

May 4, 2000

MEMORANDUM IN SUPPORT OF HEARING REQUEST

SUMMARY

Barclays Global Fund Advisers, iShares Trust, future series of the Trust, and SEI Investments Distribution Company (“Applicants”) filed an application with the U.S. Securities and Exchange Commission (“SEC” or “Commission”) on May 2, 2000.¹ The application requests an exemption from the provisions of the Investment Company Act of 1940 (“Act”) and rules under the Act that require open-end management investment companies (“mutual funds”) to redeem their shares at net asset value.

Granting an exemption to Applicants is contrary to the public interest and the protection of investors, and inconsistent with the purposes of the Act. Applicants’ proposal to permit the sale of shares of the iShares Trust creates a substantial risk that investors will be misled about the nature of these funds.

Specifically, investors may be misled regarding whether shares of ETFs can, in effect, be redeemed at net asset value. This risk is created by statements by the American Stock Exchange, the financial press, and financial data providers that (1) the risk that exchange-traded funds (“ETFs”) such as iShares Trust will not trade at net asset value, *i.e.*, at discounts or premiums, is minimal or nonexistent, and (2) ETFs are equivalent to mutual funds, which, unlike ETFs, are legally required to redeem their shares at net asset value.

For this reason, the Commission should hold a hearing to determine whether:

- Wide-spread confusion surrounding the correlation of ETF market prices and per share net asset values, and the classification of ETFs as mutual funds or closed-end funds, necessitates additional measures to ensure that investors are fully informed about the nature of ETFs and the risk that ETF shares may trade at discounts or premiums to their net asset values.
- The fact that ETFs often trade at discounts or premiums necessitates that Applicants provide, at no charge at an easily accessible location: (1) intraday ETF per share net asset values, (2) intraday ETF premiums and discounts, and (3) charts showing the largest discrepancy between ETF market prices and ETF per share net asset values for each calendar quarter for the preceding five years.

¹ See SEC file nos. 812-11600 and 812-11598. References in this Memorandum to Applicants’ “Application” are SEC file no. 812-11600, which is virtually identical to the application file no. 812-11598.

- To require ETFs to include in their prospectuses, reports and financial statements the same performance and financial information required to be provided by closed-end funds (i.e., a table showing one-, five-, and ten-year standardized performance results based on market price and per share net asset value, and for a comparable index; and financial statements showing end-of-year per share net asset values, market prices, and discounts/premiums).
- To require ETFs to include in their prospectuses and annual reports charts showing the largest discrepancy between market prices and per share net asset values for each calendar quarter for the preceding five years.

INTRODUCTION

Exchange-traded funds are registered as mutual funds. ETFs sell and redeem their shares only in large aggregations, which are called Creation Units. Broker-dealers purchase Creation Units, break them up into individual shares, and sell them in the secondary market. These “retail shares” are not redeemable. Rather, they trade on the American Stock Exchange like stocks.

ETFs cannot operate without an exemption from the Act and rules under the Act. The Act requires that mutual funds redeem their shares at net asset value, and ETF retail shares are not redeemable.

The Commission previously has granted exemptions to ETFs from the Act’s redemption provisions on two principal grounds. First, ETFs have represented that their retail shares will trade at or close to net asset value (“NAV”), so that investors will, in effect, be able to “redeem” their shares at NAV by selling the shares in the secondary market. Second, the Commission has required, as a condition of exemption relief, that ETFs not be marketed as mutual funds, and that ETFs prominently disclose that their retail shares are not redeemable.

Neither basis for exempting ETFs is sufficient to protect investors or to ensure that ETFs are operated consistent with the purposes of the Act. ETFs have, in fact, frequently traded at market prices that deviate from their net asset value, occasionally at significant discounts or premiums. Further, there is a substantial confusion in the financial press and among financial data providers regarding the nature and operation of ETFs. Many members of the industry treat ETFs as mutual funds, a view that is reinforced by statements by the American Stock Exchange and broker-dealers, and that promotes the misconception that ETF retail shares, like mutual fund shares, are redeemable.

BACKGROUND

Confusion regarding the operation and trading behavior of investment companies is not new. Indeed, as explained in a staff report published by the Commission in 1992 (“SEC Report”),² this confusion provided a significant impetus in the enactment of the Act and an important role in the emergence of mutual funds as a popular investment vehicle.

In the 1920s, closed-end funds were far more popular than mutual funds. Closed-end funds offered a way to access securities offerings underwritten by the investment banks that sponsored the funds.³ The shares of these funds were not redeemable. Nonetheless, the funds traded at large premiums over their net asset values, reflecting the high demand for their shares and public confidence in the integrity of the banks.⁴

This changed with the stock market crash of 1929, “which virtually eliminated the market for new public offerings of closed-end securities . . . and closed-end shares began trading in the secondary market at prices below net asset value.” SEC Report at 426.

Many closed-end funds exploited the situation by repurchasing their shares at a discount, thereby creating book profits. These “profits were made at the expense of selling shareholders who had no way of knowing the extent of the discount and, therefore, the extent to which they were liquidating their shares at prices that did not reflect their true value. This was possible because closed-end *companies did not disclose the net asset value of their shares.*” Id. at 427 (emphasis added).

In this environment, mutual funds flourished. Mutual funds, “relatively unknown before the crash, quickly became popular because they offered protection from discounts by committing to redeem investors’ shares at net asset value.” Id. at 426.

Like closed-end funds, however, mutual funds did not always live up to investors’ expectations. Some mutual funds “claimed that their securities were redeemable, but then instituted barriers to redemption.” Id. at 428. These funds often “suspended redemptions based on provisions contained in charter documents that shareholders never saw.” Id.

Congress enacted the Investment Company Act to address, in part, abuses relating to the repurchase and redemption of shares of closed-end funds and mutual funds. It

² Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, U.S. Securities and Exchange Commission (May 1992).

³ Alfred Jaretzki, Jr., The Investment Company Act of 1940, 26 Wash. U. L. Q. 303, 306-7 (April 1940); see also SEC Report at 426.

⁴ Jaretzki and SEC Report, id.

imposed restrictions on repurchases of closed-end fund shares, and required that mutual funds continuously offer to redeem their shares at NAV.

The sale and marketing of ETFs threatens to recreate the problems that plagued closed-end funds and mutual funds in the 1920s and 1930s, and that prompted Congress to enact legislation regulating the repurchase and redemption of their shares. There is a widely held misperception that ETFs are mutual funds and that their shares can, in effect, be redeemed at NAV. In fact, ETFs frequently trade at discounts or premiums to net asset value, leaving retail investors exposed to the unanticipated vagaries of market prices – on top of the fully disclosed investment risks that they anticipated when investing in these funds.

ETFs AND THE MYTH OF THE ARBITRAGE OPPORTUNITY

Applicants claim that arbitrage opportunities will ensure that ETF retail shares will trade close to or at their NAVs. They argue that arbitrageurs will buy up ETF retail shares and redeem Creation Units, or buy Creation Units and sell retail shares, to take advantage of any discrepancy between retail shares' market prices, and ETFs' per share NAVs. They believe that this arbitrage opportunity will “discipline” ETFs' market prices to closely track ETFs' NAVs. Application at 58.

Experience shows that applicants' faith in the ability of arbitrageurs to “discipline” market prices is unjustified. Weisenberger analyzed the closing prices of the 30 ETFs that trade on the Amex and compared them with the same day net asset values from the inception of each fund through April 26, 2000. See Appendix at A-1 to A-9. Weisenberger's findings are striking:

- 21 ETFs traded at discounts or premiums in excess of 0.5% (50 basis points) for a total of 2,921 rolling four-day periods;
- 19 ETFs traded at discounts or premiums in excess of 100 basis points for 1,278 rolling four-day periods;
- 9 ETFs traded at discounts or premiums in excess of 200 basis points for 503 rolling four-day periods; and
- Each of 28 ETFs has traded at a discount or premium in excess of 200 basis points at least once in its history (totaling 2,021 occurrences).⁵

⁵ Applicants purport to discuss the relevant “Trading History of SPDRs, MidCap SPDRs, DIAMONDS, Nasdaq-100 Shares, WEBS and Select Sector SPDRs” (each is a type of ETF), by providing the maximum discount/premium for each. Application at 58-59. This data is unhelpful, however, as it is the frequency and persistence of discounts/premiums that are relevant, not the occasional aberration. For example, Applicants state that the maximum discount/premium for DIAMONDS was 103 basis points. Weisenberger found, however, that DIAMONDS traded at more than a 50 basis point discount/premium on

Thus, the trading history of ETFs shows that the market is not as easy to “discipline” as Applicants claim.

The case of the Malaysia WEBS Index Series, an ETF that invests in stocks traded on the Kuala Lumpur Exchange, aptly illustrates the risk that ETFs will trade at discounts or premiums.⁶

MALAYSIA WEBS AND THE MALAYSIA CRISIS

In late 1998, certain events in Malaysia provided a painful reminder of risks presented by ETFs. On September 1, 1998, the Malaysian government imposed currency restrictions that effectively prevented most investors from converting proceeds of sales of securities into foreign currencies. The effect on Malaysia WEBS Index Series was immediate.

On September 2, 1998, the Malaysia WEBS issued a press release stating that it would not be able to honor redemptions of Creation Units as stated in its prospectus, and that it might be able to honor redemption requests only in Malaysian ringgits in Malaysia. The fund suggested, “[i]n light of the circumstances, . . . that requests for the redemption of Creation Units of Malaysia Series WEBS should not be made and urge[d] investors contemplating such redemptions to consult with Malaysian counsel.”

The American Stock Exchange (“Amex”), which is the secondary market in which ETFs trade, halted trading in shares of Malaysia WEBS on September 1. When the Exchange reopened trading in Malaysia WEBS shares, the fund’s discount almost doubled from 10.26% to 19.25%. Since then, Weisenberger found that Malaysia WEBS has traded at discounts or premiums in excess of 200 basis points for 265 rolling four-day periods, in excess of 10 percent for 127 rolling four-day periods, and in excess of 30 percent for 4 rolling four-day periods.⁷

177 occasions, at more than a 100 basis point discount/premium on 116 occasions, and at more than a 200 basis point discount/premium on 41 occasions – out of approximately 550 trading days. Similarly, Applicants state that Nasdaq-100 Shares traded at a maximum premium/discount of 214 basis points, but neglect to mention, as determined by Weisenberger, that the fund traded at a discount/premium in excess of 200 basis points on 27 separate days during only the first 14 months of its existence (and in excess of 100 basis points on 62 separate days). Remarkably, both of these examples involve funds that invest in highly liquid securities traded in the U.S. markets. As discussed below, see infra text accompanying notes 7, 20-21, & 25, foreign country ETFs such as WEBS pose a much greater risk of trading at discounts/premiums not only with great frequency, but for extended periods. It is telling that Applicants have provided no trading history data for WEBS, which have experienced the most dramatic discounts/premiums of all of the ETFs.

⁶ The term “WEBS” stands for World Equity Benchmark Series. There are 17 WEBS, each of which invests in the securities of a single country.

⁷ Applicants contend that Malaysia WEBS is the “sole exception” to ETFs trading “at, or very close to, their respective NAVs.” Application at 37 & n.17. It is difficult to fathom the basis on which Applicants

Notwithstanding its experience with Malaysia WEBS, the American Stock Exchange continues to make representations that minimize or ignore the risk that ETFs will trade at discounts or premiums.

STATEMENTS REGARDING ETFs TRADING BEHAVIOR

In a number of statements in the “Index Shares” section of its web site (www.amex.com), Amex downplays the risk that WEBS shares will trade at discounts or premiums.⁸ In the “Spec Sheet” for WEBS, the section called “WEBS benefits” states that: “Pricing is anticipated to be near NAV, due to WEBS’ unique structure.” See Appendix at A-10 to A-13. The section called “Creation Units” states that: “The process of creating or redeeming shares in Creation Units at their net asset value should enable WEBS to trade close to their NAV.” There is no mention of the risk that WEBS will not trade at NAV.

This risk is not mentioned until the section near the end of the Spec Sheet called “Investment Risks,” which provides the lukewarm warning that “[t]here may be premiums/discounts to NAV from time to time, but large variances are not expected to be sustained due to the Creation/Redemption process.” Yet, as discussed above, 9 ETFs have traded at discounts/premiums in excess of 200 basis points during rolling four-day periods more than 500 times.

The “FAQs” section of Amex’s web site also downplays the risk of discounts and premiums. See Appendix at A-14 to A-16. It states:

Why can Index Shares be expected to closely track the index levels?

Arbitrage is the major mechanism that keeps Index Share products trading in line with their fair value. If an Index Share begins to trade above or below fair value, program traders will move it [sic] to take advantage of the arbitrage opportunity -- buying or selling stock baskets that make up a specific index against the Index Shares that trade on it to

make this claim, in light of the maximum discounts/premiums at which the following WEBS have traded: Malaysia: 37%; Hong Kong: 32%; Singapore: 20%; Australia: 10%; Austria: 9%; Mexico: 6%; and Belgium: 5%. See Appendix at A-3 to A-9.

⁸ Barclays also provides information about WEBS on a web site (www.websonwebs.com), but this site is currently under construction. A representative of SEI stated on May 1, 2000 that Barclays’ site would include essentially all of the information on the Amex site that is discussed in this memorandum. Applicants make similar statements to those discussed below in their applications. See, e.g., Application at pp. 58 (arbitrage opportunities “should help ensure that iShares will not trade at a material discount or premium in relation to their net asset value”) & 74 (“Competitive forces in the marketplace should thus ensure that the margin between NAV and the price for Shares in the secondary market remains narrow.”).

lock in a profit from the price discrepancy. It works for you, the investor -- it means your Index Shares will continue to closely track the value of the index upon which they are based.

Amex's characterization of the trading behavior of ETFs is unequivocal. Arbitrage "keeps" – not "*may* keep" – ETFs "trading in line with their fair market value." Arbitrageurs "will move [in]" – not "*may* move in" – "to take advantage of the arbitrage opportunity." ETFs "will closely track" – not "*may* closely track" – "the value of the index upon which they are based."⁹ This suggests that there is no risk of discounts or premiums at all.

The "Q&A" section of Amex's web site further clouds the issue in its comparison of WEBS on the one hand, and mutual funds and closed-end funds on the other. See Appendix at A-17 to A-21. The comparison of WEBS and mutual funds focuses on the principal advantage offered by WEBS: continuous trading on a secondary market. Remarkably, the comparison omits any mention of the possibility that WEBS shares, unlike mutual fund shares, may trade at discounts or premiums.

The trading behavior of WEBS shares is instead addressed in the comparison of WEBS and closed-end funds, where it is presented as providing a significant advantage. The comparison emphasizes that that closed-end funds frequently trade at discounts and premiums to their NAVs, whereas Amex "believes that large discounts or premiums to the NAV of WEBS are unlikely to be sustainable." Thus, rather than discounts and premiums being presented as potential risks in comparison with mutual funds, they are presented as unlikely occurrences, that give WEBS a competitive advantage over closed-end funds.¹⁰

The comparison to closed-end funds is also confusing. It states that, as of "August 31, 1996 the WEBS have traded at an average end-of-day premium of .02 over their NAV." First, the information is almost four years old and represents only the first five months of WEBS' existence, thus making it of questionable utility.

Second, quoting an "average" premium is not helpful to assess the experience of a WEBS investor. To illustrate, a WEBS retail share that sells at a 30% premium for six months and a 30% discount for six months would have an "average" annual premium of 0%. A WEBS investor who bought shares at the beginning of this period would be like

⁹ It appears that Amex has been convinced by its own rhetoric. In its "Fact Sheet" for Malaysia WEBS, Amex lists "Annual Performance at NAV" for 1999 as 106.09%. See Appendix at A-22 to A-23. According to Weisenberger, however, this is the market price return. The actual NAV return for 1999 was 92.98% -- more than 13 percentage points lower than the market price return.

¹⁰ To use Applicants' own words, "an exchange-traded open-end investment company which provides a daily redemption feature affords significant benefits over . . . a traditional closed-end structure." Application at 37.

“the man with his feet in the oven and his head in the refrigerator: on the average he feels pretty good.”¹¹

Broker-dealers also have minimized the risk that ETFs will trade at discounts or premiums. A recent PaineWebber report, for example, states that:

ETFs are not registered as closed-end funds; rather, they are more analogous to open-end funds because of the creation and redemption feature and *the stock price values that closely track the underlying net asset values*.¹² (emphasis added).

Taking a cue from these characterizations of ETFs' trading behavior, the financial press has generally accepted the view that WEBS will not trade at discounts or premiums. On the basis of an Amex spokesman's statement that “[t]he deviation from net asset value is minimal, if any,” Forbes reported that “[u]nlike closed-end country funds, WEBS do not trade at discounts to net asset values.”¹³ Another press account, in comparing WEBS to closed-end funds, noted that WEBS had the advantage of having “[n]o discounts and premiums.”¹⁴

Thus, despite the evidence the ETF retail shares experience frequent, persistent and significant discounts and premiums, Amex and others continue to suggest that the risk of discounts and premiums is minimal or nonexistent. This problem is exacerbated by the frequent characterization of ETFs as mutual funds.

¹¹ Peter Bernstein, *Against the Gods* 74 (1996). Applicants similarly offer average discounts/premiums as evidence that ETFs trade close to their NAVs, Application at 58-59, yet this data is of little relevance to the question of the frequency and persistence of discounts/premiums. See *supra* text accompanying note 5.

¹² PaineWebber, *Exchange-Traded Funds, Equity Research (ETFs)*, appearing at www.cefa.com (Apr. 14, 2000).

¹³ Justin Doebele, *A World of WEBS*, *Forbes Global* (June 15, 1998); see also *Forbes Annual Funds Survey* (Sept. 7, 1998) (WEBS' “trading prices stay within a fairly narrow band around net asset value”).

¹⁴ Albert J. Fredman, *A New Route Overseas: Country Indexing with WEBS & CountryBaskets*, *AII Journal* at 23 (October 1996) (stating that WEBS are “designed to trade very close to net asset value, so there should be no significant discounts or premiums”); see also Lewis Braham, *Bargains in Closed-end Funds*, *SmartMoney.com* (Apr. 18, 2000) (“Because of their unique investment structure ETFs don't trade at persistent discounts to net asset value (NAV) like closed-ends do”); Craig Karmin, *Closed-End Country Funds Feel Effects of Alternative Products*, *Wall St. J.* (Jan. 10, 2000) (“because new WEBS can be created or existing ones redeemed, as shares in regular mutual funds are, the product avoids the complications of discounts or premiums to NAV”); Kathryn Haines, *Mutual Funds are Watching WEBS' Success*, at B8 (May 5, 1997) (“But like conventional, or open-end, mutual funds, new [WEBS] shares can be continually created by larger investors. That keeps the market price of the shares tightly linked to the net asset value.”).

CHARACTERIZATION OF WEBS AS MUTUAL FUNDS

The Commission’s requirement that Applicants not market ETFs as mutual funds has had little effect, as the financial press and financial data providers often treat ETFs as if they were. This reinforces the impression that ETF retail shares, like mutual fund shares, are redeemable at net asset value.

The Wall Street Journal and Washington Post list WEBS in their quarterly mutual fund performance tables.¹⁵ Morningstar presents data for WEBS in the same format as mutual funds. The Quick Stats section of this format shows the WEBS’ NAV and year-to-date return. See, e.g., Appendix at A-24 to A-25. In contrast, the Quick Stats section for closed-end funds shows the fund’s market price, NAV, and discount/premium.¹⁶ See, e.g., Appendix at A-26 to A-27.

The financial press often describes ETFs as alternatives to mutual funds,¹⁷ reflecting PaineWebber’s guidance that “ETFs are not registered as closed-end funds; rather, they are more analogous to open-end funds.”¹⁸ The Amex reinforces this

¹⁵ See, e.g., Mutual Funds Quarterly Review, Wall. St. J. Interactive (Jan. 10, 2000) (listing Malaysia WEBS as one of the top-performing mutual funds investing in Asia (excluding Japan) in 1999); 1999 Second-Quarter Mutual Fund Scorecard, Wash. Post (July 4, 1999) (listing Malaysia WEBS as the top-performing mutual fund for the second quarter of 1999).

¹⁶ Adding to the confusion, Bloomberg provides WEBS’ “IOPVs,” which stands for “Indicative Optimized Portfolio Value.” See Appendix at A-28. The IOPV is neither the NAV nor the market price.

¹⁷ See, e.g., Ken Brown, Buy! Sell! Rydex Gives Fast Traders Time of Day, Wall. St. J. (May 1, 2000); Lewis Braham, Vanguard’s Arachnophobia, SmartMoney.com (Mar. 30, 2000) (describing exchange-traded funds as a threat to Vanguard’s dominance in the low-cost index investing market); Ilana Polyak, Barclays Close to Launching Its Lineup of Exchange-Trade Indices, TheStreet.com (Mar. 9, 2000) (“Investors have been flocking to ETFs recently because they cost less than mutual funds and are easier to trade.”); Karmin, supra note 11) (“because new WEBS can be created or existing ones redeemed, as shares in regular mutual funds are, the product avoids the complications of discounts or premiums to NAV”); Dagen McDowell, Exchange-Traded Indices Pose Threat to Mutual Funds, TheStreet.com (Jan. 4, 2000) (predicting “mammoth battle between traditional mutual funds and their exchange-traded cousins”); Sandra Ward, New Spiders, New Webs, Barron’s at F3 (Nov. 15, 1999) (discussing entry by large mutual fund complexes into the exchange-traded fund market); Aaron Luchetti, Amex’s ‘Sector’ Securities Battle with Mutual Funds, Wall St. J. at A11 (Apr. 5, 1999) (discussing competition between sector exchange-traded funds and other sector mutual funds); Vanessa O’Connell, ‘Spiders’ Offer Another Way to Scale S&P 500’s Heights, Wall. St. J. at C1 (Mar. 11, 1997) (comparing Spiders with Vanguard’s S&P 500 Index fund); Anella Wynard, Learn How to Invest in ‘Spiders’ and ‘Diamonds,’ The Money Machine at <http://www.zdnet.com/zdtv/moneymachine/investing/story/0,3666,2415343,00.html> (“The growing demand for ETFs is giving mutual fund managers some sleepless nights. According to Savage, mutual fund managers are concerned about the threat that exchange-traded products pose.”).

¹⁸ Supra note 12. After the withdrawal of CountryBaskets, which was an early ETF competitor of WEBS, one consultant attributed the funds’ failure to their inability to convince investors that they were like mutual funds, noting that CountryBaskets “had to fight the notion that these were closed-end funds. For one team to do that is a huge task.” Kathleen Fraser, Deutsche Bank to Liquidate Fledgling Country Index Fund, American Banker at 11 (Feb. 6, 1997).

impression in the FAQs section of its web site. In response to the question, “How easily can I buy or sell Index Shares?” Amex states:

As easily as you can buy or sell shares of stock, Index Shares are listed and traded on The American Stock Exchange—that makes it easy for you to buy or sell shares throughout the trading day *while traditional index mutual funds can generally be purchased or redeemed only at an end-of-day closing price.* See Appendix at A-14 (emphasis added).

As if the Amex itself were uncertain as to whether WEBS are mutual funds or closed-end funds, it also states that “WEBS are not: Closed-end mutual funds.” See Appendix at A-10. This oxymoron illustrates and encourages the confusion surrounding the true nature of ETFs.

ANALYSIS

As discussed above, there is substantial confusion in the financial press and among financial data providers regarding the likelihood that WEBS will trade at net asset value, and whether WEBS are mutual funds or closed-end funds.¹⁹ This problem is compounded by statements and data provided by Amex and others.

This confusion is not so problematic when ETFs trade at or close to their NAVs. In this case, the market effectively offers investors the advantage most associated with true mutual funds: the ability to redeem at net asset value. But, as the data demonstrate, ETFs can trade at significant discounts or premiums for extended periods – even ETFs that hold portfolios made up entirely of highly liquid securities traded in U.S. markets.

The risk of discounts and premiums is particularly acute for ETFs that invest in foreign securities. The SEC report notes particularly that country funds can pose liquidity problems, and therefore be unsuitable for the mutual fund format, because the funds’ portfolios “often contain a large percentage of securities that are thinly traded or are considered to be illiquid for other reasons.”²⁰ SEC Report at 433. These securities

¹⁹ Applicants apparently agree, to some extent, with this assessment. According to Tom Taggart, a Barclays spokesman, “There’s a huge amount of confusion about [ETFs], even among brokers and financial advisors. They start out assuming it’s a closed-end fund, and once they understand that it’s not . . . they really don’t understand what it is.” Maggie Topkis, A Guide to Spiders, Webs, & Diamonds, Mutual Fund Magazine (Jan. 2000); see also id. (“There’s a huge need for education with these products,” says fund industry consultant Geoff Bobroff, . . . “and I don’t see anyone spending the money on it for either potential customers or their intermediaries.”); Passive Investing: Another Kind of Web, The Economist at <http://uk.biz.yahoo.com/000129/68/9znz1.html> (Jan. 29, 2000) (“in America more and more investors are deciding that ETFs are a more flexible and tax-efficient way of investing, even without understanding them entirely”).

²⁰ SEC Report at 421 (mutual funds’ need for liquidity “restricts their ability to invest in less liquid securities, such as some foreign securities.”).

may be illiquid for a number of reasons, including: (1) the small size of the countries' stock markets in proportion to the size of many funds, (2) slower settlement procedures for foreign securities,²¹ (3) currency restrictions that may limit a fund's ability to convert cash into U.S. dollars, and (4) difficulty valuing the securities due to limited data on market prices. SEC Report at 433.

Each of the concerns cited in the SEC Report applies to the securities markets in, for example, Indonesia, Taiwan, Turkey, Brazil, Thailand, Singapore and Malaysia. Not surprisingly, there are no country mutual funds for these countries. Yet WEBS is offering or expects to offer funds for all of them. In each case, the very concerns expressed by the Commission regarding the illiquidity of country funds' portfolios apply equally to WEBS, and each is susceptible to the kind of disruption that occurred in Malaysia. Accordingly, the risk that these WEBS will trade at significant discounts or premiums is high.

The increasing popularity of ETFs with less sophisticated investors will exacerbate the confusion surrounding the trading behavior of WEBS and increase the risk of harm to investors. A Morgan Stanley Dean Witter executive recently reported that "more retail investors are beginning to invest" in ETFs, and that she expected ETF assets to grow from \$39 billion today to \$150 billion by the end of the year.²² According to press accounts, Barclays has specifically designed its ETFs to be accessible to individual investors, and it intends to spend millions on an advertising campaign for ETFs.²³

As less sophisticated investors purchase WEBS retail shares, the risk of unforeseen losses will increase. Investors may purchase shares only to see the value of their investment plummet for no apparent reason, while the value of the fund's portfolio remains unchanged. They may unwittingly buy at a premium, only to see it dissipate as the conditions causing the premium cease. The extent of the current level of confusion regarding the trading behavior of WEBS suggests that even more sophisticated investors do not understand the discount/premium risk; unsophisticated investors will understand it even less.²⁴

In addition, the potential harm from even short-term discounts or premiums may be substantial. WEBS investors generally will not benefit if a discount or premium is short-lived because investors are expected to be short-term traders. The most heavily

²¹ In tacit acknowledgment of this factor, Applicants have requested relief from the Act's requirement that redemption proceeds be paid within seven days of a request because of slower settlement procedures in certain countries.

²² Andrew Greene, Mutual Fund Market News, appearing in Financial Planning Interactive (Apr. 24, 2000).

²³ Tim Quinson, Nasdaq Looks to Offer QQQ Fund in U.K., Bloomberg.com (Apr. 26, 2000).

²⁴ See supra text accompanying note 19.

marketed feature of WEBS is that they can be traded intraday at market prices, a feature that is highlighted in virtually every discussion of WEBS in the press. It is likely that a substantial discount of only a few days, or only a few hours, may adversely affect a large number of unknowing investors.

APPLICANTS' REQUESTS FOR RELIEF

Applicants request relief under Section 6(c) of the Act from Sections 5(a)(1) and 2(a)(32) of the Act, and Rule 22c-1 under the Act. Section 6(c) authorizes the Commission to exempt an investment company from the provisions of the Act and the rules thereunder “if and to the extent that such exemption is necessary and appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions” of the Act.

Section 5(a)(1) classifies an open-end investment company, or mutual fund, as one that offers “redeemable securities.” Section 2(a)(32) defines the term “redeemable security” as a security that entitles its holder to receive, upon presentation to the investment company, the holder’s proportionate share of the company’s net assets, or the cash equivalent. Rule 22c-1 requires that dealers buy or sell redeemable securities only at a price based on net asset value.

Applicants need relief from these requirements because ETF retail shares are not redeemable securities. They argue that relief should be granted under Section 6(c) because arbitrage opportunities will ensure that the difference between the market price and the NAV will remain narrow. They also state that they will not market ETFs as mutual funds, and will prominently disclose that ETF retail shares are not redeemable.

The exemptive relief requested is not necessary or appropriate in the public interest, and it is not consistent with the protection of investors. First, contrary to applicants’ assertions, arbitrage opportunities do not ensure that the difference between an ETF’s market price and its NAV will remain narrow. As discussed above, ETFs in many instances have not traded at their NAVs. For example, four WEBS have traded at discounts or premiums in excess of 200 basis points for extended periods.²⁵

Second, the Amex, financial press, and financial data providers have created the impression that there is little or no risk that ETFs will trade at discounts or premiums. This mistaken impression has been reinforced by the related notion that ETFs are mutual funds, which suggests that ETF retail shares are redeemable at their net asset value.

Third, investors are unable to determine easily how ETFs shares are trading in relation to their NAVs. ETFs do not make their NAVs publicly available. Nor do they provide data on their discounts or premiums. To this author’s knowledge, the only place

²⁵ The WEBS and number of four-day rolling periods are: Hong Kong (45); Malaysia (348); Mexico (20); and Singapore (73). See Appendix at A-1. These four WEBS traded at premiums or discounts in excess of 200 basis points, in the aggregate, on 1,269 separate trading days. *Id.* at A-2.

that information on ETF NAVs, discounts and premiums is publicly available is on the Web site for the Closed-End Fund Association, the national trade association for the closed-end fund industry (www.cefa.com). A representative of SEI Distributors stated that he did not know of any other place that WEBS NAVs were available.

It is contrary to the public interest and the protection of investors to permit ETFs to continue to operate under the circumstances described in this memorandum. Because of the way that ETFs are described to investors, it is unlikely that they will appreciate the risk that ETFs will trade at discounts and premiums. This problem will worsen as more single country ETFs are offered, and will be exacerbated as ETFs become more popular with retail investors, and the myth of their invulnerability to discounts and premiums becomes more deeply ingrained in the public's consciousness.

The exemptive relief requested also is not consistent with the purposes fairly intended by the policy and provisions underlying Sections 5(a)(1) and 2(a)(32), and Rule 22c-1. These provisions jointly guarantee a mutual fund shareholder's right to redeem his or her shares at net asset value. As stated in the SEC Report, a "major reason for [the] popularity [of mutual funds] is that the redemption rights of open-end shares assure shareholders of being able to exchange their shares at net asset value." SEC Report at 421. This redemption right is the essence of what distinguishes a mutual fund from other types of investment vehicles, both under the law and in the minds of tens of millions of investors.

The widely held view that ETFs are equivalent to mutual funds, a view buttressed by representations that ETF retail shares will trade at their NAVs, is patently inconsistent with the fact that ETF retail shares are not redeemable at their NAVs. This flatly contradicts the purposes of the Act, which Congress drafted to create an unbreakable link between the notion of a mutual fund and the right to redeem at NAV. While it may be possible for ETFs to be sold without violating this fundamental principle of the Act, it is not possible under Applicants' current proposal and conditions of exemptive relief.