

Futures-Based Exchange-Traded Funds—What are They, How are They Structured and Who Regulates Them?

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Introduction

The popularity of exchange-traded funds (“ETFs”) has led to almost constant innovation in this relatively young market. Many newer ETF offerings are more tailored in their investment objectives, creating greater diversity within the ETF space. This evolution includes the introduction in 2006 of the first futures-based ETFs (“Futures-Based ETFs”). This subset of the ETF industry differs from its predecessors principally because of the type of investments it makes (*e.g.*, futures contracts), its fund structure, and the cocktail of futures regulations and securities and broker-dealer regulations that apply.² As the title indicates, this outline focuses on Futures-Based ETFs³ and attempts to shed some light on a segment of the market that has amassed substantial assets under management in a relatively short time.⁴

Background

ETFs were first developed in 1992 primarily in an effort to provide investors with intraday pricing and liquidity, which was not provided by mutual funds.⁵ While addressing the “forward pricing”⁶ issue, “ETFs were initially

designed to function similar to conventional index mutual funds.”⁷ However, ETFs, as their name suggests, may be traded on securities exchanges throughout the trading day at real-time prices that are updated every few seconds (depending upon trading volume).⁸ Investors in ETFs can trade rapidly in response to changes in the value of the ETF’s underlying benchmark and its corresponding shares.⁹

Simply put, ETF shares are “derivative securities that represent ownership in funds, unit investment trusts, [trusts,] or depositary receipts with portfolios of securities, [futures contracts and other alternative investments] designed to track the performance of . . . specific benchmarks.”¹⁰ ETFs generally resemble certain index mutual funds¹¹ because they track the performance of a specific benchmark or index by holding a portfolio comprised of the instruments underlying the index or by establishing a representative sampling of the components that comprise the particular benchmark or index, thereby attempting to mirror the investment results of the index as a whole (less fund expenses).¹² ETFs also resemble closed-end funds because their shares trade on an exchange throughout the trading day pro-

viding an investment opportunity for retail investors to transact in ETF shares on an exchange.¹³ Similar to closed-end funds (and unlike mutual funds), “ETFs afford [retail] investors the opportunity to capitalize on market movements . . . [throughout] the trading day.”¹⁴ However, unlike closed-end funds, which typically trade at a discount to net asset value (“NAV”), ETFs are expected to trade at prices in the secondary market that are close to their NAV.¹⁵

ETF shares have certain common characteristics with equities. Investors may short and purchase ETF shares on margin.¹⁶ Furthermore, investors may set stop-limit orders as well as call or write options on ETFs.¹⁷ These and other advantages over mutual funds have contributed to the popularity of ETFs.

I. Futures-Based ETFs: What are they?

ETFs linked to the futures (*e.g.*, commodities and financial linked futures contracts) markets address the growing investor interest in diversification away from traditional equities and bonds and into “alternative investments.”¹⁸ On February 3, 2006,¹⁹ PowerShares DB Commodity Index Tracking Fund (“DBC”) became the first public commodity pool to be listed on a U.S. securities exchange.²⁰ DBC’s objective was and continues to be to track the changes in a specific index of commodities by investing in a portfolio of exchange-traded futures on the 14 commodities comprising the index.²¹ The DBC listing represented an effective new method by which investors could gain an exposure to the commodities market²² and served to distinguish DBC from all the other public commodity pools.²³

DBC is organized as a trust and issued shares that were listed on a securities exchange like other ETFs. However, unlike a typical ETF, DBC is not an “investment company” under the Investment Company Act of 1940 (the “‘40 Act”).²⁴ Rather, DBC is a public commodity pool regulated by the Commodity Futures Trading Commission (the “CFTC”),²⁵ an independent governmental agency with a “mandate to regulate commodity futures and option markets in the United States.”²⁶ In addition, DBC is also subject to oversight by the National Futures Association (the “NFA”), which regulates firms and individuals who conduct futures related business with public customers.²⁷

Like traditional ETFs, Futures-Based ETFs invest in futures-based instruments in order to track an underlying benchmark, which, for example, may be aimed at reflecting price changes in the U.S. Dollar,²⁸ crude oil²⁹ or precious metals.³⁰ In contrast to traditional commodity pools that may employ a number of strategies (*e.g.*, discretionary, fundamental and systematic), Futures-Based ETFs are generally unmanaged.³¹ Futures-Based ETFs may invest passively and seek merely to track their index, whether the index is rising, falling or flat.³² Therefore, they will take unprofitable positions deliberately when the index is falling.³³ Although Futures-Based ETFs may employ swaps from time-to-time to achieve their goal of index tracking, this is not to be confused with some swap-based ETFs that are offered outside of the U.S., which lack transparency and expose investors to counterparty risk.³⁴ Futures-Based ETFs present a unique set of regulatory and structural differences from ETFs registered under the ‘40 Act³⁵ and ETFs that invest in physical commodities (and not futures contracts).

While the groundbreaking achievements of DBC are now mirrored in a number of Futures-Based ETFs³⁶ and have become fairly routine, practitioners and Futures-Based ETF operators should understand the fundamental issues which affect the design and development of these new products.

The Index

Futures-Based ETFs are primarily structured as index funds.³⁷

An index is a “statistical composite that measures change in an economy[,] . . . financial market,” securities market or other market sector (the “Index”).³⁸ It is a set of rules applied to a body of data and does not represent the results of actual investment or trading. In the Futures-Based ETF space, there are additional complexities that must be understood in order to structure a Futures-Based ETF that will effectively track its Index. For example, a Futures-Based ETF may attempt to track its index by establishing positions in futures contracts that are substantially similar to the composition of its index which may be composed of, for example, a number of commodities. It is important to note that an Index does not represent actual futures contracts, and, therefore, it typically does not account for any fees or expenses associated with investing in a futures

contract or any other fund expenses. Furthermore, an Index is not subject to and does not take into account the impact of speculative position limits, position accountability limits or certain other similar limitations imposed on the ownership of futures contracts³⁹ or the ability of a Futures-Based ETF to perfectly track its index by investing in an identical number of the underlying futures contracts. Additionally, should a Futures-Based ETF reach the applicable speculative or related limits for any of its futures contracts, it is unlikely that the corresponding Index will adjust to reflect any substitute positions that the Futures-Based ETF would be required to establish. This is important because a Futures-Based ETF that establishes alternative positions that differ from the composition of the Index is likely to increase tracking error, which is essentially the delinking of the performance of the Futures-Based ETF from changes in the levels of its corresponding Index.

An Index can be calculated on either a Total Return (“TR”) or Excess Return (“ER”) basis, adding an additional layer of complexity that must be accounted for when analyzing the returns of an Index. In short, ER Indexes do not include income from a risk free investment (*i.e.*, interest income) while the TR Indexes do include such a component.

In order to understand the source of income from a risk free investment, in the context of a Futures-Based ETF, interested parties should understand the role that margin deposits play in connection with investments in futures contracts. At its most basic level, margin⁴⁰ is a small percentage of a futures contract’s face value that is deposited with a broker as collateral to establish an open position in a futures contract. Because only a fraction of the face value of the futures contracts is required for margining, a significant portion of the portfolio of the Futures-Based ETF may be comprised of cash or cash equivalents such as, for example, U.S. Treasuries and other high credit quality short term securities as permitted by the Commodity Exchange Act (the “CEA”).⁴¹

TR and ER versions of an Index

TR Index. The TR version of an Index includes an assumed amount of income received from a risk-free component (*e.g.*, the three-month United States Treasury bill), if any, which may be adjusted from time-to-time. The TR version of an Index tracks both the gains

and losses of an underlying market sector over time, and generally assumes reinvestment of any distributions and the return from a risk free component.⁴²

ER Index. The ER version of an Index reflects the changes in the value of the underlying market sector or benchmark, excluding the return of a risk free component (*e.g.*, the three-month United States Treasury bill). As a result, certain practitioners refer to the ER version of an index as “unfunded.”

While a Futures-Based ETF seeks to track its corresponding Index (whether on a TR or ER basis), it invests actual money, trades actual futures contracts and receives interest returns that are affected by current market conditions. As a result, the performance of the Futures-Based ETF reflects an internalization of certain sources of tracking error, meaning that fees and expenses impose a drag on the Futures-Based ETF’s performance and the actual interest rate earned by a Futures-Based ETF over any period may differ from the assumed amount of interest income factored into the TR version of the Index over the same period. Furthermore, the Futures-Based ETF may be subject to speculative position limits, position accountability limits and certain other limitations on its ability to trade the futures contracts that comprise the Index (the “Index Contracts”), which may compel the Futures-Based ETF to trade futures, swaps or other alternative instruments that are not Index Contracts as proxies for the Index Contracts. These factors may contribute to discrepancies, or “tracking error,” between changes in the Futures-Based ETF’s NAV per share and changes in the level of the Index over any period.

The limitations noted above, along with fees and expenses, also tend to cause the NAV per share to underperform relative to changes in the value of the Index over any given period, all other things being equal. Additionally, actual income could be higher or lower than the assumed income factored into the TR version of the Index, and therefore could cause changes in the NAV per share to outperform or underperform changes in the value of the Index over any given period.⁴³ In favorable interest rate environments, Futures-Based ETFs may attempt to minimize potential tracking error by distributing any excess interest income to their shareholders. Trading futures or other instruments that are not the Index Contracts as proxies for the Index Contracts could also cause changes in the NAV

per share to outperform or underperform changes in the value of the Index over any given period.⁴⁴

Creation and Redemption Process of Futures-Based ETFs— “Cash is King”

Futures contracts⁴⁵ cannot be transferred to third parties in in-kind transactions.⁴⁶ Therefore, unlike ‘40 Act ETFs whose investment portfolios are, for example, comprised of securities which can be transferred to third parties in in-kind transactions, Futures-Based ETFs, generally are prevented from in-kind transactions as part of the creation and redemption process. Futures-Based ETFs create and redeem shares from time to time, but only in one or more baskets. A basket is typically a block of 50,000 shares (each, a “Basket”). Futures-Based ETF shares are not redeemable securities, except when aggregated in Baskets and Baskets may be created or redeemed only by broker-dealers known as authorized participants (each, an “Authorized Participant”).⁴⁷

Because of the in-kind limitation discussed above, Authorized Participants must create Baskets in cash and a Futures-Based ETF must pay redemption proceeds in cash. This requirement accounts for one of the primary distinctions between ‘40 Act ETFs and Futures-Based ETFs with respect to the creation and redemption process.

After purchasing a Basket of shares, an Authorized Participant may hold the shares for its own account or sell them to other “brokerage firms, institutional investors or individual investors.”⁴⁸ The shares are simultaneously “listed on a national stock exchange . . . and trade through purchase and sale transactions in the secondary market,”⁴⁹ like any other exchange listed shares.⁵⁰ Futures-Based ETF shares may be purchased and sold throughout the trading day at market prices plus any additional charge incurred as normal brokerage commissions payable by retail investors to their brokers. Individual shareholders may not create or redeem Baskets directly.⁵¹ The arbitrage opportunities are presented when the market price of the shares deviates sufficiently, either positively or negatively, from the Futures-Based ETF’s NAV. For example, because Baskets of each Futures-Based ETF are priced based on the Futures-Based ETF’s NAV, if the share price in the secondary market is higher than the Futures-Based

ETF’s NAV, then an Authorized Participant can capitalize on this arbitrage opportunity by creating a Basket at the Futures-Based ETF’s NAV, selling the shares at market price and profiting from the difference.

The shares placed in the secondary market through the creation process continue trading until the market price provides an arbitrage opportunity and an Authorized Participant obtains enough shares to enable it to redeem a Basket for the cash value of shares contained in the Basket.⁵² Shares redeemed by the Authorized Participant cannot be netted against sales⁵³ and will no longer be in circulation in the public market. Thus, Futures-Based ETF operators are cautioned to carefully track the rate at which the Futures-Based ETF is processing Basket creations in order to avoid depletion of available registered shares in light of a potentially lengthy registration process for new shares.

Creation Procedures

Typically, an Authorized Participant may place an order with a Futures-Based ETF to create one or more Baskets. Purchase orders must be placed by no later than a predetermined cutoff time on the day on which the Futures-Based ETF receives a valid purchase order. The action of submitting a purchase order is typically irrevocable and the Authorized Participant’s account with The Depository Trust Company (“DTC”) may be charged a transaction fee.⁵⁴

Determination of Required Cash Payment

The total cash payment required to create each Basket will be the NAV of the Basket(s) as of the time the Futures-Based ETF’s NAV is calculated on the purchase order date. Baskets are typically issued on the business day after the purchase order was made, at the applicable NAV per Basket, but only if the required payment has been timely received.

Because orders to purchase Baskets are placed prior to the calculation of the NAV of the Futures-Based ETF, Authorized Participants will not know the total amount of cash required to create a Basket at the time they submit what is typically an irrevocable purchase order for the Basket. The

NAV of a Futures-Based ETF, and in turn, the total amount of cash required to create a Basket, could rise or fall substantially between the time a purchase order is submitted and the time the NAV of the Futures-Based ETF is calculated.

Delivery of Creation Payment

The payment associated with the creation of one or more Baskets due from an Authorized Participant is typically delivered to the Futures-Based ETF at a predetermined time on the business day immediately following the creation order date, at which time the Authorized Participant's DTC account will be credited with such Baskets.

Redemption Procedures

The procedures by which an Authorized Participant may redeem Baskets mirror the procedures for the creation of Baskets. On any business day, an Authorized Participant may place a redemption order to redeem one or more Baskets. Redemption orders must be received by a predetermined cutoff time. Redemption orders are typically irrevocable.⁵⁵

By placing a redemption order, an Authorized Participant agrees to deliver the Basket(s) to be redeemed through DTC's book-entry system to the Futures-Based ETF no later than a predetermined cut-off time on the business day immediately following the date the Authorized Participant placed its redemption order.⁵⁶ By placing a redemption order, and prior to receipt of the redemption proceeds, an Authorized Participant's DTC account may be charged a non-refundable transaction fee.⁵⁷

Determination of Redemption Proceeds

The redemption proceeds from a Futures-Based ETF consist of the cash redemption amount. The cash redemption amount is equal to the NAV of the Basket(s) of the Futures-Based ETF requested in the Authorized Participant's redemption order as of the time that the NAV of the Futures-Based ETF is determined on the redemption order date. The Administrator or the Distributor, as applicable, will instruct

the Transfer Agent and the Custodian of redemption orders by close of business on the date of the redemption order.

Delivery of Redemption Proceeds

The redemption proceeds due from a Futures-Based ETF are typically delivered to the Authorized Participant at a predetermined time on the business day immediately following the redemption order date if, by such time, the Futures-Based ETF's DTC account has been credited with the Baskets to be redeemed. The Custodian will distribute the cash redemption amount at a predetermined time on the business day immediately following the redemption order date through DTC to the account of the Authorized Participant, as recorded on DTC's book-entry system, but only if the applicable Baskets have been timely received. If the Futures-Based ETF's DTC account has not been credited with all of the Baskets to be redeemed by such time, the redemption proceeds are delivered to the extent of whole Baskets received.

Advantages of Futures-Based ETFs

The advantages of ETFs are well documented. These include, but are not limited to, (i) the ability to trade like a typical security throughout the business day (depending on trading volume) at real-time prices,⁵⁸ (ii) efficiency and lower cost created by the fact that most transactions involving ETF shares take place on secondary stock exchanges and, therefore, do not generate expenses borne by the ETF,⁵⁹ (iii) the ability of shares of ETFs to be eligible for margin accounts and (iv) the transparency created by daily disclosure of the ETF's portfolio components on the ETF's website.⁶⁰

Futures-Based ETFs provide investors the following additional advantages:

1. "Equitization" or "Retailization" of futures-based investments. Because the face value of a futures contract may be \$100,000, futures contracts are not instruments intended for the retail market. By investing in a Futures-Based ETF, an investor will gain an exposure to one or more of the futures contracts underlying the applicable Index, as applicable, and the investor's losses are limited to the

value of its initial investment (assuming that the investor established a long position in a Futures-Based ETF).

2. If an investor were to invest directly in futures contracts, he/she would be required to monitor his/her investments actively and to roll positions just prior to the maturity of each applicable futures contract in order to avoid, if applicable, delivery of the underlying commodity, financial instrument or currency. However, by investing in the shares of a Futures-Based ETF instead of investing directly in futures contracts, the managing owner of the Futures-Based ETF (the “Managing Owner”) will execute the necessary rolls (*i.e.*, the closing of open positions on futures contracts just prior to expiration and the establishment of new positions to replace the settled futures contracts.)
3. An investment in a Futures-Based ETF eliminates the need for an investor to create the necessary positions in order to construct a portfolio that would track the applicable Index. Furthermore, the Managing Owner will also rebalance the Futures-Based ETF’s portfolio in a manner consistent with the corresponding Index, which the investor would otherwise be required to handle, if the investor’s objective was to track the identical Index.
4. By investing in a Futures-Based ETF, an investor is not required to manage a futures trading account. For example, the investor will not be required to make maintenance payments or meet margin calls received from the futures commission merchant (the “FCM”). Instead, the Managing Owner will make maintenance payments or margin calls and take all other necessary management related activities with regard to the ETF’s futures account.

II. Futures-Based ETFs: How are they structured?

Formation and Jurisdiction

Futures-Based ETFs are typically formed as Delaware statutory trusts, organized either as a single trust⁶¹ or as

a series trust.⁶² The trusts are treated as partnerships for federal income tax purposes and provide pass-through tax treatment for investors. Additionally, in Delaware, the statutory trust form insulates Futures-Based ETF shareholders from personal liability to the same extent as the Delaware corporate form.⁶³ These advantages, combined with a well developed body of law, have provided additional incentives to utilize a Delaware statutory trust.⁶⁴

Investment Company Act Analysis

As a threshold matter and during the planning process, Futures-Based ETF sponsors must consider the risk that the fund could potentially be deemed an investment company required to register under the ‘40 Act. There are serious adverse consequences to operating an unregistered investment company and a Futures-Based ETF sponsor should not launch a Futures-Based ETF without a high level of comfort that the Futures-Based ETF, if operated in accordance with its stated objectives and policies, is not and will not be required to register under the ‘40 Act.⁶⁵ The determination of whether a Futures-Based ETF is an investment company begins with the definition of the term “investment company.” An “investment company” is defined in section 3(a)(1) of the ‘40 Act as an issuer that:

- “(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
- (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
- (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percentum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.”⁶⁶

Under section 3(a)(1), the key consideration is whether the issuer is “primarily engaged” in the busi-

ness of investing, reinvesting, or trading securities.⁶⁷ However, neither the Securities and Exchange Commission (the “SEC”) nor the courts have articulated a comprehensive or authoritative interpretation of the “primary engagement” standard.⁶⁸ Indeed, the SEC has stated that “[s]ince determining a company’s primary engagement involves considering many factors, no specific guidelines can be established for concluding in all conceivable circumstances whether a company is an investment company.”⁶⁹

In the past, this lack of clarity created considerable uncertainty for commodity pool operators. However, relief for commodity pool operators and, by extension, for Futures-Based ETFs, was provided in the *Tonopah Mining Co. of Nevada* and *Peavey Commodity Futures Funds* line of SEC no-action letters.

In *Tonopah Mining*, although the company met the definition of an investment company under section 3(a)(1)(C) due to the fact that over 40 percent of its assets were investment securities, the company applied to the SEC for an order under section 3(b)(2) of the ‘40 Act declaring it not to be an investment company because it was primarily engaged in metal mining, a non-investment company business.⁷⁰ The SEC adopted a five factor analysis for determining an issuer’s primary business purpose for the purpose of assessing the issuer’s status under the ‘40 Act.⁷¹ The factors were: (1) the issuer’s historical development; (2) its public representations of policy; (3) the activities of its officers and directors; and, most importantly both, (4) the nature of its present assets; and (5) the source of its present income.⁷²

This analysis was further developed with respect to commodity pools in *Peavey Commodity Futures Funds, I, II and III*. In *Peavey*, the Office of Chief Counsel of the Division of Investment Management of the SEC (the “Staff”) recognized that, for a commodity pool, the nature of the present assets on the commodity pool’s balance sheet (fourth factor articulated in *Tonopah Mining*) may not necessarily be a useful indicator of the commodity pool’s primary business for purposes of assessing the commodity pool’s status under the ‘40 Act.⁷³ Specifically, the Staff noted that

“ ... it has been recognized that with respect to a commodity pool, a snapshot picture of its balance

sheet contrasting the value of its futures contracts (unrealized gain on such contracts) with the value of its other assets, e.g., its reserves and margin deposits, which often are in the form of United States government notes, may not reveal the primary nature of the business.”⁷⁴

For example, even if the comparison establishes that a large percentage of the commodity pool’s assets are in securities, the commodity pool may not be primarily engaged in an investment company business.⁷⁵ Although it did not articulate a bright-line rule, the Staff took the position in *Peavey* that, in determining the primary engagement of an entity investing in futures, the most important factor is the “area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss.”⁷⁶ Therefore, the Staff noted, “at least with respect to such a company, a company’s intentions are of great importance in determining its primary business.”⁷⁷ However, the Staff also indicated that “*a company’s real intentions may be revealed by its operations.*”⁷⁸ (emphasis added). *Peavey* implies that some amount of securities investment activity (other than securities investing that is merely incidental to investing in commodity interests such as securities held to margin futures positions) may be undertaken by an investment fund without jeopardizing its status as a commodity pool,⁷⁹ but *Peavey* provides no guidance as to the point at which securities investing and trading becomes a primary engagement or at which point commodity interest investing and trading ceases to be a primary engagement. The Staff’s analysis in *Peavey* has been subsequently reaffirmed with respect to commodity pools, such as Futures-Based ETFs, and by now it is a well-established legal analysis for determining the status of a commodity pool under the ‘40 Act.⁸⁰

Managing Owners should keep in mind that while *Peavey* stands for the proposition that the business area with respect to which an entity anticipates realization of the greatest gains and exposure to the largest risks of loss is the most important factor to be considered in determining the primary engagement of a commodity pool, it also does not ignore the first three factors of the *Tonopah Mining* test.⁸¹

Management and Service Providers

The Managing Owner

The Managing Owner is the entity responsible for the overall management and operation of the Futures-Based ETF. The Managing Owner initially is similar to a “promoter”⁸² in that it creates and promotes the Futures-Based ETF, enters into agreements with third-party providers, and arranges for the purchase of the initial shares by an initial purchaser. Unlike a promoter, a Managing Owner continues to oversee the operations and provides ongoing management of the Futures-Based ETF. Typically, the Managing Owner also monitors the performance of the Futures-Based ETF’s portfolio and reallocates and rebalances the assets within the portfolio to ensure that the portfolio tracks its respective index.⁸³ A Managing Owner must register with the CFTC as the commodity pool operator for the Futures-Based ETF, and may also register on a voluntary basis as the commodity trading advisor. In addition, Managing Owners must be members of the NFA in such capacities. A Managing Owner must comply with regulatory requirements under the CEA and the various rules and regulations of the CFTC and the NFA.

The Managing Owner may be managed by a “board of managers,” “board of directors” or its functional equivalent. The Managing Owner may appoint its officers (who may or may not be members of the board of managers) with titles similar to that of a corporation to facilitate the Futures-Based ETF’s compliance with the requirements of the federal securities laws. For example, the Managing Owner may, at a minimum, appoint a chief executive officer (principal executive officer) and a chief financial officer (principal financial officer) to act on behalf of the Futures-Based ETF. Officers with these or similar titles are required to comply with the federal securities laws.

The Commodity Pool Operator

A commodity pool operator (the “CPO”) is a “person engaged in a business similar to an investment trust or a syndicate and who solicits or

accepts funds, securities, or property for the purpose of trading commodity futures contracts or commodity options.”⁸⁴ In other words, the CPO is an individual or organization that operates a commodity pool and solicits funds for that commodity pool.⁸⁵ The CPO either makes trading decisions on behalf of the commodity pool itself or engages a commodity trading advisor to do so.⁸⁶

The Commodity Trading Advisor

A commodity trading advisor (the “CTA”) is “a person who, for pay, regularly engages in the business of advising others as to the value of commodity futures or options or the advisability of trading in commodity futures or options, or issues analyses or reports concerning commodity futures or options.”⁸⁷ Notably, the CFTC does not require a CPO to register as a CTA if its trading advisory functions are performed in connection with its functions as a CPO. However, certain market participants have elected to register with the CFTC as both a CPO and a CTA.⁸⁸

The Commodity Broker or Futures Commission Merchant

The commodity broker (the “Commodity Broker”), in its capacity as the Futures-Based ETF’s clearing broker, when applicable, executes and clears the Futures-Based ETF’s futures transactions and may also perform certain administrative services.⁸⁹ Although a variety of executing brokers may execute futures transactions on behalf of the Futures-Based ETF,⁹⁰ these executing brokers “give up” their transactions to the Futures-Based ETF’s Commodity Broker.⁹¹ A Commodity Broker must be registered with the CFTC as a futures commission merchant and be a member of the NFA in such capacity.⁹² The CEA and the CFTC define an FCM as any person or entity that “solicit[s] or accept[s] orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any exchange and that accept[s] payment from or extends credit to those whose orders are accepted.”⁹³

The Administrator

The administrator (the “Administrator”) “performs or supervises the performance of [certain] services necessary for the operation and administration of . . . [a Futures-Based ETF] (other than making investment decisions), including receiving and processing orders from Authorized Participants to create and redeem baskets, NAV calculations, fund accounting, preparation of reports used in connection with certain filing requirements, maintaining books and records, and performing other fund administrative services.”⁹⁴

The Distributor

The distributor (the “Distributor”) must be a registered broker-dealer and a member of the Financial Industry Regulatory Authority (“FINRA”) that may act as an agent for the Futures-Based ETF and assists with the marketing of the Futures-Based ETF.⁹⁵ Its role varies depending upon the business needs of the Futures-Based ETF. However, under certain arrangements, the Distributor may also play a role in the creation and redemption process. The Distributor may work with the Administrator, the Transfer Agent and the Authorized Participant to process the receipt of creation and redemption orders.⁹⁶

The Custodian

The custodian (the “Custodian”) is a third-party entity that may hold the Futures-Based ETF’s securities and cash delivered to the Custodian on behalf of the Futures-Based ETF.⁹⁷ As part of its responsibilities, the Custodian establishes securities and cash accounts and maintains books and records segregating the assets of the Futures-Based ETF.⁹⁸ The Custodian may also retain certain financial books and records, including, for example: Basket creation and redemption books and records, fund accounting records, ledgers with respect to assets, liabilities, capital, income and expenses, the register, transfer journals and related details and trading and related documents received from futures commission merchants. The Custodian may also hold non-margin cash on behalf of the Futures-Based ETF.

The Transfer Agent

Futures-Based ETFs typically use a transfer agent (the “Transfer Agent”) to track the ownership of its shares.⁹⁹ Generally, a transfer agent performs the following functions:

- (a) keeps records of who owns a Futures-Based ETF’s shares, how many shares each investor owns and how those shares are held—typically in book-entry form, or by the investor’s brokerage firm in street name.
- (b) acts as an intermediary for the Futures-Based ETF. It may also serve as the Futures-Based ETF’s paying agent for distributions of interest income to investors. In addition, a Transfer Agent may act as proxy agent for the Futures-Based ETF (sending out proxy materials).¹⁰⁰

The Marketer

The Marketer assists the Managing Owner “with certain functions and duties such as providing various educational and marketing activities regarding the . . . [Futures-Based ETF], primarily in the secondary market, which activities [typically include] . . . communicating the [Futures-Based ETF’s] name, characteristics, uses, benefits and risks consistent with” the Futures-Based ETF’s disclosure document.¹⁰¹

The Index Sponsor

The index sponsor (the “Index Sponsor”) is the business entity that creates, establishes and oversees the index that is tracked by the Futures-Based ETF.¹⁰² As mentioned above, an index is a set of rules applied to a body of data and does not represent the results of actual investment or trading.¹⁰³ The rules of an Index inform the buying and selling of both the types and quantities of the Index Contracts.¹⁰⁴ Hence, the Index Sponsor creates, establishes and oversees the Index tracked by the Futures-Based ETF but does not actually provide investment advice to the Futures-Based ETF or the Managing Owner.

The Index Calculation Agent

For certain indices, the Index Sponsor may appoint a third-party to compute, maintain and disseminate Index data (the “Index Calculation Agent”). The Index Calculation Agent computes the value of the Index pursuant to the rules of the applicable Index. Index data is then disseminated by a number of market data vendors, typically including Bloomberg and Reuters. Through this function, the Index Calculation Agent plays an important role in maintaining the transparency of the Futures-Based ETF.

The Initial Purchaser

After a Futures-Based ETF has received clearance from the applicable regulators and prior to commencement of trading on an exchange, it must establish the appropriate positions in futures contracts so that the Futures-Based ETF may commence trading in a manner consistent with its Index and establish a NAV. This is usually accomplished by entering into a contractual agreement with a registered broker-dealer (the “Initial Purchaser”) (again, after the Futures-Based ETF’s Registration Statement, as defined below, has been declared effective) to purchase one or more initial Basket(s) on a business day prior to the commencement of trading on an exchange. The initial positions provide the investing public with a sufficient number of shares to trade until such time as one or more Authorized Participants (see discussion below) may submit creation orders. Once the Initial Purchaser creates and receives the initial Basket(s), its role as an initial purchaser of the Futures-Based ETF terminates.¹⁰⁵

The Authorized Participants

An Authorized Participant must be (i) a registered broker-dealer, (ii) a participant in DTC (clearance and settlement are done through the DTC process) and (iii) in privity of contract with the Futures-Based ETF.¹⁰⁶ Despite entering into an agreement with the Futures-Based ETF, an Authorized Participant is not contractually obligated to submit a creation or redemption order. The Authorized Participant will submit an order

based on sufficient market demand or arbitrage opportunities to close the spread between share price and the NAV of the Futures-Based ETF.¹⁰⁷

An Authorized Participant plays a role similar to that of an Initial Purchaser, except that Authorized Participants may create and redeem shares during the continuous offering of the Futures-Based ETF.¹⁰⁸ Because the shares issued to Authorized Participants may be “issued on an ongoing basis, at any point during the life of . . . [the fund] a ‘distribution,’ as such term is used in the Securities Act” of 1933 (the “’33 Act”), as well as under Regulation M under the Securities Exchange Act of 1934 (the “’34 Act”), may be occurring at any time during the life of the Futures-Based ETF.¹⁰⁹ Thus, an Authorized Participant must understand and acknowledge that some activities on its part, depending on the circumstances, will result in it being deemed to be a statutory underwriter and subject it to the provisions of the ‘33 Act¹¹⁰ (e.g., the prospectus delivery requirement).

An Initial Purchaser is not prohibited from acting as an Authorized Participant. However, institutions that serve as both the Initial Purchaser at the launch of the Futures-Based ETF and as an Authorized Participant on an ongoing basis through the life of the Futures-Based ETF are careful to distinguish these separate roles and typically enter into two separate agreements. It is important to note that the Initial Purchaser serves in a function akin to an underwriter in a public offering and its role as an Initial Purchaser is subject to all of the regulations and liability provisions applicable to an underwriter in an underwritten public offering. Authorized Participants, on the other hand, have no obligation to create any Baskets and are not subject to all such rules and liability provisions.

III. Futures-Based ETFs: Who regulates them?

CFTC’s and NFA’s Role in Regulating Futures-Based ETFs

Background

Operators of public commodity pools are subject to a panoply of regulations promulgated by

the CFTC under the CEA.¹¹¹ Futures-Based ETFs trade in futures on financial instruments or commodities and are classified as commodity pools that (through the regulation of the Managing Owner as described in the next paragraph) are subject to regulation by the CFTC and the NFA. The term commodity is broadly defined and includes what many would expect (*e.g.*, wheat, corn, cotton, rice).¹¹² However, commodities also include “services, rights and interests in which contracts for future delivery are presently or in the future dealt in.”¹¹³ CFTC regulations further provide, in pertinent part, that a “commodity interest” means “any contract for the purchase or sale of a commodity for future delivery.”¹¹⁴ Long a term without a definition, “commodity pool” is now defined by the CEA to include

“any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any

- (i) commodity for future delivery, security futures product, or swap;
- (ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i);
- (iii) commodity option authorized under section 4c; or
- (iv) leverage transaction authorized under section 19.”¹¹⁵

It is important to note that unlike the federal securities laws where the Futures-Based ETF is the registrant whose transactions are regulated by the SEC, the CFTC and the NFA do not regulate the Futures-Based ETF itself, but rather regulate the CPOs¹¹⁶ (or the Managing Owner in this context) and CTAs.¹¹⁷ The CFTC is an independent governmental agency with a mandate to regulate the commodity futures and option markets in the United States.¹¹⁸ In particular, the CFTC’s Part 4 rules (the “Part 4 Rules”) provide the regulatory regime for oversight of the operations and activities of CPOs and CTAs.¹¹⁹ The Part 4 Rules cover the disclosure, reporting and recordkeeping requirements and the registration and compliance exemptions for CPOs and CTAs, along with certain other general provisions.¹²⁰

The NFA regulates the players in the commodities markets and is the agency with which the Managing Owner has the most direct interaction. The NFA was formed and registered with the CFTC as a “registered futures association”¹²¹ pursuant to the CEA.¹²² The NFA is the only non-exchange self-regulatory organization¹²³ for commodities professionals in the United States. The CFTC has delegated to the NFA responsibility for, among other things, registering CTAs, CPOs, FCMs, introducing brokers and their respective associated persons and floor brokers, as applicable.¹²⁴ As a self-regulatory organization of the commodities industry, the NFA promulgates rules governing the conduct of commodity professionals and disciplines those professionals who do not comply with such standards.¹²⁵ For example, NFA members are subject to NFA standards relating to fair practice, financial condition, and consumer protection.¹²⁶

Futures Contracts

Futures contracts are standardized contracts made on United States or foreign exchanges that call for the future delivery of specified quantities and qualities of various agricultural commodities, industrial commodities, currencies, financial instruments or metals for a predetermined price at a specified time and place.¹²⁷ The contractual obligations, depending upon whether one is a buyer or a seller, may be satisfied either by taking or making, as the case may be, physical delivery of a specific amount of an approved grade of commodity or by making an offsetting sale or purchase of an equivalent but opposite futures contract on the same, or mutually offsetting, exchange prior to the designated date of delivery.¹²⁸

Contango and Backwardation

The commodities price curve is affected by a number of factors such as the type of commodities, the present supply and demand, maintenance, storage costs and other related factors. The price curve of commodity futures contracts is also affected by whether the market for the commodity is experiencing “contango” or “backwardation.”

A “contangoed market” is a market in which prices in succeeding delivery months are pro-

gressively higher than in the nearest delivery or “spot” month. A “backwardated market” is a market in which prices in succeeding delivery months are progressively lower in the distant delivery months. In other words, if the price curve is increasing over time, then the market is considered to be in contango and if the price curve is decreasing over time, then the market is considered to be backwardated.¹²⁹ Generally, the price curve in a matured commodity market tends to have a contango structure (*i.e.*, higher prices in the future months), which reflects, for example, the cost of carrying inventory, the effects of supply and demand and a number of other factors.¹³⁰

Contangoed markets have been problematic, and a potential trap for unwary investors in some Futures-Based ETFs. As the futures contracts held by a Futures-Based ETF near expiration, they are “rolled” or replaced by contracts that have a later expiration. Because contangoed markets are those in which the prices of contracts are higher in the distant delivery months than in the nearer delivery months, the monies raised from the low priced, closed out contracts will not buy the same number of new contracts going forward. In effect, a fund that is invested in a contangoed market will sell low and buy high, which will adversely affect the NAV of the Futures-Based ETF (while the levels of the corresponding Index may not have declined).

The recognition of the potential disadvantages presented by contango and advantages presented by backwardation has led to further developments for futures-based indices. Index sponsors have developed indexes with roll methodologies that attempt to minimize the negative effects of contangoed and maximize the positive effects of backwardated markets. These methodologies reflect another evolutionary step in the development of Indexes that Futures-Based ETFs may track.

Futures Contracts Ownership Limits

The CFTC and U.S. futures exchanges have established limits, referred to as “speculative position limits”¹³¹ (or “position limits”), “daily price fluctuation limits” (or “daily limits”) and position accountability limits which (i) set the maximum speculative positions held or owned in certain futures interests contracts, (ii) set limits

on the amount of fluctuation in futures interests contract prices during a single trading day and (iii) limit any person from holding a position of more than a specific number of certain futures contracts, respectively.¹³²

Speculative Position Limits. The CFTC has the regulatory authority “to establish position limits with respect to all commodities and has established position limits for all agricultural commodities.”¹³³ Speculative position limits set the maximum net long or net short speculative positions that any person or group of persons (other than a hedger) may hold, own or control in certain futures interests contracts. In addition, the CFTC requires each U.S. exchange “to submit position limits for all commodities traded on such exchange for approval by the CFTC.”¹³⁴

Daily Limits. Daily limits, as determined by the exchanges, “establish the maximum amount that the price of a futures interests contract may vary either up or down from the previous day’s settlement price. Once the daily limit has been reached in a particular futures interest contract, no trades may be made at a price beyond the limit.”¹³⁵ However, the exchange may elect to increase the original daily limit.

Position Accountability Limits. Through the application of position accountability limits as determined by the exchanges, any person may be prohibited from holding a position of more than a specific number of such futures contracts.¹³⁶ Under the rules of a futures exchange, an investor that holds a certain number of futures contracts may be (i) required by the futures exchange to initially report its positions to the futures exchange as its holdings approach the position accountability limits, and (ii) requested by the futures exchange to limit or decrease its holdings of such futures contracts pursuant to the futures exchange’s position accountability limits.¹³⁷

CPO Registration/Exemption

As previously noted, the Managing Owner or operator of a commodity pool is required to register, unless exempt, as a CPO with the CFTC and become a member of the NFA. Such exemptions are generally not available to Managing Owners of Futures-Based ETFs.¹³⁸

The CPO registration process involves the filing of certain registration applications with the NFA. Registration requires filings by the CPO and each principal¹³⁹ and associated person.¹⁴⁰ The CPO registration must be renewed annually¹⁴¹ and any changes to the information disclosed in the registration application must be promptly reported to the NFA.¹⁴²

The CPO must also comply, unless exempt, with disclosure, compliance, ongoing reporting and recordkeeping requirements and is subject to periodic audits.¹⁴³

Disclosure Document— CFTC Part 4 Rules

A Futures-Based ETF's offering document is known as the "Disclosure Document" for commodities purposes and the "Prospectus" (which forms a part of the registration statement that is filed to register the shares of the Futures-Based ETF (the "Registration Statement")) for federal securities purposes. The Disclosure Document for a Futures-Based ETF is prepared, in part, pursuant to CFTC Regulations 4.24 and 4.25 and must be filed electronically through the NFA's Electronic Disclosure Document Filing System.¹⁴⁴ The filing of the initial Disclosure Document with the NFA, the SEC and FINRA initiates an exchange of comment letters from these various regulators and response letters from the Managing Owner in response to the comment letters.¹⁴⁵ The synchronization of this response process is aided by an understanding of the review schedules that the different regulators observe.

The CFTC recently amended certain of its regulations as they affect CPOs. Some of these amendments relate to the rules affecting Futures-Based ETFs and reflect the CFTC's recognition that Futures-Based ETFs have become sufficiently common to justify such rule amendments. All prospective Managing Owners of Futures-Based ETFs may now benefit from the relief that Rule 4.12, discussed in more detail below, provides with respect to certain CFTC Rules that affect the operations of Futures-Based ETFs.

Timing Considerations with Respect to Filing and Use of the Disclosure Document

The CFTC requires the filing of a Disclosure Document with the NFA at least 21-days prior to the date of first use.¹⁴⁶ The SEC typically requires a minimum of 30-days to review the initial filing of the Registration Statement. Upon completion of the NFA's and the SEC's initial review, each regulator will provide the Managing Owner with its comment letter. However, the review period only indicates when the regulators will respond with written comments and does not address when the Futures-Based ETF may be offered to the public. The difference in response time notwithstanding, Managing Owners typically file the initial Registration Statement with the SEC and the Disclosure Document with the NFA at the same time. Throughout the registration process, the Managing Owner may file with both the SEC and the NFA simultaneously. However, there is no requirement to do so.

In light of the above, particularly unique to Futures-Based ETFs is the fact that unlike the SEC, which allows for initial marketing of registered offerings with a preliminary Prospectus, the NFA does not recognize an analogous preliminary Disclosure Document concept and therefore, the Futures-Based ETF may only access the market with a final Disclosure Document that has cleared all regulators.¹⁴⁷ This creates marketing dilemmas and eliminates the underwriter's ability to act during the "waiting period" that occurs after the Registration Statement (which includes the Disclosure Document) has been filed, but before it is declared effective by the SEC. In a customary SEC-registered offering, the underwriters, in accordance with SEC regulations, may market the issue (*i.e.*, solicit offers to buy) prior to effectiveness, while the Registration Statement remains subject to SEC review.¹⁴⁸

Delivery, Recordkeeping and General Disclosure

Operators of public commodity pools are subject to regulations promulgated by the CFTC

under the CEA.¹⁴⁹ Because Futures-Based ETFs were not yet conceived at the time these regulations were drafted, a number of these regulatory requirements proved to be incompatible with the structure and function of Futures-Based ETFs. As a result, Futures-Based ETF operators needed relief from the CFTC. These requests and the grants of relief eventually became routine.¹⁵⁰ In recognition of these incompatibilities and the perfunctory nature of the relief requests, the CFTC amended its regulations to provide relief from certain disclosure, reporting and recordkeeping requirements for CPOs of commodity pools whose shares are registered under the '33 Act and listed and traded on an exchange. These revisions came in the form of an amendment to Rule 4.12 which became effective on June 17, 2011. Under the revised rule, prospective Futures-Based ETF operators need only file an exemptive notice. The CFTC grandfathered and preserved the relief previously granted to CPOs of Futures-Based ETFs “so long as the requirements of the final regulations were no more restrictive than the requirements” of the relief letters previously granted to the CPO.¹⁵¹

The CFTC added paragraph (c) to Rule 4.12 that, subject to specified conditions, permits the CPO of a Futures-Based ETF to claim relief from the specific Disclosure Document delivery and acknowledgment requirements of Rule 4.21, the monthly account statement delivery requirement of Rule 4.22, and the requirement to retain the CPO's books and records at its main business address in Rule 4.23.¹⁵² In addition, the CFTC issued a Notice and Order that authorized the NFA to process claims for exemption from these requirements if the specific conditions under Rule 4.12(c) are satisfied.¹⁵³

Rule 4.21—Required Delivery of Pool Disclosure Document and Receipt of Written Acknowledgement

A CPO is prohibited from soliciting or receiving funds from an investor until the CPO delivers a final Disclosure Document to the investor. Specifically, Rule 4.21 mandates that a CPO must deliver or cause to be delivered the Disclosure Document to prospective investors,¹⁵⁴ and it may

not accept or receive funds from prospective investors unless the CPO has first received a signed and dated acknowledgement from the prospective investor acknowledging that he has received the Disclosure Document.¹⁵⁵ The obligation to deliver extends only to direct purchasers of the shares (who are the Authorized Participants) and not to retail investors.¹⁵⁶ Prior to the amendment to Rule 4.12, Authorized Participants received (and provided to the Futures-Based ETF's CPO a written acknowledgement of such receipt of) a Disclosure Document that complied with the requirements in the Part 4 Rules. Rule 4.12(c) has eliminated this specific requirement, subject to the satisfaction of certain conditions. One such condition is the requirement to post the Futures-Based ETF's current Disclosure Document on the internet website maintained by the CPO. It is expected that prospective and actual investors will utilize the services of a registered broker-dealer, and the revised Rule 4.12 requires that they either inform the investors where they may obtain the current Disclosure Document,¹⁵⁷ or, upon request, deliver a copy of the current Disclosure Document.

Rule 4.22—Reporting to Pool Participants

CPOs are required to maintain accounting systems and prepare periodic financial statements for each commodity pool they operate. Unless exempt, CPOs must distribute periodic Account Statements and a certified Annual Report, when applicable.¹⁵⁸ The Annual Report must be distributed to each commodity pool participant and must be submitted electronically, along with key financial balances from the report, to the NFA, within 90-calendar days after the end of the commodity pool's fiscal year.¹⁵⁹ The Annual Report must be prepared in accordance with generally accepted accounting principles (“GAAP”) consistently applied and must be audited by an independent public accountant.¹⁶⁰ Pursuant to Rule 4.22(h), each Account Statement and Annual Report must contain an oath or affirmation by a representative duly authorized to bind the Futures-Based ETF to the effect that “to the best of the knowledge and belief of the individual making the oath or affir-

mation, the information contained in the document is accurate and complete.”¹⁶¹

In the past, CPOs of Futures-Based ETFs have successfully obtained exemptions granted by the CFTC regarding the requirement to deliver the Account Statements, subject to monthly posting of the Account Statements (including the 4.22(h) oath or affirmation) on the Futures-Based ETF’s website. The CFTC grandfathered and preserved the relief previously granted to CPOs, “so long as the requirements of the final regulations were no more restrictive than the requirements” of the relief letters previously granted to the CPO.¹⁶²

NFA Compliance Rule 2-46 requires that each CPO must file a quarterly report with the NFA, for each commodity pool that it operates and for which it has any reporting requirement under CFTC Rule 4.22 (the “Rule 2-46 Report”). The Rule 2-46 Report is the CFTC analog of the quarterly reports filed with the SEC on Form 10-Q.¹⁶³ Within 45 days after the end of each quarterly reporting period, the CPO must file the information specified in Rule 2-46 with the NFA. The Rule 2-46 Report differs substantially from a Form 10-Q. The Rule 2-46 Report requires the CPO to provide, in part, information regarding the identity of the commodity pool’s administrator, carrying broker(s), trading manager(s) and custodian(s), a statement of changes in NAV for the quarterly reporting period, monthly performance for the three months comprising the quarterly reporting period and a schedule of investments identifying any investment that exceeds 10% of the commodity pool’s NAV at the end of such period.

Rule 4.23 – Recordkeeping

Rule 4.23 imposes requirements on CPOs to make and keep certain books and records in an accurate, current and orderly manner.¹⁶⁴ These records must be made available for inspection by shareholders.¹⁶⁵ The compliance records must be maintained at the main business office of the CPO,¹⁶⁶ except for those records that may be kept by a third-party pursuant to either Rule 4.12 or exemptive relief from the CFTC, as applicable. CPOs of Futures-Based ETFs have sought and

successfully received relief from the Rule 4.23 recordkeeping requirements to the extent that such books and records are kept by third parties in accordance with Rule 4.23 and the access to participants required under Rule 4.23 is not disturbed. The CFTC grandfathered and preserved the relief previously granted to CPOs, “so long as the requirements of the final regulations were no more restrictive than the requirements” of the relief letters previously granted to the CPO.¹⁶⁷

Rule 4.24 – General Disclosure Requirement

Rule 4.24 may be one of the most important rules for Futures-Based ETF operators.¹⁶⁸ Rule 4.24 requires CPOs to disclose the characteristics of investments of the Futures-Based ETF, such as the fees and expenses of the Futures-Based ETF, the identities and business backgrounds of the principals of the CPO, conflicts of interest, liquidity, litigation and a litany of other relevant disclosures.¹⁶⁹ Although there is significant overlap with the SEC disclosure requirements, a number of the items are particular to futures trading and the players in the commodities sector.

Rule 4.25 – Performance Disclosure Requirement

Rule 4.25¹⁷⁰ requires the CPO to disclose certain performance related information regarding the Futures-Based ETF that is being offered and, if applicable, any other commodity pools operated by the CPO. Rule 4.25 provides specific performance metrics that must be disclosed such as the commodity pool’s NAV, largest monthly drawdown, worst peak-to-valley drawdown, break even table, certain legends and additional disclosure items.¹⁷¹

SEC’s Role in Regulating Futures-Based ETFs

Public Offerings

For federal securities law purposes, the public offering of shares by Futures-Based ETFs has the same regulatory implications as any other ‘33 Act

and '34 Act registered offering. For example, it is well understood that public offerings, including offerings by Futures-Based ETFs, are subject to the Section 10(b) and Rule 10b-5 anti-fraud provisions of the '34 Act.¹⁷² However, several considerations arise from the commodities regulatory overlay. There are numerous books and articles regarding SEC registered offerings, which are beyond the scope of this outline, and therefore the outline focuses only on the particular federal securities regulations that are applicable to public offerings by Futures-Based ETFs.

Registration Requirement

1. Registration Under the '33 Act

The default form for registration of a Futures-Based ETF is the Registration Statement on Form S-1. The sale of shares may not take place until the Registration Statement has been declared effective by the SEC.¹⁷³ While Section 5 of the '33 Act permits oral offers and written offers during the “waiting period” (after the Registration Statement has been filed but before it has been declared effective),¹⁷⁴ CFTC Regulations prohibit CPOs from making offers without delivering a final Disclosure Document.¹⁷⁵ Because the Disclosure Document is not final¹⁷⁶ until it is dated (and it cannot be dated until the SEC has declared the Registration Statement effective), there can be no offering of the shares prior to the SEC's declaration of the effectiveness of the Registration Statement.

2. Registration Under the '34 Act

A Futures-Based ETF is required to register by filing a Form 8-A under the '34 Act in order to have its shares listed on a national securities exchange.¹⁷⁷

The 19b-4 Application Process

A significant regulatory obstacle faced by Futures-Based ETFs is the listing process required for shares of the Futures-Based ETFs to be listed on a national securities exchange.¹⁷⁸ Every class of security traded on an exchange must be authorized for listing by the exchange and registered with the SEC.¹⁷⁹ Each exchange has a set of listing standards that applies to its listed companies¹⁸⁰ and the different classes of securities listed on the

exchange, which guide companies through the exchange's requirements. Conventional securities (*e.g.*, stocks, bonds and even some '40 Act ETF shares) do not pose any regulatory hurdle in connection with such listing.¹⁸¹ However, Futures-Based ETFs present a wrinkle in the listing process because they do not satisfy the generic listing requirements that exist for standard securities and “plain vanilla” ETFs. Therefore, the exchanges are required to seek approval of a change in the listing rules from the SEC.¹⁸² This is achieved through the 19b-4 application process. Specifically, the exchange must submit a formal application to the SEC's Division of Trading and Markets pursuant to Section 19(b)(1) and Rule 19b-4 of the '34 Act.¹⁸³ The 19b-4 application process may significantly delay (or possibly derail) the launch of a Futures-Based ETF.

The Prospectus

1. Contents of the Prospectus

The Prospectus is prepared pursuant to the plain English principles and the requirements of Regulation S-K (other than the financial statements included therein which must meet the requirements of Regulation S-X as indicated in Part I of Form S-1). Because the Prospectus and the Disclosure Document are the same document, the Part 4 Rules must also be taken into account when drafting the Prospectus.

2. Elimination of the preliminary Prospectus Concept

As previously mentioned, the CFTC does not allow the use of Disclosure Documents that are not in final form¹⁸⁴ and this eliminates the use of preliminary Prospectuses during what otherwise would be the marketing phase of SEC-registered offerings (prior to the effectiveness of the Registration Statement). While this may hinder the ability to establish an initial offering price through the use of a preliminary prospectus in the traditional sense (*e.g.*, to determine market price), the use of a preliminary Prospectus is unnecessary in the Futures-Based ETF context because the initial share price is pre-determined. The initial share price, however, applies to the price at which the Futures-Based ETF will sell the shares to the Initial Purchaser, who in turn will sell the shares

to the public at prices that will vary depending upon the secondary market price of the shares.

3. Prospectus Delivery Requirement

Section 5(b)(2) of the '33 Act makes it unlawful to "carry or cause to be carried through the mails or in interstate commerce any . . . security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a Prospectus that meets the requirements of subsection (a) of section 10."¹⁸⁵ Futures-Based ETFs, similar to other SEC registered issuers, are subject to the prospectus delivery requirement. Since 2005, the obligation is considered to be satisfied under the "access equals delivery" method prescribed under Rule 172 of the '33 Act. In general, the rule deems a prospectus meeting the statutory disclosure standard to have been delivered to investors if it has been filed electronically with the SEC within prescribed periods.

Continuous Offering

Futures-Based ETFs are involved in a continuous offering and must stand ready to process requests for creations and redemptions of Baskets on any given day. To accommodate the continuous offering of shares, Managing Owners must have systems in place to monitor and track the number of registered and unissued shares available for continuous offering and maintain a current Prospectus at all times. The Managing Owners may replenish the Futures-Based ETF's available shares by filing new Registration Statements with the regulatory bodies in time to "restock." This, however, can be a very time consuming process and poorly timed execution may jeopardize Basket creations and lead to tracking error. This process becomes more efficient for seasoned issuers who are eligible to file Registration Statements on Form S-3 and, if applicable, become "well-known seasoned issuers."¹⁸⁶ Form S-3 allows required disclosures to be made through incorporation by reference of reports required of listed issuers under the '34 Act. Further, well-known seasoned issuers are eligible to use automatic shelf registration procedures, which become effective immediately on filing without any review by the SEC.

Regulation M

Regulation M under the '34 Act contains anti-manipulation rules that regulate certain trading practices and limits the activities of certain participants, during the course of a distribution of a security.¹⁸⁷ A "distribution" is defined in Rule 100 of Regulation M as an "offering of securities . . . that is distinguished from ordinary trading transactions by the 'magnitude of the offering', and the 'presence of special selling efforts and selling methods'."¹⁸⁸ Regulation M prohibits a "distribution participant," as defined in Rule 100 of Regulation M (*e.g.*, the Futures-Based ETF, the Authorized Participants, and their affiliates), from purchasing or attempting to induce others to purchase, during the course of a distribution, the security subject to the distribution.¹⁸⁹ As mentioned above, Futures-Based ETFs are involved in a continuous offering and must have registered shares readily available for sale to Authorized Participants at all times. Shares may be created and issued on an ongoing basis and a "distribution" may be occurring at any time during the life of the Futures-Based ETF. Therefore, a strict reading of the prohibitions created by Regulation M would prevent Authorized Participants from creating or redeeming Baskets.

ETF operators have sought relief from Regulation M asking that the regulations not be applicable to ETFs.¹⁹⁰ The SEC has previously consistently granted this relief to '40 Act ETFs and the early Futures-Based ETFs. The SEC ultimately issued class relief letters, which are now relied upon by all Futures-Based ETFs.¹⁹¹

Section 13(d) and 16(a) Reporting

The '34 Act imposes certain reporting obligations on persons acquiring more than five percent,¹⁹² or any director, officer, or shareholder who is directly or indirectly the beneficial owner of more than 10 percent¹⁹³ of any class of any equity security registered under the '34 Act. The affected individuals must file reports with the SEC disclosing the number of shares beneficially owned and any changes in ownership. The policy concerns underlying the requirement for the filings of the reports are not present in the case of Futures-Based ETFs because of the expectation that shares of Futures-Based ETFs should trade

at prices that do not deviate materially from the Futures-Based ETF's NAV. The SEC recognized this and granted the following no action relief to Futures-Based ETFs with respect to the reporting obligations under sections 13(d) and 16(a): (i) Futures-Based ETF shareholders are not required to file reports under section 13(d), and (ii) the Futures-Based ETF's insiders are not required to file reports under section 16(a).¹⁹⁴ The relief does not prohibit the voluntary filing of these reports and a number of market participants choose to file these reports as part of their overall compliance procedures.

Reporting Obligations

As reporting companies under the '34 Act, Futures-Based ETFs are subject, other than as described in the preceding paragraph, to the filing requirements of Sections 13 and 15 of the '34 Act. These requirements include, in pertinent part, the filing of quarterly reports on Form 10-Q and Annual Reports on Form 10-K.

Quarterly Report on Form 10-Q. Form 10-Q must contain unaudited interim financial statements, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), information about matters submitted to security holders for a vote, disclosure about market risks, a discussion of disclosure controls and procedures, a report on any material changes to the Futures-Based ETF's internal control over financial reporting and information about redemptions of the Futures-Based ETF's own shares. If certain types of nonrecurring and material events occurred during the quarter, then these events must also be reported on Form 10-Q. The Form 10-Q must be signed on behalf of the Futures-Based ETF by a duly authorized officer of the Futures-Based ETF. The Form 10-Q must be accompanied by personal certifications from the Futures-Based ETF's CEO (or principal executive officer) and CFO (or principal financial officer).

Annual Report on Form 10-K. Form 10-K must contain full audited financial statements for the prior three fiscal years (as well as other selected financial information) and an MD&A. Form 10-K must also include, among other things, a

description of the Futures-Based ETF's business, properties and material legal proceedings, risk factors, information about matters submitted to security holders for a vote, quantitative and qualitative disclosure about market risks, information regarding the background of, and compensation paid to, the Managing Owner's directors, managers, executive officers and any related parties, and, if the Futures-Based ETF is an accelerated filer, a large accelerated filer or a well-known seasoned issuer, material unresolved SEC staff comments.

SEC rules mandated by the Sarbanes-Oxley Act of 2002 require additional disclosures on Form 10-K. The most significant of these is the obligation to include a report of the Managing Owner's management on the effectiveness of internal control over financial reporting of the Futures-Based ETF. Assuming that the Futures-Based ETF becomes a public company in 2011, the requirement to include an internal control report will first apply to the Futures-Based ETF's Form 10-K for the year ending December 31, 2012. The Futures-Based ETF's registered public accounting firm must include an audit report on the effectiveness of the Futures-Based ETF's internal control over financial reporting in the Futures-Based ETF's second Form 10-K filing.

FINRA's Role in Regulating Futures-Based ETFs

FINRA is "the largest independent regulator for all securities firms doing business in the United States. FINRA's mission is to protect . . . investors by making sure the securities industry operates fairly and honestly."¹⁹⁵ Analogous to the NFA, which regulates the CPO and not the Futures-Based ETF, FINRA regulates the FINRA members that are involved with the Futures-Based ETF, not the Futures-Based ETF itself. The full breadth of FINRA's regulations is beyond the scope of this outline, which only addresses the FINRA rules that most directly affect the public offering of Futures-Based ETFs. FINRA primarily regulates the participation of FINRA members in public offerings of securities through FINRA Rule 5110, the Corporate Financing Rule. FINRA Rule 2310 provides guidance on members' ability to participate in public offerings of securities of direct par-

ticipation programs. Finally, NASD Rule 2210 governs FINRA members' communications with the public.

Corporate Financing Rule

In relevant part, Rule 5110 governs underwriting terms and arrangements by establishing FINRA filing requirements, compensation requirements and standards for the valuation of compensation. Rule 5110 prohibits a FINRA member from participating in an offering unless certain documents¹⁹⁶ have been filed with and reviewed by FINRA's Corporate Financing Department and FINRA has issued an opinion that it has no objections to its members participating in the proposed underwriting or its terms and arrangements.¹⁹⁷ This "no objections" opinion is essential because the SEC will not declare the Futures-Based ETF's Registration Statement effective until it has received confirmation that FINRA has "no objections." Further, if FINRA determines that any of the terms and arrangements in connection with the distribution are unfair or unreasonable, no FINRA member or associated person may participate in the offering.¹⁹⁸ Furthermore, all forms of pre- and post-offering compensation must be disclosed in the Prospectus.¹⁹⁹ Finally, no FINRA member or associated person may make payments using non-cash forms of compensation.²⁰⁰ However, Rule 5110 sets forth a number of exceptions, generally involving offering-related training events and arrangements hosted by an issuer or in-house within the broker-dealer.²⁰¹

Direct Participation Programs

Direct participation programs include programs that provide for *flow-through tax* consequences, such as those provided by the statutory trust structure of the Futures-Based ETF. Rule 2310 regulates FINRA members who participate in the offering of the shares of a Futures-Based ETF. Under Rule 2310, no FINRA member or person associated with a member may participate in any manner in any public offering of securities of a "direct participation program," unless such program has established standards of suitability for participants and such standards are fully dis-

closed in the Prospectus.²⁰² There is an exemption for exchange listed companies, such as Futures-Based ETFs, pursuant to Rule 2310(b)(2)(d). Because Futures-Based ETFs are listed on national stock exchanges, certain of the suitability requirements of Rule 2310 do not apply to the offering of Futures-Based ETF shares by FINRA members. Additionally, Futures-Based ETF operators and FINRA members must ensure that the items of value, as defined in Rule 5110,²⁰³ will not exceed 10% of the offering proceeds. No sales of securities subject to Rule 2310 may commence unless (i) certain required documents and information have been filed and reviewed by FINRA pursuant to Rule 5110 and (ii) FINRA has provided a "no objections" letter.

Communications with the Public

NASD Rule 2210 governs FINRA members' communications with the public. All FINRA member's communications with the public must be "fair and balanced" and must provide a "sound basis for evaluating the facts in regard to any particular security" without predicting or projecting performance.²⁰⁴

At least ten business days prior to first use or publication, FINRA members must file any advertisements or sales literature concerning public direct participation programs such as the offering of shares by Futures-Based ETFs for review and clearance by FINRA.²⁰⁵

NASAA Guidelines for Public Commodity Pools

The North American Securities Administrators Association ("NASAA") is a voluntary association that furthers the efforts of state securities agencies responsible for efficient capital formation.²⁰⁶ Securities or transactions, including those of public commodity pools,²⁰⁷ that fall within the enumerated NASAA statements of policy published by NASAA must meet the requirements contained in those statements, as enacted by various state regulators pursuant to the state securities or "Blue Sky" laws.²⁰⁸ Although NASAA has specific guidelines for public commodity pools,

Futures-Based ETFs are not subject to the public commodity pool guidelines due to federal preemption of Blue Sky laws afforded certain investment products that are listed on national securities exchanges. This is a significant advantage that Futures-Based ETFs have over non-exchange listed public commodity pools.

IV. The Interplay Between Different Regulators

The successful launch of a Futures-Based ETF is dependent on all regulators clearing the Registration Statement. Although this may appear to be a fairly straightforward concept, an understanding of what actions are permissible under one regulatory regime but prohibited under another (*e.g.*, using preliminary Prospectuses) is essential.

Filings and Fees

Filing fees can be a significant organizational expense and the Futures-Based ETF sponsor is well advised to carefully determine the market potential for the Futures-Based ETF in connection with planning the registration process. The SEC and FINRA impose a fee on the dollar amount of shares being registered. Fortunately, the NFA review does not increase the cost of registration, as the NFA does not assess any fees in connection with reviewing the Disclosure Document. There are also legal, accounting, printing, back office and other costs.

Ongoing Operations

After a successful launch of a Futures-Based ETF, the managing owner will have a number of ongoing operational and compliance related responsibilities. While certain duties are subject to overlapping regulations, other duties are required by each specific regulatory regime. For example, the NFA has adopted a number of ongoing reporting obligations that overlap with, and are satisfied by the compliance with, the SEC's requirements. However, there are a number of differences in the ongoing obligations required by the regulators which must be kept in mind by the practitioners and Futures-

Based ETF operators, such as, the monthly reports required by the NFA, the differences in the quarterly and annual reports required by the NFA and the SEC, the NFA requirements for fund performance information and the SEC's requirement that audited financials included within a prospectus be no more than 16 months old.

V. Conclusion

As noted at the beginning of this outline, ETFs were first created in 1992. During the 18-year span from 1992 to 2009, the aggregate assets under management in the ETF sector expanded to approximately \$776 billion. Prior to February 2006, the Futures-Based ETF market did not exist. As of the end of 2009, aggregate assets under management in the Futures-Based ETF sector were approximately \$74 billion.²⁰⁹ After approximately four years, the Futures-Based ETF sector accounts for approximately 9.5% of the ETF market.

Accordingly, as Futures-Based ETFs continue to innovate and evolve, regulatory requirements should be expected to develop in response to the real and perceived impact of these products, positive and negative, on both the financial markets and the investing public.

NOTES

- 1 The authors practice in the Investment Funds, Advisers and Derivatives group of the New York office of Sidley Austin LLP. The views expressed in this outline are those of the authors. The authors acknowledge the dedication and assistance of Michael S. Yadgar. The authors would also like to thank Michael J. Schmidtberger, John A. MacKinnon, James C. Munsell, Michael S. Sackheim, Howard G. Godwin, Michael Hyatte, Benjamin L. Nager, Raynard O. Jones and Edward J. Ferraro, Esq.
- 2 In contrast to Futures-Based ETFs, certain ETFs take actual delivery of physical commodities and therefore are not "commodity pools" that are regulated by the CFTC under the Commodity Exchange Act (CEA).
- 3 Futures-Based ETFs commenced with the offering of PowerShares DB Commodity Index Tracking Fund (formerly DB Commodity Index Tracking Fund) on February 3, 2006. See PowerShares DB Commodity Index Tracking Fund, Annual Report (Form 10-K), at 1 (Feb. 28, 2011) available at <http://sec.gov/Archives/edgar/>

- data/1328237/000119312511049988/d10k.htm. "[C]ommodities exchange-traded products [, which] are one of the fastest-growing 'alternative' sectors of the exchange-traded marketplace, [swelled] . . . to \$73.7 billion in total assets in 2009." *In Focus: Commodity ETFs*, Index Universe, available at <http://www.indexuniverse.com/etf-education-center/7532-in-focus-commodity-etfs.html>.
- 4 See generally W. Thomas Conner, *Fundamentals of Mutual Funds and Exchange Traded Funds 2011 - The Evolving Nature of Exchange Traded Product Regulation*, 1890 PLI/Corp at 191. ("By one estimate, since the first ETF was introduced in 1992, assets grew to \$433 billion by year-end 2006. It took the U.S. mutual fund industry from 1924 to 1984 to grow to this level of assets. By year-end 2009, the number of ETFs and other exchange-traded vehicles . . . had grown to 914 and total assets had grown to \$794 billion (a significant increase from the year-end 2008 total of \$543 billion in ETF assets), and as of November 2010, U.S. ETFs and other exchange-traded vehicles were on track to hit \$1 trillion in assets around the end of 2010." *Id.*) See also James T. Holter, *FuturesMag.com, ETF Guide: A Rising Tide*, available at <http://www.futuresmag.com/Issues/2011/March-2011/Pages/ETF-GUIDE-Arising-tide.aspx>.
- 5 William A. Birdthistle, *The Fortunes and Foibles of Exchange Traded Funds: A Positive Market Response to Mutual Funds*, 33 DEL. J. CORP. L. 72 (2008).
- 6 "Forward pricing" means that a mutual fund is only capable of calculating the price of the shares at the net asset value as of the close of business on the listed shares' exchange. Consequently, all purchase and sale orders received throughout the business day prior to the close of business on the listed shares' exchange are valued at the same NAV determined at the close of business on the listed shares' exchange.
- 7 See Conner, *supra* note 4, at 191. See also Birdthistle, *supra* note 5, at 77.
- 8 See generally Birdthistle, *supra* note 5, at 87.
- 9 See generally Joseph A. Riley, A.J. Alex Gelinas and Deanna Flores, *Taxation of Exchange-Traded Funds and Similar Products*, 7 J. OF TAXATION OF FINANCIAL PRODUCTS 47, at 50 (2008). See also William M. Humphries, *Leveraged ETFs: The Trojan Horse Has Passed the Margin-Rule Gates*, 34 Seattle Univ. L. R. 299, 304 (Fall 2010). ("[...] ETFs are traded like stock, providing the investor with flexibility. Unlike mutual funds, which are purchased for the price of the fund at the close of the previous day (net asset value), ETFs are priced and traded continuously. The price is based on the market value of the underlying index of the ETF. In addition, they can be bought on margin, sold short, or held for long periods.").
- 10 See Peter N. Hall, *Bucking the Trend: The Unsupportability of Index Provider's Imposition of Licensing Fees for Unlisted Trading of Exchange Traded Funds*, 57 VAND. L. REV. 1125, 1126 (2004). ETFs were initially organized as Unit Investment Trusts (UIT), but UITs were unable to use portfolio sampling strategies and were restricted to investing on a full replication basis. This limitation, led ETF sponsors to abandon the UIT form when structuring ETFs, particularly, Futures-Based ETFs.
- 11 See Hall, *supra* note 10, at 1126-27. See Riley, Gelinas and Flores, *supra* note 9, at 48. ("The ETF structure was initially developed for index funds seeking to track the performance of a particular stock index, such as the S&P 500 index."). See generally Humphries, *supra* note 9 at 302-04.
- 12 See Riley, Gelinas and Flores, *supra* note 9, at 48. ("The ETF structure was initially developed for index funds seeking to track the performance of a particular stock index, such as the S&P 500 index."). See generally Humphries, *supra* note 9 at 302-04.
- 13 Ira P. Shapiro, *An Introduction to U.S. ETFs*, in *Practicing Law Inst., Nuts & Bolts of Fin. Products 2008* 357, 361 (2008). See also U.S. Securities and Exchange Commission, *Closed-End Funds*, available at <http://www.sec.gov/answers/mfclose.htm> (detailing the structure of closed-end funds and their intra-day trading).
- 14 Stuart M. Strauss, *Financial Product Fundamentals: Law - Business - Compliance Chapter 16, Exchange Traded Funds* in *Practicing Law Institute* (2006).
- 15 See Riley, Gelinas and Flores, *supra* note 9, at 48. ("[C]losed end funds typically trade at a discount to net asset value. Under the ETF structure, the market price of the exchange-traded shares is designed to closely follow the net asset value of the fund.").
- 16 Ignacio Griego, CPA and Adam Lenford, CPA, *The Evolution of the ETF*, WALL STREET ARGUS, THE FINANCIAL SERVICES NEWSLETTER OF ROTHSTEN KASS (December 2010).
- 17 *Id.*
- 18 "Alternative investments" are investments that differ from the traditional investments such as stocks and bonds, and may include, for example, commodity pools, hedge funds and private equity.
- 19 *PowerShares DB Commodity Index Tracking Fund (Prospectus) (Jan. 3, 2011)*, available at <http://dbfunds.db.com/dbc/index.aspx> (last visited Sept. 23, 2011).
- 20 Michael Sackheim, Michael Schmidtberger and James Munsell, *DB Commodity Index Tracking Fund: An Innovative Exchange-Traded Fund*, FUTURES INDUSTRY MAGAZINE, 34 (May-June 2006).
- 21 The specific index tracked by DBC is the DBIQ Optimum Yield Diversified Commodity Index Excess Return. *PowerShares DB Commodity Index Tracking Fund (Prospectus)*, *supra* note 19, at 3-4. Currently, the 14 commodities that make up the index are Light Sweet Crude Oil (WTI), Heating Oil, RBOB Gasoline, Natural Gas, Brent Crude, Gold, Silver, Aluminum, Zinc, Copper Grade A, Corn, Wheat, Soybeans, and Sugar. *Id.* at 4.
- 22 See Sackheim, Schmidtberger and Munsell, *supra* note 20, at 34.
- 23 Shares in traditional public commodity pools typically are issued and are redeemable monthly at NAV. A commodity pool that is listed on a

- securities exchange in the United States (e.g., a Futures-Based ETF) generally is regulated by the same rules as a traditional public commodity pool, subject to the exceptions illustrated in this outline.
- 24 Exchange Traded Funds, Securities Act Release No. 8901, Investment Company Act Release No. 28,193, 2008 SEC LEXIS 548, n.4 (proposed Mar. 18, 2011).
- 25 "Prior to the launch of DB Commodity Index Tracking Fund, investors wishing to diversify into the commodities markets without purchasing and storing physical commodities had several options. They could trade on their own in commodity futures contracts, or retain a commodity trading advisor to manage their commodity futures trading, or become a participant with limited liability in a private or public commodity pool that buys and sells commodity futures contracts. They could also invest in the securities of companies involved in the production or refinement of commodities, in mutual funds that acquire the securities of such companies, or in other securities linked to commodities." See Sackheim, Schmidtberger and Munsell, *supra* note 20, at 34.
- 26 *Id.* at 36.
- 27 *NFA's Role in the U.S. Futures Industry, Who We Are*, NATIONAL FUTURES ASSOCIATION, <http://www.nfa.futures.org/NFA-about-nfa/who-we-are/NFAs-role-US-futures-INDUSTRY.html> (last visited Sept. 23, 2011).
- 28 See e.g., PowerShares DB US Dollar Index Trust (Registration Statement on Form S-3)(File No. 333-136574) available at <http://www.sec.gov/Archives/edgar/data/1371531/000119312509248589/ds3.htm> with respect to both PowerShares DB US Dollar Index Bullish Fund and PowerShares DB US Dollar Index Bearish Fund.
- 29 See e.g., United States Oil Fund, LP (Registration Statement on Form S-3) (File No. 333-57823) available at <http://www.sec.gov/Archives/edgar/data/1327068/000114420409032814/0001144204-09-032814-index.htm>.
- 30 See e.g., SPDR® Gold Trust (Registration Statement on Form S-3) (File No. 333-167132) available at <http://www.sec.gov/Archives/edgar/data/1222333/000095012310053663/y03452sv3asr.htm>, iShares® Silver Trust (Registration Statement on Form S-3) (File No. 333-173755), available at <http://www.sec.gov/Archives/edgar/data/1330568/000119312511112321/ds3asr.htm>.
- 31 However, a number of ETFs are actively managed. Bear Stearns launched the first actively managed ETF. See Murray Coleman, *Bear Stearns Launches First Ever Active ETF* (March 25, 2008), available at <http://seekingalpha.com/article/69871-bear-stearns-launches-first-ever-active-etf>. A number of advisors sponsor actively managed ETFs. See Michael Johnston, *Complete List of Active ETFs* available at <http://etfdb.com/2011/complete-list-of-active-etfs/> (last visited Sept. 23, 2011).
- 32 "Because of the manner in which ETFs are formed and function, investors gain attractive benefits. First, ETFs generally have lower costs than mutual funds because they are traditionally passively managed, meaning the only changes made in an ETF's portfolio are to adjust it to assure the portfolio matches the underlying index [...]. Generally, ETFs are not actively traded like a mutual fund trying to gain the highest return for investors. ETFs do not try to outperform the index, but rather seek to mirror it. The reduced trading frequency and volume characteristics of ETFs allow for lower transaction and administrative costs, while also reducing the amount of potential capital-gain distributions." Humphries, *supra* note 9, at 302.
- 33 *Id.* at 304.
- 34 See Chris Flood, *iShares launches swap-based ETFs*, (Sept. 19, 2010), available at <http://www.ft.com/cms/s/0/0be1160c-c27f-11df-956e-00144feab49a.html>.
- 35 See generally Birdthistle, *supra* note 5, at 76-81.
- 36 See generally ETfdb, available at <http://etfdb.com/type/commodity/all/> (last visited Sept. 23, 2011) and ETfdb, available at <http://etfdb.com/etfdb-category/currency/> (last visited Sept. 23, 2011). (Although these lists include a number of Futures-Based ETFs, these lists also include, for example and as applicable, exchange traded products that invest in the underlying physicals and exchange traded notes.)
- 37 Investors cannot actually invest in an index. Rather, investors may invest in a security or derivative of such security, such as a share of a Futures-Based ETF, that attempts to track an index as closely as possible. Index funds were a natural progression in the evolution of the mutual fund industry. "Unlike actively managed funds, an index fund does not try [, for example,] to pick the best stocks. Rather, the goal of an index fund is to mimic the performance of a major index such as the S & P 500 or the Russell 2000. Index funds advertise that they provide adequate investment performance at low cost, which results in superior total returns for investors. The theory behind index funds is that since the fund will mimic a cross section of the market, the investor will still profit from the general market performance. In addition, the manager, who must merely mimic an index, need not spend a lot of money on research and can be paid less than the counterpart in an actively managed fund. Furthermore, an index fund will ordinarily have a lower turnover rate. Hence, the expense ratio will ordinarily be lower in an index fund than in an actively managed fund. Index fund enthusiasts argue that the investor will have superior total earnings." Shimon B. Edelstein, *Indexing Capital Gains for Inflation: The Impacts of Recent Inflation Trends, Mutual Fund Financial Intermediation, and Information Technology*, 65 BROOKLYN L. REV. 783, 811-812 (1999).

38	DICTIONARY OF FINANCE AND INVESTMENT TERMS 326 (7 th ed. 2010).	investopedia.com/terms/t/total_return_index.asp (last visited Sept. 23, 2011).
39	"To protect futures markets from excessive speculation that can cause unreasonable or unwarranted price fluctuations, the Commodity Exchange Act (CEA) authorizes the Commission to impose limits on the size of speculative positions in futures markets. Core Principle 5, of Section 5(d) of the CEA, requires designated contract markets to adopt speculative position limits or position accountability for speculators, where necessary and appropriate, to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month. There are three basic elements to the regulatory framework for speculative position limits. They are: the size (or levels) of the limits themselves; the exemptions from the limits (for example, hedged positions); and the policy on aggregating accounts for purposes of applying the limits." U.S. COMMODITY FUTURES TRADING COMMISSION, <i>CFTC Glossary, Speculative Limits</i> , available at http://www.cftc.gov/IndustryOversight/MarketSurveillance/SpeculativeLimits/index.htm (last visited Sept. 23, 2011). See generally 17 C.F.R. § 150.	43 "For an index fund, it is important to avoid incurring transaction costs that would handicap the fund's ability to mirror the performance of the index. Traditionally, therefore, index funds had been organized as closed-end funds to avoid transaction costs resulting from inflows and outflows of investor monies....But closed-end funds typically trade at a discount to net asset value. Under the ETF structure, the market price of the exchange-traded shares is designed to closely follow the net asset value of the fund." See Riley, Gelinas and Flores, <i>supra</i> note 9, at 48. 44 See PowerShares DB Base Metals Fund, Annual Report (Form 10-K), at 26 (Feb. 29, 2011) available at http://sec.gov/Archives/edgar/data/1367305/000119312510049970/d10k.htm . 45 According to the CFTC Glossary, a futures contract is "an agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) that obligates each party to the contract to fulfill the contract at the specified price; (3) that is used to assume or shift price risk; and (4) that may be satisfied by delivery or offset." See U.S. COMMODITY FUTURES TRADING COMMISSION, <i>CFTC Glossary, Futures Contract</i> , available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_f.html#futurescontract (last visited Sept. 23, 2011).
40	According to the CFTC Glossary, margin is the "amount of money or collateral deposited by a customer with his broker, by a broker with a clearing member, or by a clearing member with a clearing organization. The margin is not partial payment on a purchase. Also called Performance Bond. (1) Initial margin is the amount of margin required by the broker when a futures position is opened; (2) Maintenance margin is an amount that must be maintained on deposit at all times. If the equity in a customer's account drops to or below the level of maintenance margin because of adverse price movement, the broker must issue a margin call to restore the customer's equity to the initial level...Exchanges specify levels of initial margin and maintenance margin for each futures contract, but futures commission merchants may require their customers to post margin at higher levels than those specified by the exchange." See U.S. COMMODITY FUTURES TRADING COMMISSION, <i>CFTC Glossary, Commodity Pool Operator</i> , http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_m.html#margin (last visited Sept. 23, 2011).	46 CEA § 4(a) indicates that one is not permitted to trade in unlisted futures contracts. This section states that, unless exempted by the CFTC, it is unlawful for any person to enter into a contract for the purchase or sale of a commodity for future delivery, unless the transaction is: (1) conducted on or subject to the rules of a board of trade that has been designated or registered by the CFTC as a contract market . . . ; (2) the contract is executed through a contract market; and (3) the contract is evidenced by a written record. See <i>In re Stovall</i> , et al., COMM. FUT. L. REP. (CCH) 20,941 (Dec. 6, 1979).
41	See generally 7 USC § 6d.	47 "In contrast to traditional mutual fund redemptions, ETF investors purchase shares in the secondary market from an authorized participant (AP), rather than the fund. An AP is essentially a broker or dealer with a standing inventory of shares in the fund. The AP acquires and redeems large blocks of fund shares (typically 50,000 shares), called 'creation units,' in transactions with the fund. The AP acquires creation units in exchange for a basket of securities published by the fund called the 'creation basket.' APs typically acquire and exchange securities for creation units on the same trading day." Riley, Gelinas and Flores, <i>supra</i> note 9, at 48. See generally Hall, <i>supra</i> note 10 at 1127.
42	An Index's TR version may more accurately represent the result of certain market sectors than an ER version of the Index because the TR version of the Index assumes reinvestment of any distributions or a risk free component, as applicable (e.g., by assuming reinvestment of a dividend, a TR version of an Index accounts "for stocks in an index that do not issue dividends and instead reinvest their earnings within the underlying company.") See generally INVESTOPEDIA available at http://www .	48 See Conner, <i>supra</i> note 4, at 194. 49 <i>Id.</i> 50 <i>Id.</i>

- 51 Investors who are not Authorized Participants may only transact in shares of an ETF through an Authorized Participant. Although the following language describes securities based ETFs, the concepts are equally applicable in the Futures-Based ETF context. “. . . ETFs[, including Futures-Based ETFs, for example,] are different than open-ended mutual funds, such as index funds. ETFs do not sell directly to investors. They issue shares in large blocks called “Creation Units” which they exchange for a basket of securities that generally reflect the securities in the ETFs. The large blocks are typically sold to institutions, which sell shares in the secondary market. ETFs do not provide liquidity through redemption of shares like a mutual fund. To redeem shares, an investor sells in the secondary market or sells the Creation Units back to the ETFs in exchange for securities underlying the asset. Because shares are not redeemable as in a fund, ETFs cannot call themselves mutual funds. However, they are a vehicle for investing in diversified stock portfolios, to date have provided equivalent liquidity, and thus generally compete directly with indexed mutual funds.” John C. Coates IV and R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 IOWA J. CORP. L. 151, 164 at n.57 (Fall 2007).
- 52 See Actively Managed Exchange-Traded Funds, Exchange Act Release No. IC-25258, 17 C.F.R. § 270 (Nov. 8, 2001), available at <http://www.sec.gov/rules/concept/ic-25258.htm>. (“Because of arbitrage opportunities inherent in the ETF structure, ETF shares generally have not traded in the secondary market at a significant premium or discount in relation to NAV. If ETF shares begin to trade at a discount (i.e., a price less than NAV), arbitrageurs may purchase ETF shares in the secondary market and, after accumulating enough shares to equal a Creation Unit, redeem them from the ETF at NAV, and thereby acquire the more-valuable securities in the Redemption Basket. In purchasing the ETF shares, arbitrageurs create greater market demand for the shares, which may raise the market price to a level closer to NAV. If ETF shares trade at a premium (i.e., a price greater than NAV), arbitrageurs may purchase the securities . . . [required to purchase one or more Creation Units], use them to obtain the more-valuable Creation Units from the ETF and then sell the individual ETF shares in the secondary market to realize their profit. As the supply of individual ETF shares available in the secondary market increases, the price of the ETF shares may fall to levels closer to NAV. An exchange specialist designated to maintain a market in the ETF shares also works to provide appropriate amounts of shares in the secondary market in response to supply and demand.”).
- 53 See Conner, *supra* note 4, at 205.
- 54 PowerShares DB Commodity Index Tracking Fund (Prospectus), *supra* note 4, at 50.
- 55 See generally Coates and Hubbard, *supra* note 51, at 164 n.57.
- 56 An Authorized Participant typically must represent that it will not place a request to redeem a Basket unless it first ascertained that (i) it or its customer, as the case may be, owns outright or has full legal authority and legal and beneficial right to tender for redemption the Baskets to be redeemed, (ii) it is entitled to receive the entire proceeds of the redemption, and (iii) such Baskets have not been loaned or pledged to another party and are not the subject of a repurchase agreement, securities lending agreement or any other arrangement which would preclude the delivery of such Baskets to the Futures-Based ETF on the business day following the date when the order is placed.
- 57 PowerShares DB Commodity Index Tracking Fund (Prospectus), *supra* note 19, at 51.
- 58 See Actively Managed Exchange-Traded Funds, *supra* note 52 (Noting that ETFs provide investors with the ability to “purchase and sell ETF shares in the secondary market at a known price anytime during the trading day, to purchase ETF shares on margin, and to sell ETF shares short.”).
- 59 Because mutual funds process the purchases and redemptions of every investor, higher mutual fund expenses are borne by the investors, which does not occur for ETFs. Individual investors should expect to be charged a customary commission by their brokers in connection with purchases and sales of ETF shares.
- 60 As a condition to listing, the exchange on which a Futures-Based ETF is listed requires that the Futures-Based ETF disclose an approximation of the current value of the Futures-Based ETF’s basket on a per share basis, typically at 15 second intervals, throughout the trading day and disseminates the current value of the index.
- 61 See for example, the Registration Statements for PowerShares DB Commodity Index Tracking Fund (Registration Statement on Post-Effective Amendment No. 2 to Form S-3) (File No. 333-158733) available at <http://www.sec.gov/Archives/edgar/data/1328237/000119312511000129/dposar.htm>; PowerShares DB G10 Currency Harvest Fund (Registration Statement on Form S-3) (File No. 333-132484) available at <http://www.sec.gov/Archives/edgar/data/1354730/000119312510264248/ds3.htm>; FactorShares 2X: S&P500 Bull/TBond Bear (Registration Statement on Form S-1) (File No. 333-164754) available at <http://www.sec.gov/Archives/edgar/data/1482875/000089109211000342/e41616s1a.htm>; FactorShares 2X:TBond Bull/S&P500 Bear (Registration Statement on Form S-1) (File No. 333-164758) available at <http://www.sec.gov/Archives/edgar/data/1482878/000089109211000345/e41619s1a.htm>; FactorShares 2X: S&P500 Bull/USD Bear (Registration Statement on Form S-1) (File No. 333-164757), FactorShares 2X:

<p>Oil Bull/S&P500 Bear (Registration Statement on Form S-1) (File No. 333-164756) available at http://www.sec.gov/Archives/edgar/data/1482877/000089109211000344/e41618s1a.htm; and FactorShares 2X: Gold Bull/S&P500 Bear (Registration Statement on Form S-1) (File No. 333-164755) available at http://www.sec.gov/Archives/edgar/data/1482879/000089109211000346/e41620s1a.htm.</p>	<p>69</p> <p>70</p> <p>71</p>	<p>Company Act Release No. 10,937, 1979 SEC LEXIS 340, at text following n. 26).</p> <p><i>Id.</i></p> <p>In re Tonopah Mining Co. of Nev., 26 S.E.C. 426, 426-27 (Jul. 22, 1947).</p> <p>FSLR-Selected Releases (1940 - 1972), SEC-DOCKET 45-47 CCH Dec., FSLR 75,805, Investment Company Act Release No. 1084, In the Matter of The Tonopah Mining Company of Nevada (Jul. 22, 1947), Securities and Exchange Commission, (Jul. 22, 1947).</p>
<p>62 See generally PowerShares DB Multi-Sector Commodity Trust (Registration Statement on Form S-3) (File No. 333-135422) available at http://www.sec.gov/Archives/edgar/data/1367305/000119312509246082/ds3.htm and PowerShares DB US Dollar Index Trust (Registration Statement on Form S-3) (File No. 333-136574) available at http://www.sec.gov/Archives/edgar/data/1371531/000119312509248589/ds3.htm.</p>	<p>72</p>	<p>Tonopah, <i>supra</i> note 70, at 427. Although the courts and the SEC have not expressly articulated the theory underlying these five factors, it appears the analysis is intended to determine what a reasonable investor would perceive as the nature of the issuer's business. See Sydney H. Mendelsohn, Mark B. Goldfus and Mark J. Mackey, <i>Status Seeking: Resolving the Status of Inadvertent Investment Companies</i>, 38 BUS. LAW. 193, 200-201 (1982) (analyzing several cases decided by the courts and the SEC, including Tonopah Mining). The second factor (the issuer's public representations of policy) is important in ascertaining whether investors invested based on an expectation of gain from securities activities. Edmund H. Kerr, <i>The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act</i>, 12 STAN. L. REV. 29, 53 (1959).</p>
<p>63 Laurin Blumenthal Kleiman and Carla G. Teodoro, <i>Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations</i>, 1890 PLI/Corp at 76.</p>	<p>64</p>	<p>Peavey Commodity Futures Funds, I, II, III, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2576, 8 (June 2, 1983).</p>
<p>64 An additional part of the historic development of the use of the statutory trust for the formation of Futures-Based ETFs was due to certain limitations of the unit investment trust structure. Unlike unit investment trusts which are prohibited from holding a representative sample of the index they are tracking, statutory trusts allow a fund to hold a sampling of the instruments underlying the index, creating additional flexibility for the managing owner. See Daniel J. Grimm, <i>A Process of Natural Correction: Arbitrage and the Regulation of Exchange-Traded Funds Under the Investment Company Act</i>, 11 U. PA. J. BUS. & EMPL. L., 95, 109 (Fall, 2008).</p>	<p>65</p> <p>66</p> <p>67</p>	<p>73</p> <p>74</p> <p>75</p> <p>76</p> <p>77</p> <p>78</p> <p>79</p> <p>80</p>
<p>65 Futures-Based ETF sponsors may (clearly) express their intention of not being classified as an investment company by including a clause in the constituent document of the Futures-Based ETF that would automatically terminate the Futures-Based ETF should it be required to register as an investment company.</p>	<p>66</p> <p>67</p>	<p>See <i>Managed Futures Association</i>, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 623 (July 5, 1996). ("In our view, therefore, a commodity pool's primary business should be deemed to be investing or trading in commodity interests if (1) the pool looks primarily to commodity interests as its principal intended source of gains, (2) the pool anticipates that commodity interests present the primary risk of loss, and (3) the pool's historical development, public representations of policy (in its prospectus or offering circular and in marketing materials) and the activities of those charged with management of the pool demonstrate that the pool's primary business is investing or trading in commodity interests, rather than securities." <i>Id.</i>)</p>
<p>66 15 U.S.C. § 80a-3(a)(1).</p>	<p>67</p>	<p>Peavey, <i>supra</i> note 73, at 8.</p>
<p>67 Even under section 3(a)(1)(C), which apparently adopts a statistical test for when a company is deemed to be an "investment company," the question of whether the company is "primarily engaged" in investment company business remains important. This is because sections 3(b)(1) and 3(b)(2) of the '40 Act establish exemptions where, even when the statistical test is met, the issuer will not be deemed an "investment company" if it is "primarily engaged" in a non-investment company business. See 15 U.S.C. §§ 80a-3(b)(1)-(2).</p>	<p>68</p>	<p>Rule 405 under the '33 Act defines the term promoter to include, in relevant part:</p> <p>"Any person who, acting alone or in conjunction with one or more other persons, directly or indi-</p>
<p>68 Certain Prima Facie Investment Companies, Investment Company Act Release No. 11,551, 1981 SEC LEXIS 2277, n.9 (Jan. 14, 1981) (citing Certain Prima Facie Investment Companies, Investment</p>	<p>81</p> <p>82</p>	<p>Company Act Release No. 11,551, 1981 SEC LEXIS 2277, n.9 (Jan. 14, 1981) (citing Certain Prima Facie Investment Companies, Investment</p>

- rectly takes initiative in founding and organizing the business or enterprise of an issuer; or
- Any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of such securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.”
- 83 See generally PowerShares DB Multi-Sector Commodity Trust (Registration Statement on Form S-3) (File No. 333-135422) available at <http://www.sec.gov/Archives/edgar/data/1367305/000119312509246082/ds3.htm> and PowerShares DB US Dollar Index Trust (Registration Statement on Form S-3) (File No. 333-136574) available at <http://www.sec.gov/Archives/edgar/data/1371531/000119312509248589/ds3.htm>.
- 84 NATIONAL FUTURES ASSOCIATION, *Commodity Pool Operator*, available at <http://www.nfa.futures.org/nfa-registration/cpo/index.html> (last visited Sept. 23, 2011).
- 85 *Id.*
- 86 U.S. COMMODITY FUTURES TRADING COMMISSION, *CFTC Glossary, Commodity Pool Operator*, available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_co.html (last visited Sept. 23, 2011).
- 87 U.S. COMMODITY FUTURES TRADING COMMISSION, *CFTC Glossary, Commodity Trading Advisor*, available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_co.html (last visited Sept. 23, 2011).
- 88 See e.g., PowerShares DB Commodity Index Tracking Fund, (Prospectus), *supra* note 19, at 6.
- 89 *Id.* at 7.
- 90 *Id.* See also FactorShares Funds (Prospectus) (Feb. 22, 2011), at 16.
- 91 U.S. COMMODITY FUTURES TRADING COMMISSION, *CFTC Glossary, Give Up*, available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_g.html (last visited Sept. 23, 2011). (“Give Up: A contract executed by one broker for the client of another broker that the client orders to be turned over to the second broker. The broker accepting the order from the customer collects a fee from the carrying broker for the use of the facilities. Often used to consolidate many small orders or to disperse large ones.”)
- 92 See generally NATIONAL FUTURES ASSOCIATION, <http://www.nfa.futures.org/NFA-registration/fcm/index.HTML> (last visited Sept. 23, 2011).
- 93 U.S. COMMODITY FUTURES TRADING COMMISSION, *CFTC Glossary, Futures Commission Merchant*, available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_f.html (last visited Sept. 23, 2011). See 7 U.S.C. § 1a(20).
- 94 PowerShares DB Commodity Index Tracking Fund (Prospectus), *supra* note 19, at 7.
- 95 See e.g., *Id.* at 8.
- 96 See e.g., FactorShares Funds (Prospectus), *supra* note 90 at 17.
- 97 *Id.* at 105.
- 98 *Id.*
- 99 PowerShares DB Commodity Index Tracking Fund (Prospectus), *supra* note 19, at 65-66. FactorShares Funds (Prospectus), *supra* note 90 at 105, 110-11.
- 100 See U.S. SECURITIES AND EXCHANGE COMMISSION, *Investor Information, Transfer Agents*, available at <http://www.sec.gov/answers/transferagent.htm> (last visited Sept. 23, 2011).
- 101 See PowerShares DB Multi-Sector Commodity Trust (Prospectus) (Jan. 3, 2011), available at <http://dbfunds.db.com/dbc/index.aspx> (last visited Sept. 23, 2011).
- 102 PowerShares DB Commodity Index Tracking Fund, Annual Report (Form 10-K), *supra* note 3 at 1-4.
- 103 *Id.* at 28.
- 104 See generally Birdthistle, *supra* note 5, at 84. (“Every potential investor in SPDRs knows that the ETF is attempting to replicate the performance and price of the S&P 500 stocks and can evaluate the performance of the ETF on those terms.”) Although Birdthistle’s statement applies to the SPDRs ETF, his statement is equally applicable in the Futures-Based ETF context.
- 105 The (former) Initial Purchaser may continue in a similar role on an ongoing basis if it chooses to act as an authorized participant.
- 106 See generally FactorShares Funds (Prospectus), *supra* note 90, at 91.
- 107 See section II.B.2 of Actively Managed Exchange-Traded Funds, *supra* note 51.
- 108 See generally FactorShares Funds (Prospectus), *supra* note 90, at 122-23. See also Griego, *supra* note 16. (“The authorized participants [may] ... act as market makers who then work with [and/or serve as] broker dealers or registered investment advisers to make shares available to investors for purchase or sale on the secondary market.”)
- 109 FactorShares Funds (Prospectus), *supra* note 90, at 123.
- 110 Except as more fully explained in this article, under Regulation M, distribution participants (e.g., the Initial Purchaser and the Authorized Participants) are prohibited from certain market activities at specified times during a distribution. See generally FactorShares Funds (Prospectus), *supra* note 90, at 122-23.
- 111 See generally 17 C.F.R. 4.1-4.41.

- 112 See 7 U.S.C. § 1a(4) (defining the term “commodity” as including “wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs... Irish potatoes, wool, wool tops, fats and oils...cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions... and all services, rights and interests...in which contracts for future delivery are presently or in the future dealt in.”)
- 113 *Id.*
- 114 17 C.F.R. § 1.3(yy) (defining the term “Commodity interest”).
- 115 7 U.S.C. § 1a(10).
- 116 See 7 U.S.C. § 1a(5) (defining the term “commodity pool operator” as meaning “any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility, except that the term does not include such persons not within the intent of the definition of the term as the Commission may specify by rule, regulation, or order.”)
- 117 NFA MANUAL: NFA’S FUNCTIONS EXPLAINED: NFA IN BRIEF, available at <http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=1001&Section=1> (last visited Sept. 23, 2011).
- 118 See U.S. COMMODITY FUTURES TRADING COMMISSION, *Mission & Responsibilities*, available at <http://www.cftc.gov/About/MissionResponsibilities/index.htm> (last visited Sept. 23, 2011).
- 119 See generally 17 C.F.R. § 4.
- 120 *Id.*
- 121 NFA Manual, *supra* note 117.
- 122 See 7 U.S.C. § 21 (“Registered futures associations”).
- 123 The NFA plays a role in the commodities sector that is analogous to FINRA’s role in the broker-dealer/securities sector.
- 124 NFA Manual, *supra* note 117.
- 125 See generally NFA Manual, *supra* note 117. See also NATIONAL FUTURES ASSOCIATION, NFA COMPLIANCE RULES, available at <http://www.nfa.futures.org/nfaManual/NFAManual.aspx?Section=4> (last visited Sept. 23, 2011).
- 126 NATIONAL FUTURES ASSOCIATION, NFA COMPLIANCE RULES, available at <http://www.nfa.futures.org/nfaManual/NFAManual.aspx?Section=4> (last visited Sept. 23, 2011).
- 127 See *In re Stovall*, *supra* note 46 (defining the basic elements of a futures contract).
- 128 *Id.* at n. 13. (For example, in *Stovall*, “...on May 4, 1972, Vernon L. Henrichs contracted to buy and *Stovall* to sell 36,000 pounds of #3 frozen pork bellies to be delivered between July 1 and August 6, 1972. This commodity was never delivered. Rather, on May 5, 1972, Henrichs contracted to sell and *Stovall* to buy an identical quantity of #3 pork bellies to be delivered during the same period. The matching and opposite obligations coupled with the payment of the cash differential between the contract prices, ‘offset’ each other, cancelling both contracts.”)
- 129 See FEDERAL RESERVE SYSTEM, *Trading and Capital-Markets Activities Manual: Commodity-linked Transactions* at 3 (Feb. 1998), available at http://www.federalreserve.gov/boarddocs/supmanual/trading/trad_p4.pdf (last visited Sept. 23, 2011).
- 130 *Id.*
- 131 As of September 26, 2011, the CFTC was still considering changes to certain rules in accordance with the proposed rule change issued in January 2011, which included speculative positions limits and account aggregation. See generally *Position Limits for Derivatives*, 76 Fed. Reg. 4,752 (Jan. 26, 2011).
- 132 See generally *U.S. Commodity Futures Trading Commission, Futures Commission Merchant*, available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_f.html (last visited Sept. 23, 2011); See also *FactorShares Funds* (Prospectus), *supra* note 90, at Part II.
- 133 *PowerShares DB Commodity Index Tracking Fund* (Prospectus), *supra* note 19, at 87. Historically, the CFTC has imposed speculative position limits only on agricultural futures. Pursuant to the Dodd-Frank Act, the CFTC has proposed to impose speculative position limits in metals, agricultural and energy futures and economically equivalent swaps. However, there is no equivalent mandate in respect of financial futures. According to the CFTC Glossary, speculative position limit means “[t]he maximum position, either net long or net short, in one commodity future (or option) or in all futures (or options) of one commodity combined that may be held or controlled by one person (other than a person eligible for a hedge exemption) as prescribed by an exchange and/or by the CFTC.” See U.S. COMMODITY FUTURES TRADING COMMISSION, *CFTC Glossary, Speculative Position Limit*, available at http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_s.html (last visited Sept. 23, 2011).
- 134 *PowerShares DB Commodity Index Tracking Fund* (Prospectus), *supra* note 19, at 87.
- 135 *Id.*
- 136 *FactorShares Funds* (Prospectus), *supra* note 90, at 168.
- 137 *Id.*

- 138 NFA, *supra* note 84. See also Sidley Austin LLP, *Investment Funds, Advisers and Derivatives Update*, (Feb. 23, 2011), available at http://www.sidley.com/files/News/cf9c42ff-dba6-46f7-bf0d-63e8dbdda72c/Presentation/NewsAttachment/39dc0910-bbab-40b2-99fb-3a8eeca7df74/Investment_Funds_Advisers_and_Derivatives_Update_02-23-2011.pdf.
- 139 See 17 C.F.R. § 3.1(a) (defining the term "Principal").
- 140 See 7 U.S.C. § 6(k)(2).
- 141 7 U.S.C. § 6n(2).
- 142 17 C.F.R. § 3.31.
- 143 See generally 17 C.F.R. § 4. See generally NATIONAL FUTURES ASSOCIATION, *Compliance*, available at <http://www.nfa.futures.org/NFA-compliance/index.HTML> (last visited Sept. 23, 2011).
- 144 See 17 C.F.R. §§ 4.24 and 4.25.
- 145 The review period associated with the filing of a Disclosure Document may range from several days to longer than a year in the case of an IPO.
- 146 17 C.F.R. § 4.26(d).
- 147 Note that, prior to first use, the Registration Statement (containing the Disclosure Document) must clear the NFA, SEC and FINRA.
- 148 See generally Charles J. Johnson, Jr. and Joseph McLaughlin, *Corporate Finance and the Securities Laws, Fourth Edition*, § 1.05[C][2][d].
- 149 See generally 17 C.F.R. 4.1-4.41.
- 150 Prior to the adoption of Rule 4.12(c), it was necessary for Futures-Based ETF operators to request certain exemptive relief from the CFTC. The CFTC Division of Clearing and Intermediary Oversight consistently granted relief to Futures-Based ETF operators from CFTC Rules 4.21, 4.22 and 4.23. See Sackheim, Schmidtberger and Munsell, *supra* note 20, at 36-37. Managing Owners of Futures-Based ETFs have been granted relief from: (i) the requirement of Rule 4.21(b) "to obtain a signed acknowledgment of receipt of a disclosure document [(i.e., the prospectus)] prior to accepting subscription funds from prospective [commodity] pool participants with respect to sales of shares by authorized participants when authorized participants create baskets," (ii) from the requirement of Rule 4.22 to deliver monthly account statements to purchasers of shares, and (iii) the requirement of Rule 4.23 to keep required books and records at the commodity pool operator's main business office. *Id.* In addition, the CFTC has previously recognized that a CPO of a Futures-Based ETF is "not required to provide a disclosure document to a person purchasing an interest in the [commodity] pool in connection with secondary market trading of the [commodity] pool's shares, subject to the requirement that the CPO did not solicit the purchase." *Id.* Note that with respect to item (i), the exemption from CFTC Rule 4.21(b) "is expressly conditioned on the information required in the disclosure document being maintained and kept current on the...[internet, including on the websites of the exchange, the SEC, and the ETF]." *Id.* This requirement has been codified by the adoption of Rule 4.12(c).
- 151 Commodity Pool Operators: Relief From Compliance With Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools, Final Rule, 76 Fed. Reg. 28,641, 28,643 (May 18, 2011) [hereinafter *Commodity Pool Operators*].
- 152 In addition, as part of the same final rule, the CFTC added paragraph (a)(5) to Rule 4.13. This paragraph, subject to certain conditions, exempts from commodity pool operator registration an independent director or trustee of a Commodity ETF, where that person was required to serve as a director or trustee solely for purposes of constituting and maintaining the audit committee required for actively-managed public companies (including actively-managed Commodity ETFs) under provisions of the Sarbanes-Oxley Act of 2002. *Id.* at 28,645.
- 153 Performance of Certain Functions by National Futures Association With Respect to Commodity Pool Operators, Commodity Futures Trading Commission Notice and Order, 76 Fed. Reg. 28,755 (May 18, 2011).
- 154 17 C.F.R. § 4.21(a)(1).
- 155 17 C.F.R. § 4.21(b).
- 156 The CPO's obligation to deliver a Disclosure Document (and the requirement to obtain a signed acknowledgment of receipt) extends to the direct purchaser of units of participation, and not to persons who purchase from that purchaser. In this regard, the CFTC has stated that, with respect to the transfer of a participation unit in a commodity pool, the CPO of the pool "is not required to provide a Disclosure Document (Rule 4.21) to a person who purchases a unit of participation or interest in the pool from a pool participant if the pool operator did not solicit the purchase." *Commodity Pool Operators and Commodity Trading Advisors; Interpretation of Rules*, 44 Fed. Reg. 25,658, 25,659 (May 2, 1979). The CPO's obligation to deliver a Disclosure Document (and the requirement to obtain a signed acknowledgment of receipt) extends to the direct purchaser of units of participation (e.g., the Authorized Participant), and not to persons who purchase from that purchaser. *Id.*
- 157 This requirement has been codified by the adoption of Rule 4.12(c).
- 158 See generally NATIONAL FUTURES ASSOCIATION, *FINANCIAL REQUIREMENTS*, available at <http://www.nfa.futures.org/nfa-compliance/NFA-commodity-pool-operators/cpo-financial-requirements.HTML> (last visited Sept. 23, 2011).
- 159 17 C.F.R. § 4.22(c).
- 160 17 C.F.R. § 4.22(d).
- 161 17 C.F.R. § 4.22(h).

- 162 Commodity Pool Operators, *supra* note 151, at 28,643.
- 163 For information regarding quarterly reports on Form 10-Q, see section "SEC's Role in Regulating Futures-Based ETFs – Reporting Obligations."
- 164 17 C.F.R. § 4.23.
- 165 *Id.* Shareholders may inspect the books and records during normal business hours or they may request to have the records mailed to them if reasonable reproduction and distribution costs are paid by the shareholder. *Id.*
- 166 *Id.*
- 167 Commodity Pool Operators, *supra* note 151, at 28,643.
- 168 See *generally* 17 C.F.R. § 4.24.
- 169 *Id.*
- 170 See *generally* 17 C.F.R. § 4.25.
- 171 *Id.*
- 172 See 17 C.F.R. § 240.10b-5.
- 173 See 15 U.S.C. § 77e.
- 174 See *generally* Johnson and McLaughlin, *supra* note 148, § 1.05[C][2][d].
- 175 See *generally* 17 C.F.R. § 4.26.
- 176 See also sections "Regulation of Futures-Based ETFs – CFTC's and NFA's Role in Regulating Futures-Based ETFs – Disclosure Document – CFTC Part 4 Rules" and "Regulation of Futures-Based ETFs – FINRA's Role in Regulating Futures-Based ETFs – Corporate Financing Rule" regarding clearing each of the NFA and FINRA, respectively.
- 177 See 15 U.S.C. § 781(b).
- 178 See e.g., NYSE, Listed Company Manual, available at <http://nysemanual.nyse.com/lcm/> (last visited Sept. 23, 2011).
- 179 See Conner, *supra* note 4, at 215-16.
- 180 *Id.* Different companies have different listing standards that are, in part, developed in response to the type of company. For example, Futures-Based ETFs are "not subject to the same compliance and governance requirements that apply to listed issuers organized as corporations or limited liability companies." *Id.* Because of the passive nature of Futures-Based ETFs (i.e., statutory trusts), they are "not required to have a majority of independent directors on their board of directors or have a nominating and compensation committees." *Id.*
- 181 *Id.* The listed company manuals of all major exchanges have well-developed guidelines applicable to these plain vanilla securities. *Id.*
- 182 The exchange files the proposed rule change with the SEC's Division of Trading and Markets. The SEC publishes the notice and invites all interested persons to submit written data, views, and arguments concerning the proposed rule change, including whether the proposed rule change is consistent with the '34 Act. See *generally* Conner, *supra* note 4, at 215-16.
- 183 Managing owners should note that the 19b-4 process may be relatively slow depending upon the novelty, complexity and the underlying instruments invested in by the Futures-Based ETF.
- The SEC, in its sole discretion, may designate a longer period to review the application (and may institute proceedings to determine whether the proposed rule change should be disapproved) if it finds such longer period to be appropriate. For example, if a proposed Futures-Based ETF will employ leverage and is structured to potentially invest in over-the-counter instruments, the review process may become relatively lengthy.
- 184 See *generally* 17 C.F.R. § 4.26.
- 185 See 15 U.S.C. § 77e.
- 186 See 17 C.F.R. § 230.405.
- 187 See 17 C.F.R. §§ 242.100–242.105.
- 188 See 17 C.F.R. § 242.100.
- 189 17 C.F.R. § 242.101.
- 190 See The American Stock Exchange, SEC No-Action Letter (Aug. 17, 2001) available at <http://www.sec.gov/divisions/marketreg/mr-noaction/etifclassrelief081701-msr.pdf>.
- 191 See *generally* Conner, *supra* note 4, at 213-14.
- 192 See 15 U.S.C. § 78m (d).
- 193 See 15 U.S.C. § 78p (a).
- 194 See Select Sector SPDR Trust, SEC No-Action Letter (May 6, 1999). See PDR Services Corporation, SEC No-Action Letter (Dec. 14, 1998).
- 195 See *generally* FINRA, *About FINRA*, available at <http://www.finra.org/AboutFINRA/> (last visited Sept. 23, 2011).
- 196 These documents include the registration statement and any documents used to offer securities to the public, any document that describes the underwriting or the terms and conditions of other arrangements made in connection with the distribution, any amendments to the registration statement or offering documents, and the final registration statement as declared effective by the SEC and a list of the members of the underwriting syndicate. See FINRA Rule 5110(b)(5).
- 197 Norman S. Poser and James A. Fanto, BROKER-DEALER LAW AND REGULATION, § 13.07(A) FINRA Regulation of Offerings.
- 198 *Id.* See also FINRA Rule 5110(c).
- 199 Poser and Fanto, *supra* note 197, at § 13.07(A). See also FINRA Rule (c)(2).
- 200 FINRA Rule 5110(h).
- 201 Poser and Fanto, *supra* note 197, at § 13.07(A). See also FINRA Rule 5110(h)(2).
- 202 The suitability standards require that a FINRA member must have reasonable grounds to believe that the participant is or will be in a financial position that will enable him to realize the benefits described in a prospectus to a significant extent, the participant has a fair market net worth sufficient to sustain the risks inherent in the program, and that the program is otherwise suitable for the participant.
- 203 FINRA Rule 5110(c)(3)(A).
- 204 NASD Rule 2210(d)(1).
- 205 NASD Rule 2210(c)(9).
- 206 See NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, *About NASAA*,

- available at http://www.nasaa.org/About_NASAA/ (last visited Sept. 23, 2011).
- 207 See NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, *NASAA Commodity Pool Guidelines*, available at www.nasaa.org/content/Files/Registration_of_Commodity_Pool_Programs.pdf (last visited Sept. 23, 2011).
- 208 See ARIZONA CORPORATION COMMISSION, *Raising Capital: Overview Of Registration of, and Exemptions From Registration for, Securities Offerings* (August 2010), available at http://www.azinvestor.gov/ImportantTopics/Raising_Capital.pdf (last visited Sept. 23, 2011).
- 209 ETF assets rose 45% in 2009, MarketWatch, available at <http://blogs.marketwatch.com/etfblog/2010/01/11/etf-assets-rose-45-in-2009/> (last visited Sept. 23, 2011). “[C]ommodities exchange-traded products [, which] are one of the fastest-growing “alternative” sectors of the exchange-traded marketplace, [swelled] . . . to \$73.7 billion in total assets in 2009.” In Focus: Commodity ETFs, Index Universe, available at <http://www.indexuniverse.com/etf-education-center/7532-in-focus-commodity-etfs.html> (last visited Sept. 23, 2011).