derivatives by Funds (March 25, 2010).

2. *See* Remarks to the ALI CLE 2012 Conference on Investment Adviser Regulation: Legal and Compliance Forum on Institutional Advisory Services (December 6, 2012).

3. Id. Footnote omitted from quoted text.

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