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Starting an ETF and Recent ETF Development Trends Webinar

The panelists explore the steps to launching an exchange-traded fund and recent trends in ETF product development. This webinar also focuses on exemptive relief filings, service provider selections, and will help attendees better understand the steps involved in bringing an ETF to the marketplace.

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Introduction

Bibb L. Strench, Counsel, Seward & Kissel LLP

- Represents ETFs, mutual funds and advisers
- Started career at SEC's Division of Investment Management
- First Sharia-based ETF
- J.D., University of Virginia, and B.A., Vanderbilt University (Economics)

James Simpson, President, ETP Resources, LLC

- Leading consultant and analytics provider in the ETF industry
- Executive in ETF marketplace and derivatives regulation at the American Stock Exchange
- Pioneer in development of U.S. listed ETFs
- B.S., Purdue University (Economics)

ETP Taxonomy

1

Equity Derivative Securities

10

Equity Derivative Securities - Issued and Redeemed Daily in Specified Aggregate Amounts.

100

Commodity Futures Trust Shares

101

Commodity Index Trust Shares

102

Commodity- Based Trust Shares

103

Currency Trust Shares

104

Index Fund Shares

105

Managed Fund Shares

106

Managed Trust Securities

107

Paired Trust Shares

108

Partnership Units

109

Portfolio Depository Receipts

110

Trust Issued Receipts

111

Trust Issued Receipts Based on Investment Shares

Overview

Select the type of ETF you plan to form

- **Exchange-Traded Funds (ETFs)** invest in securities and are generally structured as investment companies and registered under the '40 Act (e.g., SPDR S&P 500)
- **Exchange-Traded Products (ETPs)** invest in non-securities like commodities, futures, real estate, etc. and are generally structured as grantor trusts and registered under the '33 Act (e.g., Gold ETPs)
- **Exchange-Traded Notes (ETNs)** are bank debt/obligations, designed to provide returns based on investments in securities, commodities, real estate, etc., and registered under the '33 Act (e.g., iPaths)

Overview

Transparency

ETFs must disclose portfolio holdings on a daily basis as a condition to exemptive relief.

As a result:

- a low percentage of ETFs are actively managed;
- advisers fear proprietary strategies will be reversed engineered if required to make daily disclosure of portfolio positions; and
- SEC has entertained but not granted exemptive relief with alternative ways of giving market arbitragers transparency.



First Steps

Organizing the ETF

- Establish Own ETF
 - + More control
 - + More profitable in long run
 - Costly in short run
- Establish a Series of a Umbrella (Shared) Trust
 - + Faster to market
 - + Cheaper in short run
 - Board may side with service providers if there is a dispute



First Steps

Organizing the ETF

Key Items on Your Laundry List

1. File incorporating documents in home state or consider filing in Delaware or Maryland
2. Draft governing documents
 - Liability and indemnity sections
 - Proxy (voting) provisions
3. Appoint sole director who performs most initial organizational actions
4. Select fiscal year end
5. Select service providers



First Steps

Board

1. Find at least 2 independent directors
2. Vet them through questionnaire and other means
3. Pick directors with an accounting and markets backgrounds



First Steps

Registration

SEC Filings Depend on Type of Entity:

- 1.ETF: Form N-1A
- 2.ETP: Form S-1*
- 3.ETN: Form S-1

* May also have to file with the CFTC

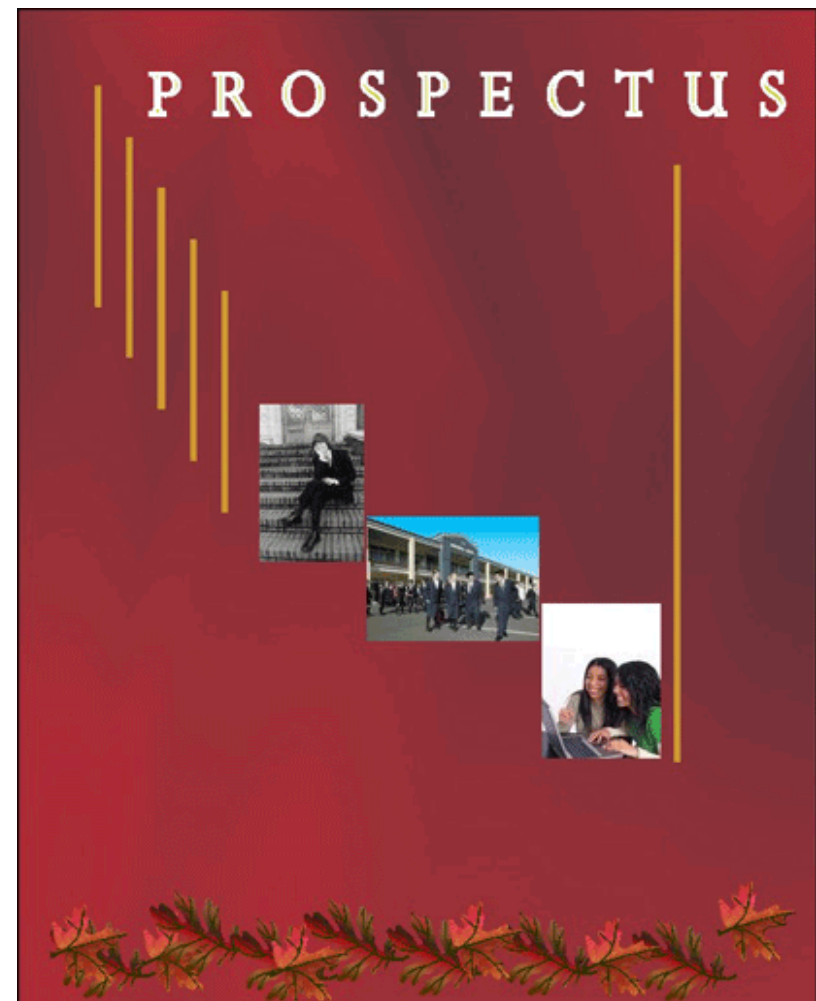


First Steps

Registration

Key Documents to Prepare:

1. Prospectus
2. SAI
3. Exhibits
4. Opinion
5. Auditor's Consent



Exemptive Relief Barrier

Type of Relief

	40 Act Misc Provisions
ETF – Actively Managed	Yes
ETF - Index	Yes
ETP	No
ETN	No

Exemptive Relief Barrier

Type of Relief



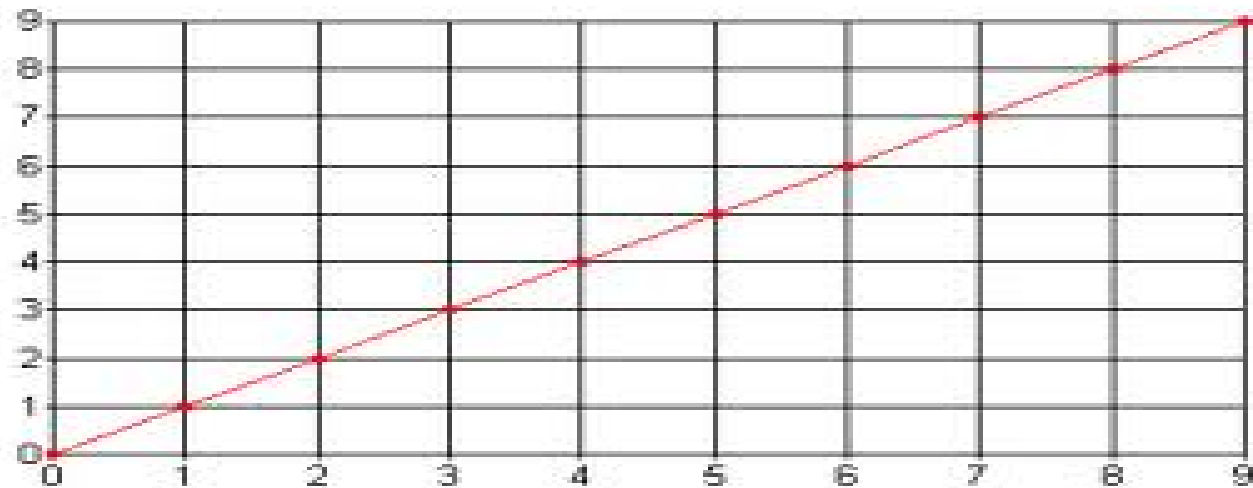
When applying for exemptive relief, consider obtaining broader relief to cover the following even if such relief is not necessary for the first ETF:

- Active and Passive
- Affiliated Index Provider (Self-Indexing)
- 12(d)(1) “Reverse” Relief for Investing Funds
- Multi-Manager
- ETF of ETFs

Exemptive Relief Barrier

Timing of Relief

COMPLEXITY



TIME

Exchange Listing Constraints Generic vs. 19b-4

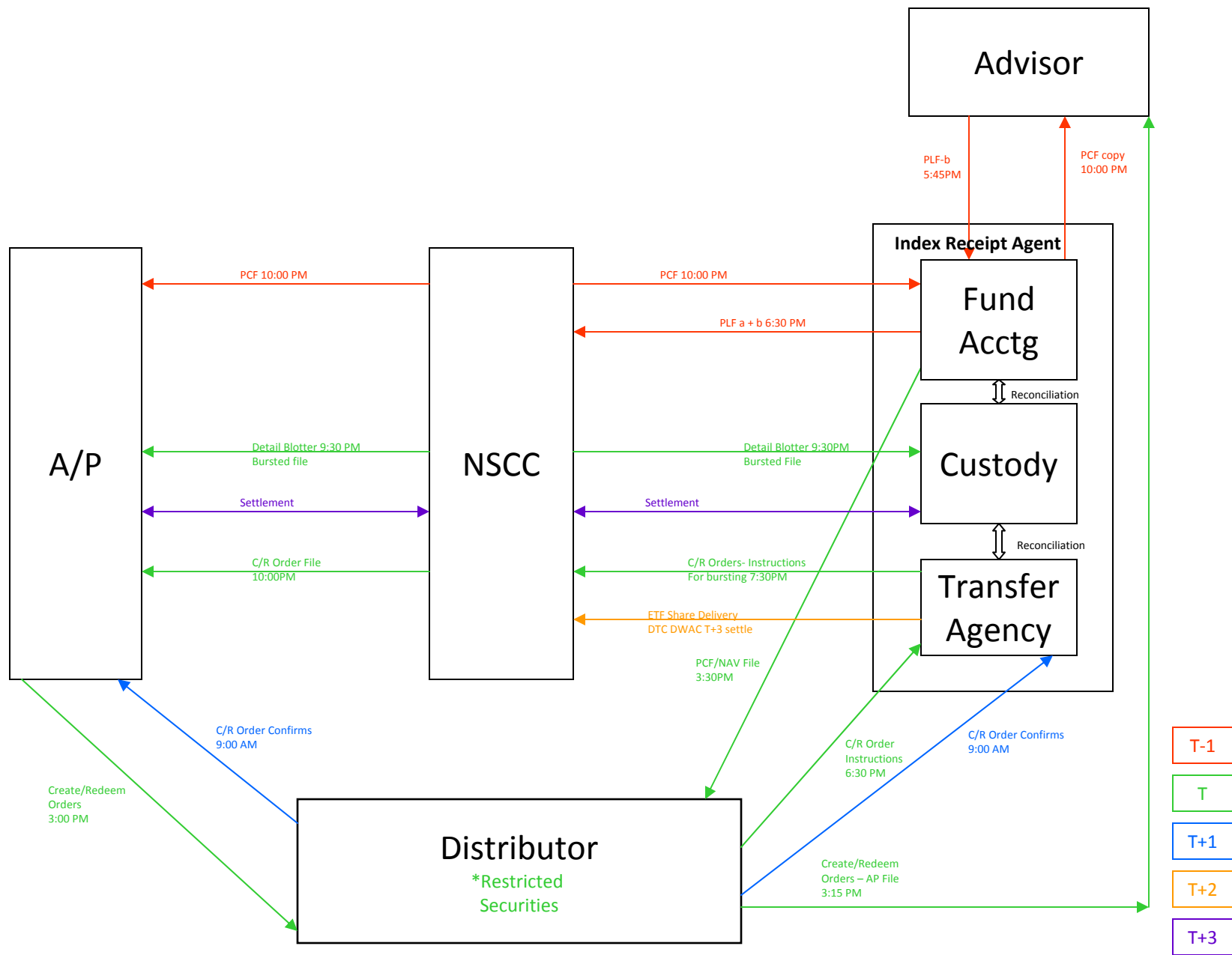
- Exchanges have limited ability to list certain equity derivatives for trading
- Some index-based ETFs can be listed quickly if they meet certain requirements (70% of weight have minimum monthly trading volume of 250,000 shares, etc.).
- Exchanges must file lengthy rule changes in order to list any active-ETFs and most ETPs.



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ETF Service Providers

Similar to Mutual Funds	Unique to ETFs	Recommended Specialists
Custodian Bank	Listing Exchange	Fund Counsel
Fund Accountant	Calculation Agent for Intraday Indicative Value	Product Development Consultant
Transfer Agent	Index Receipt Agent	Wholesalers
Public Accounting Firm	Lead Market Maker	
Distributor	Authorized Participants	
Index Provider **		



1940 Act and IRC Constraints

SEC Authority

The SEC can stifle innovative ETFs through one of three ways on the grounds of protecting shareholders:

- 1.Registration Process
- 2.Exemptive Process
- 3.Exchange Rule Filing



1940 Act and IRC Constraints

Potential Strategies/Investment Methods Constrained

Strategies that work in private funds but limited or not available to ETFs include:

- Hedging
- Leverage
- Equitization
- Synthetic Positions
- Market Neutral Strategies
- Inverse



1940 Act and IRC Constraints

1940 Act Provisions

Section 18(a) - Borrowing

- ETFs can only borrow from a bank and the amount of borrowings may not exceed $33 \frac{1}{3}$ % of the ETF's assets
- This limit greatly limits the extent to which an ETF can achieve leveraged returns
- Some sponsors seek to achieve leverage through swaps and other instruments that simulate leverage



1940 Act and IRC Constraints

1940 Act Provisions

Section 18(c) – Senior Security

Options, futures or derivative positions that create an obligation for the ETF require the ETF to cover the obligation by:

- Earmarking ETF portfolio assets equal to the obligation; or
- Setting aside cash or liquid assets that cover the obligation.

This requirement can severely limit the use of these instruments.

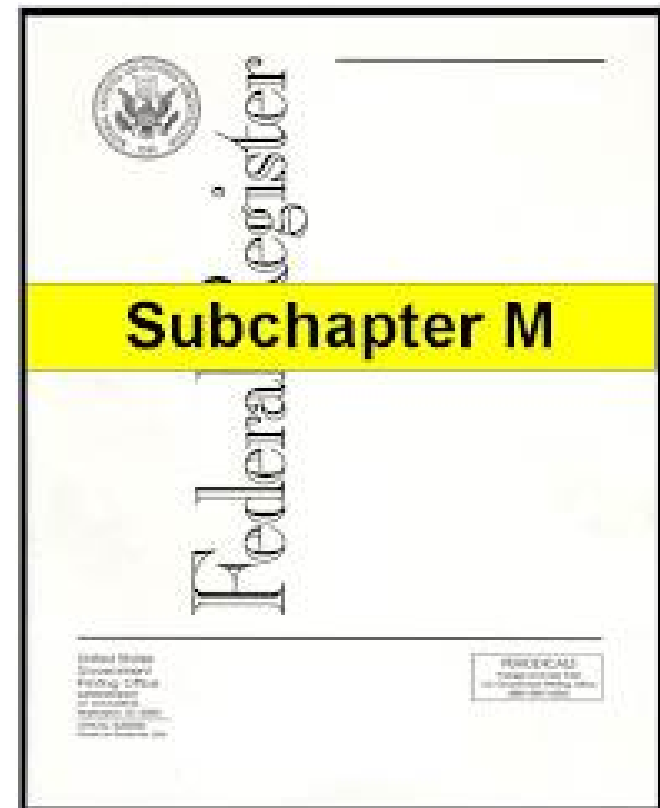


1940 Act and IRC Constraints

Tax

ETFs are “regulated investment companies” for tax purposes and therefore to avoid shareholder double taxation must comply with:

- diversification requirements under the Internal Revenue Code (as well as the 1940 Act);
- mandatory annual distribution of 90% of net investment income and 98% of net capital gain income;
- requirements on the source of investment income (e.g., 90% derived from dividends, income and capital gains on securities).



Fees and Other Economics of Advising an ETF Necessary Capital & AUM Levels

- Trust will require \$100,000 seed capital for at least one year.
- Advisor should count both start-up costs and first year's operational costs. Plan on committing at least \$1MM.
- Many equity funds break even around \$75MM AUM.
- Each estimation is unique, seek qualified help to determine the expenses up front before committing to the build.



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Fees and Other Economics of Advising an ETF

Service Provider	Typical Fees Per Fund Per Year
Exchange - Initial Listing	\$20,000 – 30,000
Exchange - Annual Fees	\$7,000 (increases with greater shares outstanding)
IOPV Calc Agent	\$5,000-10,000 (depends on complexity of investments)
Custody/Fund Acct	10bps with AUM price breaks (\$80,000 – 120,000 minimum)
Admin	30,000-40,000
Transfer Agent	\$250-1000/month
Public Accountant	\$30,000
Distributor	\$25,000
Index Provider	3bps – 20bps (\$1,000/month minimum)

Fees and Other Economics of Advising an ETF Unitary Fee & How to Set a Fee

- Many ETF advisors use a unitary fee, worth considering.
- Advisors should analyze existing comps in the ETF space, although detailed expense data can be difficult to locate.
- Keep in mind alternative ways investors get exposure through other derivatives, program trading desks, other packaged products.



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Trends in ETF and ETP Filings

SEC & ETF Exemptive Relief Orders

Date Range	Total Number of ETF-Related Orders
1Q2012	2
2Q2012	4
3Q2012	5
4Q2012	6
1Q2013	12
2Q2013	16
3Q2013	16



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Trends in ETF and ETP Filings

ETF Exemptive App Wait Times Shrink

Applicant	Request	Date Filed	Date Noticed
U.S. Global Investors, Inc.	Index Fund Shares + Self Indexing	Jul 30	Sep 25
Horizons ETFs Management (USA) LLC	Managed Fund Shares	Jul 17	Aug 27
Calamos Advisors LLC	Managed Fund Shares	Jun 21	Jul 24
ERNY Financial Advisors	Managed Fund Shares	Apr 5	May 13



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Most Recent ETF Registration Filings

Registration Date	Fund Name
Oct 7	First Trust NASDAQ Rising Dividend Achievers ETF
Oct 4	iShares Enhanced International Small-Cap ETF
Oct 3	Direxion Daily China Bear 3X Shares
Oct 1	Market Vectors Emerging Markets Aggregate Bond ETF
Oct 1	PowerShares China A-Share Portfolio
Oct 1	WisdomTree Short-Term High Yield Corporate Bond Negative Duration Fund
Sep 30	Cambria Sovereign High Yield Bond ETF

Current ETF Regulatory Developments

What's going on ...

Recent developments include:

- SEC's IM Director says that ETF rule is a priority
- Moratorium on leveraged and inverse ETFs remains in place
- Copper ETP held up because of legal challenges
- SEC has relaxed conditions on self-indexing by ETF sponsors
- Non-transparent actively managed ETFs

