

# Exchange-Traded Funds: Navigating The Regulatory Maze

The Editor interviews **Michael W. Mundt**, Partner, Stradley Ronon Stevens & Young, LLP.

**Editor:** You joined Stradley recently after more than 13 years in the Division of Investment Management at the Securities and Exchange Commission. What prompted you to make the change?

**Mundt:** I loved my work at the SEC. I was very committed to its mission of investor protection and enjoyed shaping policies to achieve that goal. Stradley offered a unique opportunity for me to apply the legal skills I had acquired to help its clients. It has an excellent reputation with the SEC staff for quality work. Also, I knew and highly respected a number of the partners at Stradley, some of whom had worked with me when they were at the SEC. I was particularly attracted by Stradley's interest in exchange-traded funds (ETFs).

**Editor:** Tell us about your role at the SEC.

**Mundt:** I was in charge of one of the offices in the Division of Investment Management, which grants exemptive orders under the Investment Company Act. The Investment Company Act is a complicated piece of legislation implemented by detailed rules. Congress built into the statute the ability for the SEC to grant exemptions to allow for product innovations and new services. My role at the SEC was to consider the many new services and products that fund companies wanted to offer and the policy ramifications of granting any necessary exemptions.

One of the main types of exemptive applications in recent years is related to ETFs. ETFs include characteristics of the types of investment companies authorized by the Investment Company Act, but they are not actually described in the law. Therefore, applicants need to obtain specific exemptions in order to introduce ETFs.

The first ETF was introduced in 1993. When I started working at the SEC in 1997, there were only about 20 ETFs with less than \$10 billion in total assets under management. By the time I left the SEC earlier this year, there were more than 1,000 ETFs with around \$1 trillion in assets under management. All of those ETFs had to obtain exemptions from the SEC before they could operate.

The types of ETFs also changed through the years. The early ETFs were mostly based on equity securities indices that were very well known. Over time, ETF sponsors sought and obtained the necessary exemptions to introduce ETFs for other types of asset classes and with indices that were increasingly specialized or even developed by affiliates of the ETF advisors themselves. Sponsors also obtained relief to introduce leveraged ETFs and actively managed ETFs. I had the opportunity to supervise the regulatory relief for each of those innovations.

In addition, I was the primary author of the SEC's "Concept Release on Actively Managed ETFs" in 2001 and worked on the SEC's ETF rule proposal in 2008. I was also part of the team that analyzed the impact of the "flash crash" of May 6, 2010 on ETFs. The other staff



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at the SEC came to appreciate my ETF expertise, so even if ETF issues came up in a different regulatory division at the SEC, I was often consulted. In addition, I worked with various foreign regulators in considering ETF issues in other jurisdictions. In recognition of my ETF work, I was awarded the SEC's prestigious Paul R. Carey Award earlier this year, which honors an SEC staff member who demonstrates exceptional personal commitment on a significant policy matter.

**Editor:** How important are ETFs in total market trading?

**Mundt:** According to some reports, daily trading in ETF shares can represent as much as 50 percent of the trading in securities that occurs on U.S. exchanges. In addition, people who trade ETFs often hedge their positions by trading in other securities as well, so there is probably even a greater amount of trading that is indirectly related to ETFs. As I mentioned, the growth of investor assets in ETFs over the past decade has been dramatic. So they've definitely emerged as an important investment option for investors and a significant component of the securities markets generally.

**Editor:** How does your experience at the SEC make your practice a fit for Stradley?

**Mundt:** In running one of the SEC's exemptive applications offices, I was asked to consider many innovative ideas, and I worked with applicants to analyze the way that the law applied to those new services or products. At Stradley, I also expect to work with clients who have developed new ideas for ETFs and other products and to help analyze the related legal issues. Because I have a full understanding of the SEC's policy concerns on various issues, I should be able to help clients effectively address those concerns, both with respect to ETFs and other exemptive matters. I also expect to work on the full array of other regulatory issues that an ETF sponsor may encounter. This includes helping to organize the legal entities, registering the ETFs as investment companies under the Investment Company Act, and working with exchanges and the SEC to obtain any necessary listing approvals.

**Editor:** Tell us about Stradley's ETF practice.

**Mundt:** Currently, Stradley has a number of ETF clients, and we have helped them with all aspects of their businesses, including obtaining the exemptions that I've talked about, registering the funds under the Investment Company Act, working with them to obtain exchange listing, and helping with the ongoing work that investment company boards and advisors need to comply with the various requirements under the Investment Company Act.

The partners and associates serving ETFs are part of our Investment Management/Mutual Funds Practice Group, a large practice group that totals about 45 attorneys who work on the full range of issues affecting entities subject to the Investment Company Act. These attorneys work on supporting all types of investment companies, including helping their advisors and boards with all of the nuts and bolts of fund operations.

Many of these activities are also applicable to ETFs, because even though the ETFs require special relief and have some unique issues, they are in most instances registered as investment companies. So, much of the work that our Investment Management/Mutual Funds Practice Group would do for other types of investment companies, it also does for ETFs.

In addition, Stradley has a number of other strong practice areas that could be relevant to ETFs. ETFs can have issues relating to tax, litigation, intellectual property and advisor acquisitions, among other matters. We have Stradley attorneys who specialize in each of these areas.

**Editor:** ETFs seem to be a hot topic lately. Why do you think that is?

**Mundt:** There are a lot of reasons for the explosive growth in the ETF area. ETFs have characteristics that appeal to short-term as well as long-term investors. Since ETFs can be sold intraday, they offer a degree of flexibility that doesn't exist for mutual funds. This means that short-term traders can use ETFs in trading strategies in a way that they simply cannot do with respect to other types of investment companies. This can be particularly true because ETFs have a high degree of portfolio transparency and are often index based. As a result, they can be an efficient way of adjusting market exposure.

At the same time, the unique structure of the ETFs has in many cases caused them to have lower expenses than comparable mutual funds. ETFs also generally do not have the same types of sales charges as other types of investment companies. In some cases, ETFs have been more tax efficient than other types of investment companies. Those types of savings can be attractive for long-term investors as well. ETF popularity relates to the fact that they offer characteristics that are appealing to such a wide range of investors.

**Editor:** Has your group had any notable recent representations or deals that you can share with us?

**Mundt:** We are currently working with clients in filing registration statements and exemptive applications for traditional types of ETFs. I also expect to work with various clients on ideas about the next

generation of ETFs. Currently, for example, the only actively managed ETFs that have come to market must commit to full portfolio transparency, which requires them to publish their portfolios on a daily basis. Some active managers do not want to commit to that level of transparency out of concerns that other market participants could observe their trading strategies and take advantage of that information by mimicking or front-running the strategies. As a result, there has been interest in the development of less transparent, actively managed ETFs. I expect that we will be working with clients in thinking through the way that those types of products could obtain the regulatory relief necessary for them to come to market.

**Editor:** Is your firm in a position to help clients who might wish to launch ETFs in foreign markets?

**Mundt:** ETFs are definitely an area that is developing in the global markets, and I expect that U.S. providers of ETFs will increasingly be looking to foreign markets and foreign exchanges for the possible introduction of products in those markets. Also, foreign investment managers may be interested in exploring the introduction of ETFs in the U.S. Major financial institutions are thinking globally, and there will be unique regulatory issues that go along with introducing products in the various jurisdictions.

In light of the globalization of the securities markets, Stradley has partnered for more than 15 years with Eversheds to work with clients in the financial services sector with international interests. Eversheds has offices across the UK, Europe, Middle East, Africa and Asia. Stradley is also a participant in Meritas – the world's largest association of independent business and commercial litigation firms. It's a network of more than 200 firms worldwide that are located in more than 70 countries and encompass 7,000 lawyers. Through these relationships, Stradley should be in a position to provide clients with access to information about the local laws and business practices in all of the major markets. So, if our clients are interested in launching ETFs in other countries, we should be able to assist.

**Editor:** Tell our readers about some of your key initiatives for the coming year.

**Mundt:** I want to raise the firm's profile as a leader in helping ETF clients navigate the regulatory maze. I expect to help by speaking about ETF issues at various conferences and other events. I will also be working with existing and new clients who may be considering introducing ETFs for the first time or adding new ETFs to their existing ETF product lines. ETFs are an exciting area. They present some unique regulatory issues, and Stradley is well positioned to help clients with the new issues, as well as to work with them on all the routine regulatory issues that go along with running an investment company within the regulatory framework of the Investment Company Act. My expectation is that Stradley will continue to bring thoughtful analysis and value to the legal needs of its clients, and I'm looking forward to being a part of that effort.

Please email the interviewee at [mmundt@stradley.com](mailto:mmundt@stradley.com) with questions about this interview.