



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

August 17, 2001

Claire P. McGrath, Esq.
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The American Stock Exchange
55 Trinity Place
New York, NY 10008-1872

Re: Exemptive Relief for Exchange Traded Index Funds
File No. TP 00-133

Dear Ms. McGrath:

In your letter dated July 12, 2001, as supplemented by conversations with the staff, the American Stock Exchange (AMEX) requests no-action advice and exemptive relief with respect to specified rules under the Securities Exchange Act of 1934 (Exchange Act) for Portfolio Depositary Receipts (PDRs) and Index Fund Shares¹ that meet certain standards described in your letter. We are responding to your request and have enclosed a photocopy of your letter. Each defined term in this letter has the same meaning as defined in your letter, unless we note otherwise.

Specifically, the AMEX requests, on behalf of itself and persons or entities engaging in transactions involving Fund Shares, certain exemptions from, or no-action advice regarding, Section 11(d)(1) of the Exchange Act and Rules 10a-1, 10b-10, 10b-17, 11d1-2, 14e-5, 15c1-5, and 15c1-6 thereunder, and Rules 101 and 102 of Regulation M in connection with secondary market transactions in Fund Shares and the creation and redemption of Fund Shares meeting the specified criteria.²

¹ For purposes of this letter, PDRs and Index Fund Shares are collectively referred to as Exchange Traded Funds (ETFs). Shares, portfolio deposit receipts, or units of beneficial interest issued by ETFs for trading are collectively referred to as Fund Shares.

² The Commission has granted relief under these rules on prior occasions for certain ETFs, traded on the AMEX, as well as other exchanges. See letter from Nancy J. Sanow, Assistant Director, Division of Market Regulation, to James F. Duffy, General Counsel, AMEX, dated January 22, 1993 (regarding SPDRs listed on the AMEX); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, to James F. Duffy, General Counsel, AMEX, dated March 3, 1999 (regarding Nasdaq 100 Fund listed on the AMEX); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, to Mary Joan Hoene, Carter, Ledyard & Milburn, dated September 5, 2000 (regarding iShares S&P 100 listed on the CBOE); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, to Mary Joan Hoene, Carter, Ledyard & Milburn, dated December 1, 2000 (regarding iShares S&P 100 Global listed on the NYSE).

Response:

The relief granted herein extends to all ETFs trading on any registered national securities exchange that have obtained Rule 19b-4(e) listing approval from the Commission. ETFs meeting the following criteria are granted exemptive and/or no action relief, as more fully described below, from Section 11(d)(1) of the Exchange Act and Rules 10a-1, 10b-10, 10b-17, 11d1-2, 14e-5, 15c1-5, and 15c1-6 thereunder, and Rules 101 and 102 of Regulation M, provided that the following conditions are satisfied:

1. Fund Shares must be issued by an open-end management investment company or a unit investment trust, registered under the Investment Company Act of 1940;³
2. ETFs must consist of a "basket" of twenty (20) or more different Component Stocks,⁴ in which no one stock can constitute more than 25% of the total value of the ETF.
3. At least 85% of the ETF must be comprised of Component Stocks that have a minimum public float value of at least \$150 million and a minimum average daily trading volume (ADTV) of at least \$1 million during each of the previous two (2) months of trading prior to formation of the relevant ETF; provided, however, if the ETF has 200 or more Component Stocks, then 75% of the Component Stocks must meet the \$150 million public float and the \$1 million ADTV thresholds;
4. Each Component Stock must be listed on a national securities exchange or the Nasdaq Stock Market, including the Nasdaq SmallCap Market;
5. Fund Shares are only to be issued or redeemed in Creation Unit aggregations of 50,000 shares or more. The value of each Creation Unit must be at least \$1 million at the time of issuance; and

³ 15 U.S.C. 80a-1 *et seq.*

⁴ For purposes of this letter, individual stocks that comprise the ETF basket, i.e., the stocks that are assembled to replicate the particular index that the ETF tracks, are referred to as Component Stocks.

The Commission also confirms the interpretation of Rule 101 of Regulation M that a redemption of Creation Unit size aggregations of Fund Shares and the receipt of Component Stocks in exchange therefor by a participant in a distribution of Fund Shares would not constitute an “attempt to induce any person to bid for or purchase a covered security, during the applicable restricted period”⁷ within the meaning of Regulation M, and therefore would not violate Regulation M.

Rule 102 of Regulation M

Rule 102 of Regulation M prohibits issuers, selling security holders, or any affiliated purchaser of such person from bidding for, purchasing, or attempting to induce any person to bid for or purchase a covered security during the applicable restricted period in connection with a distribution of securities effected by or on behalf of an issuer or selling security holder.

On the basis of your representations and the facts presented, particularly that the ETFs will be registered open-end management investment company that will redeem at net asset value Creation Units of Fund Shares, the Commission hereby confirms that the ETFs are excepted under paragraph (d)(4) of Rule 102 of Regulation M, thus permitting each of the ETFs to redeem shares during the continuous offering of the shares.

Rule 10a-1

Rule 3b-3 under the Exchange Act defines “short sale,” and Rule 10a-1 under the Exchange Act governs short sales generally. Paragraph (a) of Rule 10a-1 covers transactions in any security registered on a national securities exchange if trades in such security are reported in the consolidated transaction reporting system, and prohibits short

⁶ We note that Regulation M does not prohibit a distribution participant and its affiliated purchasers from bidding for and purchasing Component Stocks in accordance with the exceptions contained in paragraphs (b)(6) and (c)(1) of Rule 101. Rule 101(b)(6)(i) excepts basket transactions in which bids or purchases are made in the ordinary course of business in connection with a basket of 20 or more securities in which a covered security does not comprise more than 5% of the value of the basket purchased. Rule 101(b)(6)(ii) excepts adjustments to such a basket made in the ordinary course of business as a result of a change in the composition of a standardized index. Also, Rule 101(c)(1) excepts transactions in actively-traded securities, that is, securities that have an average daily trading volume value of at least \$1 million and are issued by an issuer whose common equity securities have a public float value of at least \$150 million; provided, however, that such securities are not issued by the distribution participant or an affiliate of the distribution participant.

⁷ 17 CFR 242.101.

sales with respect to these securities unless such sales occur on a "plus tick" (that is, a price above the price at which the immediately preceding sale was effected), or "zero-plus tick" (that is, at the last sale price if it was higher than the last different price). Rule 10a-1 is designed to prevent the market price of a stock or other "reported security," as defined in Rule 11Aa3-1(a)(4) under the Exchange Act, from being manipulated downward by unrestricted short selling.

On the basis of your representations and the facts presented, in particular the composite and derivative nature of the ETFs, it would not appear that trading in Fund Shares would be susceptible to the practices that Rule 10a-1 is designed to prevent. In particular, the AMEX anticipates that the market value of Fund Shares will rise or fall based on changes in the net asset value of the Component Stocks of the particular index and supply and demand. Moreover, the short sale rule does not apply to analogous derivative products such as index options and index futures contracts. Accordingly, the Commission hereby grants an exemption from Rule 10a-1 to permit sales of Fund Shares without regard to the "tick" requirements of Rule 10a-1.

We note that the exemption from Rule 10a-1 would not apply to secondary market portfolio sales made in connection with the redemption of Fund Shares.

Rule 10b-10

Rule 10b-10 under the Exchange Act requires a broker-dealer that effects a securities transaction with or for the account of a customer to provide, at or before the completion of the transaction, a written confirmation statement to the customer disclosing the information specified in paragraph (a) of Rule 10b-10. The required information includes the identity, price, and number of shares or units (or principal amount) of the security purchased or sold by the customer.

On the basis of your representations and the facts presented, and particularly the expected institutional nature of the market for Fund Shares in Creation Unit size aggregations and the public availability of information regarding the composition of the Component Stocks to be tendered or received by customers in ETF creation and redemption transactions, the Commission hereby grants an exemption from Rule 10b-10 under the Exchange Act in order to permit broker-dealers who create or redeem Fund Shares on behalf of their customers to confirm such creation or redemption transactions without providing a statement of the identity, price, and number of shares of each individual Component Stock tendered to or delivered by the Trust pursuant to the creation or redemption transaction. This exemption does not apply to purchases and sales of Fund Shares in the secondary market. This exemption is subject to the following conditions:

- (1) Any confirmation statement of creation or redemption of Fund Shares transaction that omits any of the information specified in paragraph (a) of Rule 10b-10 will contain a statement that such omitted information will be provided to the customer upon request;
- (2) All such requests will be fulfilled in a timely manner in accordance with paragraph (c) of Rule 10b-10; and
- (3) Confirmation statements of Fund Shares creation and redemption transactions will contain all of the information specified in paragraph (a) of Rule 10b-10 other than identity, price, and number of shares of each Component Stock tendered or received by the customer in the transaction.

Rule 10b-17

Rule 10b-17, with certain exceptions, requires an issuer of a class of publicly traded securities to give notice of certain specified actions (for example, a dividend distribution, stock split, or rights offering) relating to such class of securities in accordance with Rule 10b-17(b).

On the basis of your representations and the facts presented, particularly that the ETFs will be registered under the Investment Company Act of 1940 as an open-end management investment companies, the Commission hereby grants an exemption from the requirements of Rule 10b-17 to the ETFs with respect to transactions in Fund Shares.⁸

Section 11(d)(1); Rules 11d1-1 and 11d1-2

On the basis of your representations and the facts presented, the Division will not recommend enforcement action to the Commission under Section 11(d)(1) of the Exchange Act if broker-dealers treat Fund Shares, for the purposes of Rule 11d1-2 under the Exchange Act, as "securities issued by a registered ... open-end investment company as defined in the Investment Company Act of 1940" and thereby extend or maintain or arrange for the extension or maintenance of credit on Fund Shares that have been owned by the persons to whom credit is provided for more than 30 days, in reliance on the exemption contained in the rule. The exemption provided in Rule 11d1-2 will not be available, however, with respect to any Fund Shares owned for 30 days or less by the person to whom credit is provided.

⁸ We also note that compliance with Rule 10b-17 would be impractical in light of the nature of the ETFs. This is because it is not possible for the ETFs to accurately project ten days in advance what dividend, if any, would be paid on a particular record date.

In addition, on the basis of your representations and the facts presented, the Division will not recommend enforcement action to the Commission under Section 11(d)(1) of the Exchange Act if broker-dealers that do not create Fund Shares, but engage in both proprietary and customer transactions in Fund Shares exclusively in the secondary market, extend or maintain or arrange for the extension or maintenance of credit on Fund Shares, in connection with such secondary market transactions.

Rule 14e-5

Rule 14e-5 under the Exchange Act, among other things, prohibits any covered person in connection with a tender offer for equity securities from, directly or indirectly, purchasing or arranging to purchase any subject or related securities except as part of the offer, from the time the offer is publicly announced until its expiration.

Rule 14e-5 explicitly includes dealer-managers of a tender offer within the rule's definition of covered person. Accordingly, while acting as dealer-manager of a tender offer for a Component Stock, a dealer-manager is prohibited from purchasing or arranging to purchase that Component Stock until the expiration of the offer.

On the basis of your representations and the facts presented, particularly that purchases or redemptions of Fund Shares would not appear to result in the abuses at which Rule 14e-5 is directed and that any bids or purchases by dealer-managers would not be effected for the purpose of facilitating a tender offer, the Commission hereby grants an exemption from Rule 14e-5 to permit any person acting as dealer-manager of a tender offer for a Component Stock to: (1) redeem Fund Shares in Creation Unit size aggregations for Component Stocks that may include a security subject to the tender offer; and (2) purchase Fund Shares during such offer.⁹

Rule 15c1-5 and 15c1-6

Rule 15c1-5 under the Exchange Act requires a broker-dealer controlled by, controlling, or under common control with the issuer of any security, before entering into

⁹ The Division also confirms its no-action position under Rule 14e-5 when a broker-dealer (including a member or member organization of the AMEX or other national securities exchange), acting as a dealer-manager of a tender offer for a Component Stock, purchases such Component Stock in the secondary market for the purpose of tendering them to purchase a Creation Unit size aggregation of Fund Shares, if such transactions are effected as adjustments to such a basket in the ordinary course of business as a result of a change in the composition of the relevant index.

