

# Board Oversight of Exchange-Traded Funds

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## Introduction

Over the past decade, demand for exchange-traded funds (ETFs) has grown markedly as investors—both institutional and retail—increasingly turn to them as investment options in their portfolios. With the increase in demand, sponsors have offered more ETFs with a greater variety of investment objectives.

ETFs are commonly structured as open-end investment companies, and so are governed by the same regulations as other open-end funds (i.e., mutual funds). In order to operate, however, these ETFs must receive exemptive relief from the Securities and Exchange Commission (SEC) from certain provisions of the Investment Company Act of 1940 (1940 Act). This paper focuses on ETFs structured as open-end funds, which require oversight by a fund board, and not on other exchanged-traded products, such as commodity ETFs and exchange-traded notes (ETNs), that are not governed by boards.<sup>1</sup>

An ETF director's responsibilities are substantially similar to those of mutual fund directors, although with some differences and different areas of focus. Like all fund directors, ETF directors have a fiduciary duty to the fund and serve to protect the interests of fund shareholders.

The Independent Directors Council (IDC) has prepared this document to assist directors of ETFs in performing their oversight responsibilities. The paper also may be useful for directors who do not currently oversee ETFs but wish to be more familiar with a board's oversight role, including those whose fund groups may currently invest in ETFs or intend to launch ETFs in the future. The paper includes practical guidance in the form of potential questions to ask in areas that may be of particular interest in the ETF context.

Additional background information relating to ETFs is available at the Investment Company Institute's [Resources on Exchange-Traded Funds](#),<sup>2</sup> which includes frequently asked questions on such subjects as the ETF structure, the U.S. ETF market, and how ETFs compare to other investments, including mutual funds. The SEC's Office of Investor Education and Advocacy also issued a [bulletin](#) to educate investors about ETFs.<sup>3</sup>

## Overview of ETFs

Simply put, ETFs are open-end funds whose shares trade on securities exchanges. Like a mutual fund, an ETF represents a portfolio of investment assets (e.g., stocks, bonds, cash, swaps, futures, and forwards), and each share represents an undivided interest in that pool of assets. ETFs also comply with the same overarching regulatory framework as mutual funds. For example, an ETF must comply with limitations on leverage and liquidity; its assets must be maintained separate from the assets of the adviser (typically with

a custodian); and it must calculate its net asset value (NAV) daily. ETFs also qualify as registered investment companies under the tax laws and, as such, must meet a tax diversification test every quarter.<sup>4</sup> In addition, ETFs have a chief compliance officer, designated by the board, who administers the ETF's compliance program.

While ETFs share many characteristics with mutual funds, the exchange-traded nature of an ETF's shares creates key operational and structural differences. One major difference is that investors buy and sell ETF shares on a stock exchange through broker-dealers, much as they would trade individual stocks. In contrast, mutual fund shares are not listed on stock exchanges. Investors buy and sell mutual fund shares through a variety of distribution channels, including directly from a fund company or through a financial adviser or broker-dealer.

In addition, the exchange-traded nature of ETFs creates differences in the prices investors pay for shares. Mutual fund investors can place orders to buy or sell shares throughout the day, but all orders received during the day will receive the same price—the fund's NAV at the next time it is computed (usually 4:00 p.m. eastern time). In contrast, orders for ETF shares can be placed and executed intraday at a price based on trading on a stock exchange.

Certain investors, however, still transact with the ETF at the end of the day at the ETF's NAV. In ETF parlance, these transactions are called "creations" (for purchases) and "redemptions." ETF shares may only be created and redeemed by an entity known as an "authorized participant" or "AP," which is typically a large institutional investor, such as a broker-dealer, who has entered into a participation agreement with the ETF. Each business day, the ETF publishes the contents of a "creation basket," which is a specific list of names and quantities of securities or other assets the ETF will accept for a creation or will pay out for redemption. An AP provides the creation basket or cash (or both) to the ETF, which then issues to the AP a "creation unit," a large block of ETF shares (typically 50,000 shares). The AP can either keep the ETF shares that make up the creation unit or sell all or part of them on a stock exchange. For more information about the process for creating and redeeming ETF shares, see [Frequently Asked Questions About ETF Basics and Structure](#).<sup>5</sup>

Investors use ETFs in a variety of ways. Individual investors may use ETFs to build a diversified portfolio for the long term, or use one or more ETFs to gain exposure to a certain asset class—either for the long term or temporarily. Institutional investors and other traders may use ETFs in the same way. They may also use ETFs for shorter-term purposes, such as to obtain short-term exposure to an asset class or hedge other investments in a portfolio.

## Comparison of ETFs and Mutual Funds

	ETFs	Mutual funds
<b>Regulatory framework</b>	Regulated as open-end funds under the 1940 Act; require SEC exemptive relief in order to operate; subject to exchange's listing requirements.	Regulated as open-end funds under the 1940 Act.
<b>Board oversight</b>	Required to have a fund board.	Required to have a fund board.
<b>Transparency requirements</b>	Daily disclosure of portfolio holdings and/or composition of creation basket, in addition to quarterly disclosure of portfolio holdings.	Quarterly disclosure of portfolio holdings.
<b>Share prices</b>	Shares are bought and sold on a stock exchange at market-quoted prices throughout the trading day. Only APs transact with the ETF at the NAV.	Shares purchased or redeemed throughout the day receive the same daily price—the fund's NAV at the next time it is computed (usually 4:00 p.m. eastern time).
<b>Tax efficiency</b>	To the extent that an ETF distributes its portfolio holdings "in kind" to APs that redeem shares, the ETFs do not incur capital gains on the disposition of portfolio holdings (and may also distribute low cost basis holdings to the redeeming AP). Instead, investors pay taxes on the appreciation of their ETF shares when they sell them. This may make some ETFs more tax efficient than comparable mutual funds.	Share redemptions by a mutual fund investor may require the fund manager to sell portfolio holdings at a gain, which will result in taxable distributions to shareholders if there are no offsetting losses. This may make some mutual funds less tax efficient than comparable ETFs.

ETFs, like mutual funds, can be classified as *index-based* or *actively managed*. Currently, the vast majority of ETFs are index-based.

- An *index-based* ETF tracks the performance of a target index either by replicating the holdings of the index (i.e., holding all securities in the target index in the same proportion as the index) or using an optimization or sampling technique (i.e., holding only a representative sample of the component securities). Representative sampling is a practical solution for an ETF when its target index contains hundreds or thousands of securities or some securities that are hard to obtain and/or trade. Certain index-based ETFs are leveraged, seeking to provide magnified exposure to an index (typically by a multiple of two or three times the return of the index) as measured on a daily basis. Inverse ETFs seek to produce the opposite of the daily return of an index, and may be leveraged to magnify performance.
- An *actively managed* ETF does not seek to track the return of a particular index. Instead, its investment adviser, like the adviser of an actively managed mutual fund, creates a unique mix of investments to meet a particular investment objective and policy.

The market price of an ETF share on an exchange is influenced by the forces of supply and demand. While imbalances in supply and demand can cause the price of an ETF share to deviate from the market value of the underlying instruments (also known as the intraday indicative value, or IIV), substantial deviations tend to be short-lived for many ETFs.

Two primary features of an ETF's structure promote trading of an ETF's shares at a price that approximates the market value of the ETF's underlying assets: portfolio transparency and the ability for APs to create or redeem ETF shares at the NAV at the end of each trading day.

ETFs contract with third parties (typically market data vendors) to calculate an estimate of an ETF's IIV, using the portfolio information an ETF publishes daily. IIVs are disseminated at regular intervals during the trading day (such as every 15 seconds). Some market participants use their own computer programs to estimate the underlying value of the ETF on a more real-time basis. The transparency of an ETF's holdings enables investors to observe discrepancies between the ETF's share price and its estimated underlying value during the trading day and to attempt to profit from them.

The creation and redemption process allows APs to engage in an arbitrage strategy that adjusts the supply of an ETF's shares on the market, and thus helps the ETF trade at market prices approximating its estimated underlying value. For example, when an ETF is trading at a premium, APs may sell short the ETF during the day while simultaneously buying underlying securities. At the end of the day, the AP will deliver the creation basket of securities to the ETF in exchange for ETF shares that they use to cover their short sales. The AP will receive a profit, and the additional supply of ETF shares should help bring the ETF share price back in line with the estimated value of its underlying assets. When an ETF is trading at a discount, the reverse happens (i.e., the AP may buy the ETF shares and sell short the underlying securities). See ["What determines an ETF's price?"](#) in [Frequently Asked Questions About ETF Basics and Structure](#) <sup>6</sup> for more detail.

Although ETF shares are designed to trade on the secondary market at a price that approximates the market value of their underlying assets, they typically trade at some premium or discount for a number of reasons. For one, an AP will generally create shares only when the premium is sufficient for it to realize a profit after covering the associated trading costs. The ETF's bid-ask spread and liquidity, as well as the liquidity of the underlying securities, factor into the trading costs, which APs consider when determining whether to engage in arbitrage transactions. Trading costs may be higher with respect to some ETFs than others. For example, international equity ETFs typically have higher spreads than domestic equity ETFs. The higher spreads are due to higher transaction costs in the underlying securities, as well as increased market risks absorbed by the market maker resulting from underlying markets being closed during ETF trading hours.

## Oversight by Fund Directors

The directors of an ETF oversee its management and operations under the same regulatory framework as other registered funds. The 1940 Act imposes significant responsibilities on fund directors in addition to the duties of loyalty and care to which they are typically bound under state law. Independent directors, in particular, serve an important role on behalf of the fund's shareholders: they serve as independent watchdogs and monitor potential conflicts of interest between the fund and its adviser and other affiliates.

ETF directors, like all fund directors, are engaged in a variety of oversight activities. They meet regularly, request and review numerous reports relating to fund matters, and engage in discussions with the adviser, counsel, and others. They oversee compliance, portfolio performance, valuation, and disclosure, among other functions. They also annually review and approve continuation of the advisory contract. (For more information about fund directors' roles and responsibilities generally, see [Frequently Asked Questions About Mutual Fund Directors](#).<sup>7</sup>)

ETFs may be subject to additional requirements, such as those imposed by the exchange on which the ETF is listed. For example, the New York Stock Exchange requires each audit committee member to be "financially literate." ETFs, however, are often exempt from certain listing requirements (including those applicable to closed-end funds), such as the requirement to hold an annual shareholder meeting. The listing standards may impose more requirements on ETFs than mutual funds may have, but tend to

impose less than those imposed on closed-end funds.

ETFs may also be subject to SEC exemptive relief conditions that impose certain additional responsibilities on the ETF board. For example, exemptive orders that permit other funds to purchase ETF shares in excess of the limits imposed by the 1940 Act require the board of any acquired ETF, including a majority of the independent directors, to determine that any consideration paid by the ETF to the acquiring fund or an affiliate of the acquiring fund in connection with any services or transactions is fair and reasonable.<sup>8</sup> More information on the ETF exemptive process [can be found in the next section](#).

## Potential Areas of Inquiry

The oversight practices of ETF directors (such as types of reports reviewed, topics discussed with the adviser, and questions asked) vary depending upon a number of different factors, including the investment objective of the ETF(s) overseen by the board (e.g., index or actively managed, international or domestic, equity or fixed income). Below is a list of topics and questions that a board might consider in connection with its oversight of ETFs.

The questions are not intended to reflect best practices or to be a model for boards to follow. Rather, they are meant to assist boards in considering the types of information they might seek and discuss with the adviser. Many boards may already address these topics, while others may determine that they are not applicable, given the facts and circumstances of their particular fund. In addition, the topics addressed are not intended to be comprehensive—the list does not cover all of the responsibilities that ETF directors fulfill, including those similar to mutual fund directors. Rather, the topics are intended to highlight some of the considerations pertinent to ETFs. In many cases, the topics relevant to ETFs are the same as those for mutual funds.

## Exemptive Process for ETFs

Directors at fund complexes contemplating introducing ETFs or expanding their ETF offerings might want to understand the regulatory process for obtaining SEC exemptive relief, which can be lengthy.<sup>9</sup> ETFs need exemptive relief from a number of provisions of the 1940 Act in order to operate. In general, the relief relates to the ability to create and redeem shares at the NAV only with certain authorized investors and in units of a designated size (the creation unit), while at the same time allowing ETF shares to trade on a secondary market at negotiated prices, rather than at the NAV. As a condition for this relief, ETFs typically agree to disclose their portfolio holdings and/or the composition of the creation basket on a daily basis. Broad categories for relief include passively managed ETFs, actively managed ETFs, and master-feeder arrangements (which, for example, require additional relief from affiliated transactions limitations). Index-based ETFs that track affiliated indexes adopt procedures required under the Investment Advisers Act of 1940 reasonably designed to prevent the misuse of material nonpublic information by the adviser or associated persons.

ETF directors should understand the general terms of the exemptive relief under which the ETF operates, the conditions for that relief, and the adviser's processes for ensuring compliance with the conditions. The directors, of course, should know if the exemptive order imposes certain responsibilities on them.

Directors might consider:

- What is the process for obtaining exemptive relief from the SEC and how long might it take?
- Has the SEC previously granted similar relief to other ETFs?
- What type of exemptive relief is the ETF seeking (or has the ETF obtained) and why?
- What are the conditions to the exemptive relief? What processes are employed to ensure compliance with those conditions?
- Does the exemptive relief impose specific responsibilities on the fund board?

## ETF Design and Investment Objective

To provide a framework for overseeing the management and operations of an ETF, directors will want to understand the structure and investment objective of the ETF, just as they would a mutual fund. The board also might seek to understand how the ETF's investment objective affects its design and the adviser's expectations for the ETF's performance, given that design. Many ETFs that follow very broad indexes use an optimization or sampling technique to track the performance of the index, because it is impractical to hold all of the index components. An ETF also might weight its holdings differently from its underlying index in order to comply with applicable legal requirements. For example, some sector or country funds are not permitted to hold the full weighting of a single security because of securities or tax law diversification requirements.

The design of an index-based ETF may involve trade-offs between minimizing tracking error, on one hand, and reducing costs and increasing efficiency of the creation and redemption process, on the other. An ETF that replicates (rather than samples) an index

may minimize tracking errors because it is an exact replica of the index. However, depending on the number of underlying securities and their liquidity, among other factors, it also might have higher trading costs for APs, which could lead to higher premiums and discounts. By contrast, an ETF that samples its index may have higher tracking errors, but may be less costly to create and redeem and therefore may trade more efficiently. The liquidity of the securities in the index also is a factor: the bid-ask spread is likely to be much lower for an ETF with highly liquid portfolio securities, such as an S&P 500–based index ETF, than one that tracks an index with less-liquid securities.

The board also might inquire whether APs will be permitted to purchase or redeem creation units in kind, with cash, or both (subject to the representations made in the ETF exemptive relief application). ETFs that track indexes of less-liquid or hard-to-obtain securities, or securities that cannot be readily transferred to APs, such as those in an emerging market index, might allow APs to purchase creation units in cash, rather than with a creation basket of securities. Cash transactions create transaction costs for the funds, however, and eliminate some of the tax efficiencies created by the in-kind creation/redemption process. Where APs purchase or redeem creation units partly or wholly in cash, ETFs typically charge APs an additional fee to protect shareholders from the transaction costs associated with investing the cash or selling portfolio holdings to generate cash.

Whether creation units may be purchased or redeemed in cash also may be a factor in a board's determination of whether it should adopt policies to detect and deter frequent trading and market timing of ETF shares.<sup>10</sup> Often, an ETF's board will determine that it is not necessary to adopt a policy because frequent trading of ETF shares on secondary markets does not disrupt portfolio management or raise the other types of concerns relating to market timing that frequent trading of mutual funds do. With respect to the creation and redemption process, frequent creation and redemption activity by APs similarly does not disrupt portfolio management if the transactions are done in kind. If an ETF permits creations or redemptions partly or totally in cash, some boards may determine to adopt policies on frequent trading, while other boards may determine that it is not necessary to adopt a policy for various reasons, including, for example, the payment by APs of fees, which are designed to protect the ETF and its shareholders from the dilutive costs associated with the creation and redemption activity.

Directors might consider:

- What is the investment objective of the ETF and what is the adviser's strategy for seeking to achieve this investment objective?
- How does the ETF fit within the adviser's fund offerings? If the ETF's investment objective is similar to existing funds within the complex, what is the expected impact of the ETF on the existing fund and its shareholder base?
- If the ETF is index-based:
  - How was the index selected? What are the characteristics of the index? What due diligence was performed on the index provider?
  - Does the adviser seek to replicate the index or sample it? If it uses an optimization or sampling technique to track the performance of the index, what is the adviser's methodology?
  - Does the construction of the index pose any SEC or Internal Revenue Service (IRS) limitation issues (e.g., diversification)?
  - Are there any size limitations to the ETF?
  - Does the ETF seek to return a multiple of its target index (e.g., for a leveraged ETF) or an inverse of the index? What is the adviser's strategy for seeking to achieve this objective?
- If the ETF is actively managed:
  - How frequently does the portfolio manager anticipate trading portfolio securities?
  - What processes are employed to minimize the potential for market participants to access the ETF's investment strategies (free ride) or to trade ahead of the ETF (front-running)?
- Are APs permitted to create and redeem in kind, in cash, or both? What are the considerations and implications with respect to either?

## ETF Contractual Relationships

ETF directors oversee the same types of service providers as mutual fund directors—e.g., the adviser, auditor, distributor, custodian, and transfer agent. However, the focus of their oversight may be tailored to the ETF context. (For more information about directors' oversight of service providers, see [Board Oversight of Certain Service Providers](#) and [Board Oversight of Subadvisers](#).<sup>11</sup>) For instance, the distributor plays an important role in promoting the ETF to APs and market makers, whose trading helps to maintain efficient pricing of ETF shares. The APs operate pursuant to a contract, typically with the ETF and its distributor. The APs are not selling agents of the ETF, however, and have no legal obligation to purchase or redeem creation units. All fund boards, including an

ETF board, oversee the distributor and annually approve the continuation of the fund's contract with it. ETF directors might consider the distributor's services in connection with the APs and market makers when evaluating the distributor's services.

The board also may oversee additional contractual relationships, including with a primary listing exchange and an index provider (for an index-based ETF).

*Primary listing exchange.* One of the conditions of an ETF exemptive order is that the ETF lists its shares for trading on a national securities exchange. Listing on an exchange provides an organized and continuous trading market for the ETF shares at negotiated prices. The ETF will contract with a primary listing exchange, which also provides a designated or lead market maker for the ETF.

Some ETF sponsors may contemplate listing ETFs on foreign exchanges to gain access to investors in foreign markets. ETF directors will want to fully understand the implications for them if the ETF were listed on a foreign exchange, including the risks and potential liabilities under the foreign jurisdiction.

Directors might consider:

- Why was the exchange selected to serve as the primary listing exchange? What are the listing costs?
- Do the listing standards of the exchange impose responsibilities on the board?
- Who is the recommended lead or designated market maker? What is the market maker's expertise? What is the market maker's willingness to make capital commitments, including seed capital, to support the ETF?
- If listing on a foreign exchange is being contemplated, what are the responsibilities and potential liabilities of directors under the laws of that jurisdiction?

*Index provider.* The index provider may be affiliated or unaffiliated; typically, it is unaffiliated. The considerations relating to the relationship with the index provider will be similar to those of an index mutual fund.

Directors might consider:

- Is the index provided by an affiliated entity or a third party?
  - If the index is provided by an affiliated entity, what processes and policies are in place to prevent communication of material nonpublic information?
- What are the terms of the licensing agreement with respect to cost, exclusivity, duration, and termination?
- When will the licensing agreement with the index provider expire? What are the adviser's contingency plans if it is unable to renew the license? Is the ETF's name linked to the name of the index?

## Trading of ETF Shares

Directors will want to understand the processes for creating and redeeming ETF creation units, the trading of ETF shares on the secondary market, and how well that process is working for the benefit of ETF investors. Important considerations include the extent to which ETF shares have been trading at a premium or a discount, as well as the bid-ask spread, which is an important element of the cost to ETF investors.

To oversee the ETF's trading, fund boards might receive regular reports regarding premiums and discounts, bid-ask spreads, tracking error and correlation, and trading volume. Boards also might receive periodic reports on the number of APs, the number of market makers, and their trading volumes so they are familiar with their activities in making markets for the ETF.

Directors might consider:

- Have ETF shares been trading persistently at a premium or a discount on the secondary market?
  - If so, why is that? Are there any steps that should be taken to address this?
- What has been the historic bid-ask spread for the ETF's shares in the secondary market? How does this spread compare with relevant industry data?
  - If historic spreads are larger than, or significantly different from, relevant industry data, what are the reasons? Are there any steps that should be taken to address this?
- What has been the trading volume? How does it compare to relevant industry data?
- What are the exchange's policies for breaking trades, and how frequently have trades of the ETF's shares been broken?



As discussed in the next section, boards also may inquire about the ETF's tracking error.

## Portfolio Management and Trading of Underlying Securities

ETF directors' considerations in overseeing performance will be similar to those of mutual funds with similar investment objectives. For instance, as noted earlier, tracking error will be a key consideration for the director of an index-based ETF, just as it is for the director of an index mutual fund. If the ETF tracks an index using a sampling methodology (rather than replicating the index), performance oversight will likely include evaluation of the effectiveness of that methodology. The relationship of the ETF's portfolio performance with the process for creating ETF shares also might be a point of inquiry. For instance, as noted earlier, sampling may enable APs to more cost-effectively assemble the creation basket and participate in arbitrage transactions, which then promotes liquidity in the ETF shares. However, sampling also is likely to produce a larger tracking error than replicating the index would.

A number of factors may affect the ETF's tracking error (for both those that seek to replicate the index and those that sample it), including portfolio trading and differences in the pricing sources and methodology of the ETF and the index. For example, an international ETF and its target index may price the same securities differently because the index generally uses closing prices on local markets while the ETF must value its securities at "fair value" prices reflecting the events that occur after the close of local markets. In addition, the index may use different pricing vendors.

While directors of actively managed ETFs will oversee the portfolio management of the fund in a manner similar to oversight of mutual funds, they also may inquire about trading considerations unique to ETFs. In theory, an actively managed ETF could trade its portfolio securities regularly. In practice, however, most existing actively managed ETFs trade less frequently for a number of reasons, including minimizing the risk of other market participants front-running their trades (submitting trades in advance of the ETF to take advantage of any predictable changes in security prices). In addition, a relatively stable portfolio promotes arbitrage and AP trading.

Additionally, if the ETF has an investment objective similar to other mutual funds in the fund complex, then the ETF board might inquire about trade allocation policies and other policies that address potential conflicts of interest between funds.

Some ETFs may use derivatives to implement their investment strategies.<sup>12</sup> For example, a leveraged ETF might use swaps or futures as a substitute for investing directly in stocks or bonds, in order to gain leveraged exposure to a target index. As is the case with mutual funds, the ETF board might ask questions regarding the use of derivatives and processes for managing risks associated with them. For more information about derivatives oversight, see IDC's paper, [Board Oversight of Derivatives](#).<sup>13</sup> Some ETFs also may engage in securities lending, and the board's oversight role would be the same as it is for a mutual fund that loans securities.

Directors might consider:

- If the ETF is index-based:
  - What is the adviser's expectation for the tracking error, given the design of the ETF? Has this expectation been adjusted since the ETF was launched? If so, why?
  - If the adviser uses a sampling strategy for tracking the index, how effective has the strategy been? Have there been any changes to the methodology, or are any changes recommended?
  - If the tracking error is larger than expected, why is that so, and what steps are being taken to address it?
  - To what extent did the following affect the tracking error:
    - portfolio trading to reflect a rebalanced index;
    - differences between the ETF and the index in the pricing of the securities;
    - restrictions on the ability to mirror the index, such as SEC or IRS tax diversification requirements;
    - the methodology for sampling the index; and
    - fees?
  - Does the ETF engage in securities lending?
    - What is the lending agent and what are its qualifications?
    - What have been the results and costs of the securities lending program?
    - What risks does securities lending pose and how are those risks being minimized?

- Does the ETF have the authority to use derivatives, and if so, how does the adviser use them?
  - What processes does the adviser follow to manage any counterparty risks?
- Does the ETF have an investment objective similar to those of other funds in the fund complex? If so, what policies are followed to address any potential conflicts between the funds?

## Disclosure

ETFs comply with the same general disclosure requirements as mutual funds. For example, ETFs, like mutual funds, are required to maintain a current prospectus, which provides investors with information about the ETF's investment objectives, investment strategies, risks, fees and expenses, and performance. They also may provide investors with a summary prospectus containing key information about the ETF, while making more information available on the Internet and in paper format upon request. In addition, like mutual funds, ETFs are required to prepare statements of additional information and issue annual and semiannual reports.

Some disclosure requirements, however, are tailored to ETFs. In particular, prospectus disclosure is designed for ETF investors who buy and sell ETF shares through the secondary market, rather than the APs who purchase and redeem creation units. ETFs must explain in their prospectuses that shares may only be purchased and sold on an exchange, and that the price of the ETF shares may be greater than or less than the NAV, among other things.<sup>14</sup> They also must disclose, either in their prospectuses or on their websites, the number of days ETF shares were traded at a premium or a discount for the previous calendar year (and most recent calendar quarters).<sup>15</sup> Another difference relates to portfolio holding disclosure: while mutual funds must disclose their portfolio holdings only on a quarterly basis,<sup>16</sup> as a condition of their exemptive relief, ETFs also disclose daily their portfolio holdings and/or the composition of the creation basket.

The board oversees the process by which ETF disclosure is prepared and updated, and it may be liable under the federal securities laws for material misstatements or omissions in the ETF's registration statement, including its prospectus. ETFs are available in a wide range of strategies. Some are complex and some, such as leveraged and inverse ETFs, may be designed to achieve their performance objectives on a daily, rather than a long-term, basis.<sup>17</sup> Fund boards may seek to understand the investor base for which the ETF is designed and how the ETF is marketed.

Directors might consider:

- Are there any inherent or unique factors that will likely affect tracking error (such as SEC/IRS diversification requirements, sampling methodology, and liquidity) that should be disclosed in the ETF's prospectus?
- Are the ETF's use of derivatives and its securities lending practices (if applicable) appropriately disclosed?
- If the ETF is designed to achieve its performance objective on a daily (rather than long-term) basis, is that appropriately disclosed?
- What is the process for ensuring that the marketing materials and website content are consistent with the ETF's registration statement?

## Conclusion

ETF directors are subject to the same regulatory responsibilities as directors of mutual funds. As such, they serve to protect the interests of fund shareholders, and do so through ongoing oversight of the ETF's management and operations.

## Notes

<sup>1</sup> ETFs that invest in commodity derivatives (typically futures and/or options) are regulated primarily by the Commodity Futures Trading Commission as commodity pools, while those that invest solely in physical commodities are regulated by the SEC under provisions of the Securities Act of 1933 (1933 Act). ETNs are unsecured debt securities, typically issued by banks, which, like bonds, can be traded or held to maturity by an investor. These securities are registered under the 1933 Act but not under the 1940 Act. See [Frequently Asked Questions About How ETFs Compare with Other Investments](#), available at [www.ici.org/etf\\_resources/background/faqs\\_etfs\\_other\\_invest](http://www.ici.org/etf_resources/background/faqs_etfs_other_invest). ETFs also may be structured as unit investment trusts (UITs), which are registered under the 1940 Act. Commodity ETFs, ETNs, and ETFs structured as UITs are not required to have a board.

<sup>2</sup> Available at [www.ici.org/etf\\_resources](http://www.ici.org/etf_resources).

<sup>3</sup> Available at <http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-exchange-traded-funds-etfs>.

<sup>4</sup> ETFs, like mutual funds, are subject to special tax rules set forth in subchapter M of the Internal Revenue Code.

<sup>5</sup> Available at [www.ici.org/etf\\_resources/background/faqs\\_etfs\\_basics](http://www.ici.org/etf_resources/background/faqs_etfs_basics).



<sup>6</sup> See *id.*

<sup>7</sup> Available at [www.idc.org/idc/policy/governance/ci.faq\\_fund\\_gov\\_idc.idc](http://www.idc.org/idc/policy/governance/ci.faq_fund_gov_idc.idc).

<sup>8</sup> Section 12(d)(1) of the 1940 Act limits the amount one fund can invest in another fund. A fund may use ETFs to implement an investment strategy (e.g., to gain interim exposure to a particular market while gradually investing directly in that market) and may want to own ETFs in excess of these limits.

<sup>9</sup> In March 2008, the SEC proposed rule amendments to permit ETFs to operate without exemptive relief, but the SEC has not yet adopted the changes. See *Exchange Traded Funds*, SEC Release Nos. 33-8901; IC-28193 (March 11, 2008), available at [www.sec.gov/rules/proposed/proposedarchive/proposed2008.shtml](http://www.sec.gov/rules/proposed/proposedarchive/proposed2008.shtml). In March 2010, the SEC issued a moratorium on granting exemptive relief for ETFs that would make significant investments in derivatives. See the SEC's press release at [www.sec.gov/news/press/2010/2010-45.htm](http://www.sec.gov/news/press/2010/2010-45.htm).

<sup>10</sup> All funds, including ETFs, must disclose whether the board has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares by fund shareholders. See Item 11(e) of Form N-1A under the 1940 Act.

<sup>11</sup> Available at [www.idc.org/pdf/21229.pdf](http://www.idc.org/pdf/21229.pdf) and [www.idc.org/pdf/idc\\_10\\_subadvisers.pdf](http://www.idc.org/pdf/idc_10_subadvisers.pdf), respectively.

<sup>12</sup> ETFs that received exemptive relief before the SEC moratorium (referenced in n.9, *supra*), may have the authority to use derivatives.

<sup>13</sup> Available at [www.idc.org/pdf/ppr\\_08\\_derivatives.pdf](http://www.idc.org/pdf/ppr_08_derivatives.pdf).

<sup>14</sup> See Item 6 of Form N-1A under the 1940 Act.

<sup>15</sup> See Item 11(g) of Form N-1A under the 1940 Act.

<sup>16</sup> Rule 30b1-5 under the 1940 Act.

<sup>17</sup> The SEC issued an investor alert regarding leveraged and inverse ETFs because it believed individual investors might be confused about their performance objectives. It stated that investors should be aware that performance of these ETFs over a period longer than one day could differ significantly from their stated daily performance objectives. See Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors, at [www.sec.gov/investor/pubs/leveragedetfs-alert.htm](http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm).

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