WILLKIE FARR & GALLAGHER LLP

CLIENT
MEMORANDUM

SEC DIVISION OF MARKET REGULATION PROVIDES CLASS RELIEF FOR FIXED INCOME EXCHANGE-TRADED FUNDS

On Monday, April 9, 2007, the staff of the Division of Market Regulation (the "Staff") of the Securities and Exchange Commission (the "Commission") issued a letter to Willkie Farr & Gallagher LLP granting class relief from certain rules under the Securities Exchange Act of 1934 (the "Exchange Act"), Regulation M, and Regulation SHO for exchange-traded funds ("ETFs") that are comprised only of Fixed Income Securities (as defined below) ("Fixed Income ETFs"). Specifically, the Staff provided exemptive relief and no-action and interpretive advice with respect to Rules 10a-1 and 10b-17 under the Exchange Act, Rules 101 and 102 of Regulation M, and Rule 200(g) of Regulation SHO for certain Fixed Income ETFs.

Fixed Income ETFs meeting the conditions of the Staff's letter will no longer be required to seek separate relief for these issues. The conditions to this relief are similar to the listing standards for ETFs recently adopted by the American Stock Exchange. Along with similar relief granted to equity funds and commodity-based funds in 2006,[1] this relief should serve to streamline the process for introducing new ETFs. In particular, the Fixed Income ETF relief eases the conditions for the availability of pricing data, as compared to prior equity fund relief, which would have been difficult to apply to fixed income securities.

Scope of Class Relief for Fixed Income ETFs

The Staff's letter applies to ETFs that correspond to the performance of an underlying index consisting only of "Fixed Income Securities," which are defined to be notes, bonds, debentures or other evidence of indebtedness that include, but are not limited to, U.S. Department of Treasury Securities ("Treasury Securities"), government-sponsored entity securities, municipal securities, trust preferred securities, supranational and sovereign debt and convertible bonds. The relief also applies to ETFs designed to exceed the performance of a particular underlying index of Fixed Income Securities by a specified multiple or to correspond to the inverse of the performance of a particular underlying index by a specified multiple.

[1] Letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation, to Stuart M. Strauss, Clifford Chance US LLP, dated October 24, 2006, with respect to an extension of relief granted in prior letters to exchange-traded funds from Rules 10a-1, 10b-17 and 14e-5 under the Exchange Act, Rules 101 and 102 of Regulation M and Rule 200(g) of Regulation SHO. Letter from Racquel L. Russell, Branch Chief, Division of Market Regulation, to George T. Simon, Foley & Lardner LLP, dated June 21, 2006.

Purchases of Shares While Participating in a Distribution:
Rules 101 and 102 of Regulation M

Rule 101 of Regulation M prohibits underwriters, prospective underwriters, brokers, dealers or other persons who participate in a distribution of securities "to bid for, purchase, or attempt to induce any person to bid for or purchase," any security which is the subject of distribution until after the applicable restricted period. Rule 102 of Regulation M prohibits issuers, selling security holders, or any affiliated purchaser of such person "to bid for, purchase, or attempt to induce any person to bid for or purchase a covered security during the applicable restricted period" in connection with a distribution of securities on behalf of an issuer. These rules would effectively limit the ability of a Fixed Income ETF to engage in a continuous distribution while redemptions are simultaneously occurring.

The Staff confirmed that a Fixed Income ETF will be treated as an open-end investment company under Rule 101 of Regulation M, thereby permitting persons who may be deemed to be participating in a distribution of its shares under Regulation M to bid for or purchase such shares during their participation in the distribution, if such Fixed Income ETF meets conditions, including the following:

(a) no component security (excluding a Treasury Security) represents more than 30% of the weight of the Fixed Income ETF, and the five highest weighted component securities in the Fixed Income ETF do not in the aggregate account for more than 65% of the weight of the Fixed Income ETF; and

(b) the Fixed Income ETF (except where the fund consists entirely of exempted securities) includes a minimum of 13 non-affiliated issuers.

Fixed Income ETFs relying on the class relief must purchase and redeem shares in aggregations of multiple shares, representing 50,000 shares or such other amount where the value of a creation unit is at least $1 million. The Staff confirmed the interpretation of Rule 101 that the redemption of these "creation unit aggregations" of shares and the receipt of component securities in exchange by a participant in a distribution of shares would not constitute an "attempt to induce any person to bid for or purchase a covered security, during the applicable restricted period" within the meaning of Rule 101 of Regulation M.

The Staff further confirmed that Fixed Income ETFs are similarly excepted under Rule 102(d)(4) of Regulation M, thus permitting a Fixed Income ETF to redeem shares during the continuous offering of the shares if it meets conditions (a) and (b) set forth above without violating Rule 102.

If the Fixed Income ETF is wholly comprised of non-convertible Fixed Income Securities that are rated "investment grade" by at least one nationally recognized statistical rating organization, the Fixed Income ETF will not be required to comply with conditions (a) and (b) to rely on the above interpretations of Rule 101 or Rule 102.

Short Sales: Rule 10a-1 under the Exchange Act and Rule 200(g) of Regulation SHO

For Fixed Income ETFs that meet the conditions of the letter, the Commission granted an exemption from Rule 10a-1 to permit sales of shares without regard to the "tick" requirements of Rule 10a-1. In addition, the Staff stated that it would not recommend enforcement action under Rule 200(g) of Regulation SHO if a broker-dealer marks "short," rather than "short exempt," a short sale that is effected in shares.

Notice of Corporate Actions: Rule 10b-17 under the Exchange Act

The Staff also provided an exemption from Rule 10b-17 requirements for a Fixed Income ETF that meets the conditions of the letter. They meet Rule 10b-17 would otherwise require ETFs to give notice of certain actions, including dividend distributions and stock splits, in the manner specified by the Rule.

Additional Conditions

A copy of the letter issued by the Staff to Willkie Farr & Gallagher LLP, including the complete conditions to the relief, can be viewed at:
http://www.sec.gov/divisions/marketreg/mr-noaction/2007/fietfclassrelief040907-msr.pdf.

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If you have any questions regarding this memorandum, please contact Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com), Elliot J. Gluck (212-728-8138, egluck@willkie.com), or the Asset Management attorney with whom you regularly work.

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