**Testimony on Market Micro-Structure: An Examination of ETFs**

**by Eileen Rominger**
*Director, Division of Investment Management*
*U.S. Securities and Exchange Commission*

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Chairman Reed, Ranking Member Crapo, members of the Subcommittee:

My name is Eileen Rominger, and I am the Director of the Division of Investment Management at the Securities and Exchange Commission. I am pleased to testify on behalf of the Commission on the topic of exchange-traded funds, or "ETFs," as they are commonly known.

ETFs are a type of exchange-traded product or "ETP" that must register as investment companies. The SPDR or "spider" ETF, which tracks the S&P 500 stock index, was the first ETF and is still one of the largest on the market. Since their inception in the 1990s, ETFs have become increasingly popular as a type of investment vehicle. With investors ranging from institutional to retail, there has been a proliferation of these types of funds in the marketplace.

ETFs in the United States have grown to account for approximately $1 trillion in assets, or approximately 10 percent of the long-term U.S. open-end investment company industry, with U.S.-domiciled ETFs making up approximately two-thirds of global offerings.[1] As ETFs gained in popularity, ETPs expanded from ETFs tracking equity indexes into the development of a variety of ETPs, including those based on fixed-income instruments, commodities, currencies, and foreign securities. This product development also has generated increasingly complex structures, such as leveraged, inverse, and inverse leveraged ETFs. Because of the growth and development in such ETFs and ETPs, the Commission has been actively following, and continues to engage in the analysis of, these products.

My testimony will provide a general overview of ETPs and the SEC's roles with respect to these products. It also will discuss recent developments in the markets regarding ETFs, including their market impact. The testimony will conclude with a summary of the SEC's current efforts in this ever growing and evolving market.

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[1] See Financial Stability Oversight Council Annual Report 2011 at 66, available at http://www.treasury.gov/initiatives/fsoc/Documents/Financial%20Developments.pdf.

## Overview of Exchange-Traded Products

ETPs, of which ETFs are one type, seek to provide investors exposure to a specific benchmark or investment strategy by investing in securities and other assets. ETPs are issued by entities organized in a variety of different legal forms, including as ETFs registered as investment companies under the Investment Company Act of 1940 ("1940 Act") which register their securities for the offer and sale to the public. ETPs also can be offered and sold publicly as interests in trusts and commodity pools, or exchange-traded notes issued by public companies, which are not registered as investment companies. However, all offerings of ETP securities, whether or not the ETP entity is registered under the 1940 Act, are registered under the Securities Act of 1933 ("Securities Act"), and the securities are listed for trading on a national securities exchange. Some of the more popular types of ETP securities trading in the marketplace include the following:

**(1) ETFs that are registered under the 1940 Act as open-end management investment companies or as unit investment trusts.** ETFs offer investors an undivided interest in a pool of securities and other assets. There are two basic types of ETFs: (1) index-based ETFs; and (2) actively managed ETFs.

*Index-Based ETFs*. Most ETFs trading in the marketplace are index-based ETFs, which seek to track an underlying securities index by achieving returns that closely correspond to the returns of that index, before fees. This type of ETF primarily invests in equity or fixed-income securities issued by the companies that are included in the index or a representative sample of those securities. For example, the SPDR fund invests in equity securities of all of the companies contained in the S&P 500 stock index.

Today, there are approximately 984 index-based ETFs registered under the 1940 Act with about $900 billion in assets. There are approximately 24 providers or advisers who sponsor index-based ETF shares. The shares of these ETFs are primarily listed on NYSE Arca and NASDAQ. Leveraged, inverse and inverse leveraged ETFs, which are discussed below, generally are considered index-based ETFs because they track a securities index.

*Actively Managed ETFs*. The first actively managed ETF was approved in 2008. While there are fewer actively managed ETFs than index-based ETFs trading in the marketplace today, there has been an increase in new actively managed ETFs over the past few years. Actively managed ETFs are not based on an index. Rather, they seek to achieve a stated investment objective by investing in a portfolio of securities and other assets. This type of ETF is actively managed because, unlike an index-based ETF where the components of an index are relatively static, an actively managed fund adviser may buy or sell components in the portfolio on a daily basis, provided such trades are consistent with the overall investment objective of the fund. To address transparency concerns, actively managed ETFs are currently required to publish their holdings daily. Because there is no underlying index that can serve as a point of reference for investors and other market participants as to the fund's holdings, disclosing the specific fund holdings ensures that market participants have sufficient information to engage in the arbitrage, described below, that works to keep the market price of ETF shares close to the net asset value ("NAV") of the fund or portfolio.

Currently, there are approximately 35 actively managed ETFs with about $6 billion in assets. There are approximately five providers or advisers who sponsor these types of ETFs. The shares of these ETFs are also primarily listed on NYSE Arca and NASDAQ.

**(2) ETPs issued by entities such as trusts and other pooled vehicles, such as commodity pools.** ETPs that are not based on securities and whose portfolios may consist of physical commodities, currencies, or futures are created, redeemed and traded on a national securities exchange in a manner similar to ETFs, but the entities offering the ETPs are not registered or regulated as investment companies under the 1940 Act.

**(3) Exchange traded notes or "ETNs," which, unlike interests in ETFs, generally are unsecured debt securities issued by public companies, in most cases by bank holding companies or investment banks**. ETNs also are exchange-traded securities that can provide the investor with investment exposure to certain market benchmarks or strategies. As ETNs are debt obligations of the issuer of the security, the ETN does not provide the investor with any ownership interest in the referenced security or securities in the referenced index. In addition, an investor in an ETN is exposed both to the market risk of the linked securities or index of securities and the credit risk of the issuer. ETNs do not share the same fund-like or trust-like structure as do other ETPs, and are not registered or regulated as investment companies under the 1940 Act.[2]

Although this testimony will focus primarily on ETFs, some of the structures, features, and trading characteristics of ETFs, as well as the issues and concerns discussed below also apply to other ETPs.

*Structure and Features Unique to ETFs*

ETFs combine features of a mutual fund, which can be purchased or redeemed at the end of each trading day at its NAV per share, with the intra-day trading feature of a closed-end fund, whose shares trade throughout the trading day at market prices that may be more or less than its NAV. A fundamental difference between ETFs versus mutual funds is that ETFs do not sell individual shares directly to, or redeem their individual shares directly from, all investors. Instead, ETF sponsors enter into relationships with one or more financial institutions that become "Authorized Participants" for the ETF. Authorized Participants are typically large broker-dealers. Only Authorized Participants are permitted to purchase and redeem shares directly from the ETF, and they can only do so in large aggregations or blocks (such as 50,000 ETF shares)

[2] ETNs, which are debt securities that track the performance of an underlying benchmark index, asset, or strategy, are generally not redeemable by the holder, unless the terms of the particular series of ETNs permit the holder to do so. There are no Authorized Participants (as described herein) for ETNs, and because ETNs do not hold portfolios of securities or other assets, the same arbitrage opportunities available for ETFs are not applicable to ETNs.

commonly called “Creation Units.” The value of the Creation Unit could range from hundreds of thousands of dollars to several million dollars.

Creation Unit purchases and redemptions are typically in-kind, although cash transactions may be permitted for certain ETFs or under certain prescribed circumstances. To create ETF shares in-kind, an Authorized Participant assembles and deposits a designated basket of stocks with the fund, and in return, receives ETF shares from the fund. Once the Authorized Participant obtains the ETF shares, it is free to sell the ETF shares into the open secondary market, either to individual investors, institutions, or market makers in the ETF. The redemption process is simply the reverse. An Authorized Participant buys a large block of ETF shares on the open market and delivers the shares to the fund; in return, the Authorized Participant receives a pre-defined basket of individual securities, or the cash equivalent.

Like operating companies or closed-end funds, the offerings of the shares of ETFs are registered under the Securities Act, and a national securities exchange lists the ETF shares for trading. As with other listed securities, investors also may trade ETF shares in off-exchange transactions. In either case, ETF shares trade at negotiated prices. The development of the secondary market in ETF shares depends upon the activities of market makers and interest from individual investors, traders, and institutional investors. Individual investors may dispose of ETF shares by selling them in the secondary market at the market price, which may be higher or lower than the NAV of the shares, and paying customary brokerage commissions on the sale.

However, ETFs are structured in a way that seeks to minimize the potential for their shares to trade in the secondary market at a significant premium or discount in relation to their intraday NAV. This is a result of the arbitrage opportunities inherent in the ETF structure. Depending on the liquidity of the underlying securities or assets, market volatility, supply and demand, and other factors, whenever the price of an ETF diverges from the NAV of its underlying components, market participants have an opportunity to buy the cheaper of the ETF or its underlying components, and sell the more expensive of the two. Market participants who are Authorized Participants, or who have agreements with Authorized Participants, can lock in this arbitrage profit by creating or redeeming ETF shares at the end of the day, thereby offsetting their exposure in the underlying components.

For example, with respect to a simple U.S. equity index-based ETF, if the price of the underlying stocks comprising the index is below the price of the ETF shares, a market maker who is an Authorized Participant can buy the underlying stocks and short the ETF. Then, at the end of the day, the Authorized Participant can buy shares of the ETF in-kind through the creation process using the underlying stocks purchased earlier in the day. In return, the Authorized Participant receives shares of the ETF that can be delivered against the short ETF position.

The creation/redemption process therefore serves as the basis for the arbitrage mechanism that provides market participants with an incentive to buy or sell shares of the ETF whenever sufficient divergence between the market price of the ETF and the NAV of the underlying components occurs. To further aid in the process, an estimated NAV, also referred to as the “intraday indicative value,” is disseminated at least every 15 seconds throughout the trading day.

*Differences between ETFs and Mutual Funds*

ETFs differ from mutual funds. For example, on average, operation and management fees for ETFs historically have been less than those for index mutual funds. ETFs generally disclose their holdings every day in addition to the quarterly disclosure required for all funds. ETF shares are listed and traded on exchanges and can be bought or sold at market prices at any time of the trading day. Mutual funds shares are available for purchase and redemption in transactions with the funds at their daily calculated closing NAV per share. Lastly, ETFs can be more tax efficient than mutual funds because ETF shares are generally redeemable "in-kind," which can limit the potential for incurring taxable gains. Not all ETFs have been more tax efficient, however.

**Regulation of Exchange-Traded Products: Roles of SEC Divisions and Offices**

An ETF, as an investment company, must file a registration statement with the Commission under the 1940 Act and register the offering of its shares under the Securities Act. In addition to registering under the 1940 Act, under existing regulations, the ETF must rely on an order, typically issued to the ETF's sponsor, giving relief from certain provisions of the 1940 Act that would not otherwise allow the ETF structure. The SEC issued the first order to an ETF organized as a unit investment trust in 1992, and began issuing orders to ETF sponsors for ETFs organized as open-end funds in 1996. The SEC now has issued more than 100 orders on which ETF sponsors rely to launch their ETFs.

As discussed above, while ETFs are typically registered with the SEC as investment companies, there are other ETPs that do not hold securities, but instead hold commodity- or currency-based assets and, therefore, are not subject to the provisions of the 1940 Act. The issuers of these ETPs register the public offerings of their securities with the Commission under the Securities Act and become subject to the periodic reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act").

In addition, the sponsor of a new ETP, including ETFs, generally must receive relief from certain provisions of the Exchange Act. Moreover, in order for an exchange to list and trade a new ETP, depending on the type of ETP, the SEC must review and approve the exchange's listing proposal pursuant to specific requirements under the Exchange Act. Further, the ETP must comply with the initial and continued listing requirements of its listing exchange.

*Securities Act - Review of Registration Statements*

The Commission staff's review of filed registration statements, including those involving public offerings of securities of trusts and commodity pools, is for the purpose of ensuring complete disclosure. The Securities Act registration provisions require "full and fair disclosure" afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision. Investors in these registered securities offerings have civil remedies to protect them from materially deficient disclosure (material misstatements and omissions) in registration statements and prospectuses as well as the protections of the antifraud provisions of the federal securities laws, and the Commission's enforcement efforts.

As applied to ETPs generally, the Securities Act requirements relate primarily to disclosures made by the entity issuing the securities, including disclosures about the issuer, the securities being issued, and material risks affecting the investment.

*Registration and Exemptions under the 1940 Act*

ETFs that meet the definition of "investment company" under the 1940 Act must register as investment companies under that Act and are subject to the Commission's examination authority. Typically, an ETF meets the definition of "investment company" because it primarily invests in securities, as opposed to physical commodities or currencies. ETFs, as investment companies, are subject to the regulatory requirements of the 1940 Act, as well as to the terms and conditions of the exemptive relief necessary to operate under the 1940 Act. Together, the requirements of the 1940 Act and the relevant exemptive relief apply regulatory requirements designed to protect investors from various risks and conflicts. For example, ETFs, like other investment companies, are required to follow strict limitations on their use of leverage and transactions with affiliates. In addition, they are subject to specific reporting requirements and disclosure obligations relating to investment objectives, risks, expenses, and other information in their registration statements and periodic reports. Further, with few exceptions, ETFs are subject to oversight by boards of directors and are operated by an investment adviser registered under the Investment Advisers Act of 1940.

*Exchange Act Listing Requirements*

The federal securities laws also require a national securities exchange to have rules governing the listing and trading of securities on its markets. With respect to some types of ETPs, such as index-based ETFs, an exchange may list and trade their shares without separate Commission approval, provided the ETP satisfies each of the initial and continued listing criteria applicable to that category of product. Such listing criteria, which are generally referred to as "generic listing standards," must already have been approved by the Commission. Much of the specific quantitative and qualitative generic listing criteria pertain to the individual and collective components comprising the underlying index and include provisions relating to minimum market value (or principal amount outstanding), minimum trading volume, minimum diversification, minimum number of components, and net worth of the issuer. The exchange is required to file a form with the Commission to notify the Commission that the product is listed and trading and represent that such product complies with all of the applicable generic listing requirements.

To be able to list and trade an ETP for which the Commission has not approved "generic listing standards," such as actively managed ETFs, commodity-based trust-issued receipts and commodity pools, the exchange must file a proposed rule change with, and obtain approval from, the Commission prior to being able to list and trade the product. The Commission publishes such proposals for notice and public comment. To approve such a proposal, the Commission must determine that the proposed rules are, among other requirements under the Exchange Act, designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to, and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest. In its analysis, Commission staff considers the structure and description of the product, its investment objective, investment methodology, permitted investments, and the availability of key information and values, including the NAV, intraday indicative value, and the disclosed portfolio of securities and other assets. In addition, Commission staff closely reviews the valuation methodology of the securities and other assets that would comprise the portfolio, the circumstances in which the exchange may, or will, institute a trading halt in the shares, representations regarding the adequacy of exchange surveillance procedures, and the dissemination of information circulars relating to the product.

An issuer of a new ETP must also obtain relief from certain provisions and rules of the Exchange Act before the shares can be traded on an exchange. The relief relates to provisions of the Exchange Act that pertain to, among others, lending on new issue securities, customer disclosure requirements, Regulation M, as well as certain notice and tender offer requirements.

*Compliance and Enforcement of the Federal Securities Laws*

The Commission's Office of Compliance Inspections and Examinations ("OCIE") periodically inspects and examines SEC-registered investment advisers, broker-dealers, and exchanges in connection with issues related to ETFs and, as appropriate, ETPs, and examines issuers of ETPs that are also registered as investment companies. For registered ETFs and investment advisers, the staff examines the adequacy of internal controls and the effectiveness of the compliance structure. In addition, the staff may examine specific operations of registered ETFs and certain ETPs managed by registered investment advisers, such as the portfolio trading, execution, and investment decision-making processes. Furthermore, the staff reviews broker-dealers that sell ETPs to retail customers and that act as Authorized Participants. Broker-dealer examinations, conducted by OCIE and the Financial Industry Regulatory Authority ("FINRA"), typically review suitability, appropriate disclosure, and supervision of sales. Broker-dealers' trading practices are also reviewed to assess compliance with securities regulations. OCIE staff also conducts inspections of exchanges' initial and continued listing compliance programs and market surveillance that may include issues related to ETPs.

The Commission's Division of Enforcement investigates allegations of misconduct concerning ETPs by market participants. Such misconduct could include inadequate or misleading disclosures in ETP offering documents and marketing materials, as well as insider trading or improper sales practices involving ETPs. Within the Division of Enforcement, newly created specialized Units work closely with the Commission's other Divisions and Offices to evaluate existing and emerging risks to investors in the ETP marketplace. A continuing focus of the Units is whether ETPs – as they reflect new investment strategies and grow in popularity – are being marketed and sold to investors with appropriate disclosures and in accordance with the

The Commission recently instituted enforcement proceedings against a former Goldman, Sachs & Co. employee and his father alleging insider trading on confidential information about Goldman's trading strategies and intentions that the employee learned while working on the firm's ETF desk. The SEC's Division of Enforcement alleges that Spencer D. Mindlin obtained non-public details about Goldman's plans to purchase and sell large amounts of securities underlying the SPDR S&P Retail ETF (XRT) and that he tipped his father Alfred C. Mindlin, a certified public accountant. According to the complaint, father and son then illegally traded in four different securities underlying the XRT with knowledge of market-moving trades in these securities that Goldman would later execute.

**Developments in the Markets Regarding Exchange-Traded Products**

ETPs have become increasingly popular as an investment vehicle among investors, resulting in a proliferation of these products in the marketplace. This proliferation has been accompanied by product innovation, giving rise to new and increasingly complex products. Below is a summary of recent developments in this regard, as they relate to the ever growing and evolving ETP landscape.

*Leveraged, Inverse, and Inverse Leveraged ETFs*

The Commission received the first application for leveraged ETFs in 2000. After consideration and review of the issues, the Commission approved this first leveraged ETF application in 2006. To date, three ETF providers operate leveraged, inverse, and inverse leveraged funds registered under the 1940 Act. There are approximately 152 such leveraged, inverse, and inverse leveraged ETFs in the market with approximately $48 billion in assets.[3]

Leveraged ETFs are funds that track an underlying index, but seek to deliver daily returns that are multiples of the performance of the index or benchmark they track. Strategies for long leveraged ETFs are employed by investing in securities or other assets, as applicable, contained in underlying indices and leveraged derivative instruments, such as total return swaps, futures contracts and options. Inverse ETFs (also called "short" ETFs) seek to deliver the opposite of the performance of the index or benchmark they track. Like traditional ETFs, some leveraged and inverse ETFs track broad indices, some are sector-specific, and other ETFs are linked to commodities, currencies, or some other benchmark. Inverse ETFs have been marketed as a way for investors to profit from, or at least hedge their exposure to, downward moving markets. Inverse leveraged ETFs seek to achieve a return that is a multiple of the inverse performance of the underlying index. An inverse ETF that tracks a particular index, for example, seeks to deliver the inverse of the performance of that index, while a 2x inverse leveraged ETF seeks to deliver double the opposite of that index's performance. Strategies for inverse leveraged ETFs are also accomplished by investing in the leveraged derivative instruments mentioned earlier, which enables the funds to pursue objectives without selling short each of the securities included in the underlying index. While the portfolio composition for long leveraged ETFs generally includes a mix of stock or other assets, as applicable, including total return swaps, cash, and futures contracts, inverse leveraged ETFs' portfolios are generally composed entirely of total return swaps, futures, and cash or cash equivalent securities.

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[3] In addition, since 2006, sponsors have also introduced commodity- and currency-based leveraged, inverse, and inverse leveraged ETPs that are not registered under the 1940 Act.

Most leveraged, inverse, and inverse leveraged ETFs "reset" daily, meaning that they are designed to achieve their stated objectives on a daily basis. Their performance over longer periods of time -- over weeks, months, or years -- can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time. This effect can be magnified in volatile markets. An ETF that is set up to deliver twice the performance of a benchmark from the close of trading on Day 1 to the close of trading on Day 2 will not typically achieve twice the weekly, monthly, or annual return of that same benchmark.

Observations and feedback from market participants suggest that some investors may not fully understand the daily performance features of leveraged, inverse, and inverse leveraged ETFs, and the consequences of holding the shares of such ETFs over extended periods. To help address this issue, the Commission, together with FINRA, has issued guidance and other information to alert investors and other market participants of the risks of holding such ETF shares for a period of more than one day.

Separately, and for the reasons discussed further below, in March 2010 Commission staff determined to defer consideration of exemptive requests for those products that fall under the 1940 Act that would permit the launch of new ETFs making significant investments in derivatives. Because leveraged and inverse leveraged ETFs often make significant use of derivatives, deferring consideration of exemptive requests related to derivatives necessarily deferred the issuance of new orders permitting leveraged and inverse ETFs that would be subject to the 1940 Act.

*Certain Complex ETPs and Actively Managed Fixed-Income ETFs*

In recent years, the types of ETPs introduced to the marketplace have become increasingly complex. For example, some ETPs, in the form of commodity-based trust-issued receipts, seek to track an index of futures on volatility of a portfolio of stocks, such as the S&P 500. Futures on volatility have added another dimension to the calculation to express future or expected volatility. In addition, the Commission has witnessed an increase in the past few years in the variety of actively managed ETFs introduced by sponsors. For example, while an assortment of actively managed ETFs based on fixed-income portfolios is listed and trading in the marketplace, there have been an increasing number of actively managed ETFs that seek to primarily invest in instruments that raise concerns with respect to liquidity and transparency, including emerging market debt securities, high-yield debt securities, and other instruments. Commission staff is currently engaged in a review of these and other types of portfolios (such as those that hold illiquid, non-transparent or other types of investments) to determine whether the underlying instruments meet minimum liquidity and other thresholds, for purposes of transparency, fair valuation, and efficiency in the arbitrage process.

*Synthetic ETFs*

Recent reports have revealed a growth of "synthetic" pools with traits similar to U.S. domiciled ETFs ("European-domiciled ETFs") investing in derivative assets in Europe and Asia. While such reports indicate that nearly half of European-domiciled ETFs synthetically replicate the underlying index using swaps and other derivatives, only about 3 percent of total U.S.-domiciled ETF assets are synthetic, mostly through leveraged, inverse, and inverse leveraged ETFs.[4] Synthetic ETFs have experienced limited growth in the United States partly because regulatory standards under the 1940 Act limit the use of derivatives to replicate underlying indexes. In addition, as already mentioned, in March 2010, pending a review of current practices, Commission staff limited the ability of new ETF sponsors to introduce ETFs that would make significant investments in derivatives. Together, these standards and actions have limited the ability of 1940 Act-registered funds to engage in derivatives-based activity and create synthetic ETF structures. With respect to other types of ETPs that are not registered under the 1940 Act, for example, commodity pools, Commission staff is continuing to consider the ramifications of significant investments in derivatives for those products, and is evaluating whether their structures, investments, trading characteristics, risks, benefits, and other factors, invite closer analysis.

**Impacts of Exchange-Traded Funds in the Markets**

Recent evidence has indicated that, while the months of August and September of this year have seen some very volatile days, the securities markets have functioned in an orderly fashion, without the types of disorderly trading that were seen on May 6, 2010. Apart from the fact that ETFs trade intraday, most ETFs are similar to mutual funds in that they both translate investor purchases and sales in the fund (and changes in investor sentiment) into purchases and sales of underlying holdings. Some ETFs, however, are structured in a way that require the purchase or sale of underlying holdings based on movements in the market even absent investors' purchases or sales of the ETF. This is the case for leveraged, inverse, and inverse leveraged ETFs.

Regardless of whether or not leverage is employed, because ETFs trade throughout the day, their prices are dynamically linked to the prices of their underlying holdings, and the price fluctuations of individual holdings, such as stocks, creates associated price fluctuations in the ETF. Likewise, buying or selling an ETF affects each of the underlying holdings.

Staff studying ETF trading that occurred on May 6, 2010 observed that under disorderly market conditions, these linkages result in heightened volatility of the ETFs. On that day, a large number of ETFs traded for a short period of time with massive intraday price swings. The shares of more than 25 percent of all ETFs experienced temporary price declines of more than 50 percent from their 2:00 p.m. market prices. One large ETF sponsor reported that 14 of its domestic stock ETFs experienced executions of $0.15 or less per share (including five ETFs that had executions of one cent or less) while also observing that its domestic bond and international ETFs appeared to execute at reasonable prices. Staff is continuing to examine the dynamics of ETF trading, the arbitrage mechanisms designed to keep the prices of ETFs close to the value of their underlying assets, and linkages (both intended and unintended) between ETFs and the market as a whole.

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[4] See Financial Stability Oversight Council Annual Report 2011 at 66-67, available at http://www.treasury.gov/initiatives/fsoc/Documents/Financial%20Developments.pdf.

For example, because ETF share prices are dynamically linked to the prices of their underlying holdings, the trading and other characteristics of the underlying portfolio investments, such as certain illiquid types of securities and particular over-the-counter or "OTC" derivatives, may impact the arbitrage process necessary to closely align the ETF share price with its NAV. In certain circumstances, temporary imbalances in supply and demand might result in the price of the ETF decoupling from the value of the ETF's underlying instruments as the ETF starts to behave more like a stand-alone product whose price responds solely to whatever liquidity is immediately available in that product, regardless of the value of the underlying investments. Under these circumstances, the ETF can begin to trade at a significant premium or discount to the NAV of its assets.

In addition, while index-based ETFs are designed to track the performance of their respective underlying indexes, an ETF may fail to meet this objective over a period of time, based on investment methodologies used and trading costs incurred. While tracking errors may be small, such deviations could lead to inefficiencies for institutional investors that are using ETFs to enter into large hedged positions. Tracking performance is particularly an issue with respect to leveraged and inverse leveraged ETFs, which promise daily returns equal to the multiple or inverse multiple of the performance of an underlying index or benchmark. Because leveraged and inverse leveraged ETFs only track daily returns, the performance of the fund and the underlying index will not correlate over extended periods of time.

**SEC Initiatives**

As noted earlier, in March 2010, Commission staff determined to defer consideration of exemptive requests for ETFs seeking to register under the 1940 Act and make significant investments in derivatives. This action was taken in light of concerns raised generally about the use of derivatives by all registered investment companies, including ETFs. While staff recognized that the use of derivatives is not a new phenomenon, the staff determined that the increasing complexity of derivatives and their growing use by funds made it the right time to reevaluate the Commission's regulatory protections. As part of this review, in August 2011, the Commission issued a concept release seeking broad public comment on funds' use of derivatives and on the current regulatory regime under the 1940 Act as it applies to funds' use of derivatives. Although the staff recognizes the competitive impact of the decision to defer the consideration of exemptive relief, the staff is committed to the Commission's mission to protect investors. Accordingly, the staff has determined not to issue any additional exemptive relief for ETFs seeking to make significant use of derivatives pending the broader review of the use of derivatives by all funds. The comment period for the concept release expires on November 7, 2011. The staff looks forward to reviewing the comments that the Commission receives and will carefully consider them in assessing how to proceed with respect to both the use of derivatives by funds generally and the staff's consideration of requests for exemptive relief for derivatives-based ETFs.

In addition, these initiatives with respect to ETFs have informed the staff with respect to ETPs more generally. As a result, Commission staff from across multiple Divisions and Offices is currently engaged in a general review of ETPs, which includes gathering and analyzing detailed information about specific products. For example, Commission staff is currently engaged in a general review of ETPs in connection with, among others, the adequacy of investor disclosure, liquidity levels and transparency of underlying instruments in which ETPs invest, fair valuations, efficiency in the arbitrage process and the relationship between market volatility and ETPs.

**Conclusion**

In conclusion, ETPs have grown significantly since the early 1990's as they have grown in popularity with both institutional and retail investors. As ETPs have proliferated, they also have grown in complexity. The SEC has a corresponding interest in making sure that investors receive information about these products that permit them to make informed decisions. Also, because of the growth and innovation in such products, the Commission has been actively following, and continues to engage in the analysis of, these products.