A PRIMER ON EXCHANGE-TRADED FUNDS

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Exchange-traded funds, commonly referred to as ETFs, are a type of exchange-traded investment product that must register with the U.S. Securities and Exchange Commission (SEC) under the federal Investment Company Act of 1940 as either an open-end investment company (generally known as “funds”) or as a unit investment trust. Another way to understand ETFs is to think of them as similar to funds that are purchased and sold on an exchange much like stocks. They are typically designed to track indexes: there are ETFs that track the major stock indexes, as well as commodities, real estate stocks and bonds. In recent years, ETFs have grown in popularity as an investment choice for many insurers. This article will define ETFs and discuss their structural characteristics, evolution and current statutory accounting and reporting treatment.

**LEGAL FORM AND REGULATION**

*New Type of Investment Company*

Most ETFs are formed as open-end companies, although some have been formed as unit investment trusts. An open-end company issues redeemable shares and holds itself out as willing to sell such shares as investors request them. By contrast a closed-end company sells a fixed amount of non-redeemable shares that trade at negotiated market prices on an exchange while a unit investment trust holds a fixed unmanaged portfolio of stocks, bonds or other assets to maturity. So, ETFs can be said to have characteristics in common with both open-end and closed-end companies.

A better way to say this is to say ETFs are a new kind of investment company that do not precisely fit the legal, organizational or regulatory pattern that has developed for investment companies such as mutual funds. In fact, today, all ETFs operate pursuant to the terms and conditions of exemptive orders granted by the SEC.

*Exemptive Order*

Exemptive orders are necessary because ETF investment characteristics do not conform to the expectation expressed in the provisions and rules promulgated under the Investment Company Act. For example, an open-end company must issue redeemable securities (Section 5(a) (1)) that must be redeemed in seven calendar days following tender (Section 22(e)) at a price that does not vary substantially from its proportionate share of the issuer’s current net asset value. In fact, today, all ETFs operate pursuant to the terms and conditions of exemptive orders granted by the SEC.

ETFs limit redemptions to creation units, not ETF shares, and the price at which a share trades on an exchange is set by negotiation. Redemption of creation units is in kind, and settlement may be longer than seven calendar days because it is contingent on delivery cycles in markets for foreign securities. There are a number of other statutory provisions and rules that do not apply as written to ETFs, from which exemptions are sought and routinely granted.

*Market Evolution*

In the 1970s, when money market funds were first introduced, the SEC permitted money market funds to operate on the basis of exemptions from the statutory provisions and rules otherwise applicable to mutual funds. The exemptions gradually evolved into a distinct regulatory paradigm for money market funds. The same is occurring with ETFs. While the SEC has traditionally granted exemptive orders to permit the operation of specific ETFs, it has proposed a new rule to regularize the treatment of ETFs by permanently exempting them from certain provisions of the Investment Company Act and applicable rules, thereby eliminating the exemptive order process.²

**STRUCTURAL CHARACTERISTICS**

*The Investment*

To invest in an ETF, one deposits a “purchase basket” of the securities and assets identified by the fund and takes in exchange a “creation unit,” typically consisting of 25,000 ETF shares. As an alternative, an investor could buy ETF shares on the exchange on which it is listed in any amount up to or in excess of those needed to form a creation unit. The owner of an ETF share has an undivided interest in the portfolio of assets held by the ETF. ETFs can own and provide an exposure to a wide range of industries, market sectors and assets. The investor can exit its position by selling ETF shares in the secondary market for cash. Alternatively, if the investor wants to get back a portfolio of securities and assets, it collects ETF shares equal to a creation unit and redeems the creation unit to the ETF sponsor in exchange for a redemption basket of securities and assets.

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1 ETFs based on commodities are not regulated by the SEC, they are regulated by the Commodities Future Trading Commission.

2 Securities and Exchange Commission - 17 CFR Parts 239, 270, and 274; Release Nos. 33-8901; IC-28193; File No. 57-07-08, RIN 3235-AJ60 - Exchange-Traded Funds.
Index or Actively Managed; Replication or Sampling
The ETF’s portfolio can be actively managed or based on an index. An actively managed ETF functions like any traditional actively managed mutual fund, where an investment advisor selects securities consistent with the ETF’s investment objectives and policies. In an index approach, the portfolio is compiled on the basis of criteria specific to the index; for example, criteria such as dividends and core earnings. The index-based ETFs may replicate the index, meaning the ETF invests in the component securities of the index in about the same proportions as exists in the index. Alternatively, it may use a representative sampling strategy, meaning the ETF designs a portfolio that reflects the underlying index’s capitalization, industry, and fundamental investment characteristics and then acquires a subset of the component securities of the underlying index (and possibly securities not in the index) to help it track the performance of the index.

Arbitrage, Pricing, Transparency and Liquidity
The market price of ETF shares trade near the NAV per share of the ETF. Many commentators attribute this to the arbitrage opportunities ETFs create and the ability to buy and redeem creation units at each day’s NAV. If ETF shares begin to trade below the fund’s NAV per share, investors can purchase ETF shares on the exchange until they have a creation unit and redeem the creation unit from the ETF for the more valuable securities in the ETF’s redemption basket. In this scenario, share purchases drive up share prices closer to NAV.

Similarly, if the price for ETF shares is greater than the NAV per share of the ETF itself, an investor can deposit a basket of securities in exchange for the more valuable creation unit of ETF shares and then sell the individual shares in the market to realize its profit. In this scenario, increasing the supply of ETF shares in the market drives down the price of the ETF shares to a level closer to the NAV of the ETF share. This arbitrage mechanism is aided by the transparency of the ETF’s portfolio. Each day, the ETF sponsor publishes the securities in the purchase and redemption baskets. The exchange will disclose an approximation of the current value of the basket on a per share basis (the “intraday value”) at 15-second intervals throughout the day and, for index-based ETFs, disseminates the current value of the relevant index.

• Current Statutory Accounting and Reporting and Expected Future Discussions
The statutory accounting and reporting of an ETF currently depends on the ETF’s classification within the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

• Bond Treatment: If the NAIC Securities Valuation Office (SVO) concludes that an ETF should be classified as a debt instrument, the SVO will include the name of the ETF on the List of Exchange Traded Funds Eligible for Reporting as a Schedule D Bond (the “ETF Bond List”). ETFs included on this listing are captured within Statement of Statutory Accounting Principles (SSAP) No. 26—Bonds, Excluding Loan-Backed and Structured Securities and reported on Schedule D, Part 1. SSAP No. 26 prescribes an amortized cost measurement. For ETFs, this measurement method, and other elements captured within Schedule D, Part 1 (e.g., par value, interest rate, effective rate of interest and stated contractual maturity date) has caused confusion and inconsistencies in statutory accounting and reporting, because ETFs do not amortize or have these characteristics. The annual financial statement instructions identify the use of original cost for measurement, but this measurement method does not portray a current view of the investment value. Furthermore, under the statutory hierarchy detailed in the Preamble of the Accounting Practices and Procedures Manual, the guidance within the SSAPs (level 1 of the hierarchy) overrule the guidance in the annual financial statement instructions (level 3 of the hierarchy).

• Preferred Stock Treatment: If the SVO concludes an ETF should be classified as a preferred stock instrument, the SVO will include the name of the ETF on the List of Exchange Traded Funds Eligible for Reporting as a Schedule D Preferred Stock (the “ETF Preferred-Stock List”). ETFs included on this list are captured within SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled or affiliated entities) and reported on Schedule D, Part 2, Section 1. SSAP No. 32 prescribes measurement methods depending on whether the investment is considered a redeemable preferred stock or perpetual preferred stock. As such, the measurement method of the ETF under SSAP No. 32 would depend on the type of preferred stocks within the ETF. The possible measurement methods under SSAP No. 32 include cost, amortized cost or fair value or the lower of cost, amortized cost or fair value. Similar to the discussion above for when ETFs qualify for bond reporting treatment, not all of the Schedule D, Part 2, Section 1 columns and measurement methods for preferred stock are suitable for ETF investments.

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• **Common Stock Treatment**: ETFs that do not qualify for bond or preferred stock treatment and, therefore, do not appear on either list, are reported as common stock under SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities). SSAP No. 30 prescribes a fair value measurement, with reporting on Schedule D, Part 2, Section 2.

• **Expected Future Discussions**: The Statutory Accounting Principles (E) Working Group has a current project (agenda item #2013-36) to review the definitions and scope of the investment SSAPs. This project was originally undertaken as a result of various issues, including, but not limited to:

1. Lack of definitions for types of investments and when definitions are included, variations between statutory accounting definitions and capital-market usage, Financial Accounting Standards Board (FASB) or SEC definitions.

2. Allowing “look-through” accounting for certain types of investments of insurers, with specific inclusion of items in the bond or equity SSAPs (e.g., certain mutual funds and ETFs) that do not meet the SSAP definition, and the reporting of such items in the investment schedules.

3. Inconsistencies regarding the reporting of items within Schedule D and Schedule BA (e.g., bonds, ETFs, loans, debt obligations of partnerships/joint ventures and different forms of mutual funds).

4. Different treatment for some investments by type of insurer (e.g., life and fraternal insurers have specific instructions for Schedule BA investments with underlying characteristics of bonds or preferred stock). During the 2014 Summer National Meeting, the Statutory Accounting Principles (E) Working Group exposed for a public comment, period ending Oct. 17, 2014, a memorandum with proposed discussion topics and suggested prioritization for the investment classification project. As noted within that exposed document, one of the suggested requirements for SSAP No. 26 investments is to require a “contractual amount of principle due.” If this requirement is implemented, all ETF’s (and other mutual funds that had qualified for bond treatment) would be eliminated from SSAP No. 26. This proposal suggests consideration for specific accounting and reporting for all funds, which would involve a collective review for investments in open-end investment companies (mutual funds), closed-end investment companies, unit investment trusts, ETFs, hedge funds and investments in “trust funds.” This proposal also suggests a new reporting schedule to separately capture these items; as such, ETFs (and other impacted “funds”) would no longer be grouped with bonds, preferred stocks or common stocks.

5. Regulators and interested parties interested in commenting on the current proposed discussion topics and suggested prioritization of the investment classification project can access the memorandum via the following link: www.naic.org/committees_e_app_sapwg.htm. Comments on the investment classification project should be directed to Julie Gann (NAIC) at jgann@naic.org.

**An Example of an ETF**

**iShares iBoxx $ Investment Grade Corporate Bond Fund (the “Fund”):** The Fund is actually one of more than 50 investment portfolios (each a “Fund” and, collectively, “the Funds”) of the iShares Trust. BlackRock Fund Advisors (BFA), a wholly-owned subsidiary of BlackRock Inc., is the advisor to the Fund. BlackRock, the world’s largest asset manager, manages more than 2,000 funds with approximately $4.3 trillion in assets under management as of Dec. 31, 2013, and tracks more than 250 global indexes. BFA uses a “passive” or indexing approach to try to achieve the Fund’s investment objective. An index is a group of securities that an index provider (in this case, Markit) selects as representative of a market, market segment or specific industry sector. It is important to distinguish the fact that an index is a theoretical financial calculation, while the Fund is an actual investment portfolio. BFA uses a representative sampling strategy to manage the Fund. Representative sampling, as the term suggests, is investing in a representative sample of bonds in the underlying index. This means that the Fund generally will not hold all of the bonds that are included in the underlying index.

However, BFA expects the correlation between the Fund’s performance and the index will be 95% or better. A figure of 100% would indicate perfect correlation. Any correlation of less than 100% is called “tracking error.” Unlike many investment companies, the Fund does not try to “beat” the markets it tracks and does not seek temporary defensive positions when markets decline or appear overvalued. Indexing may eliminate some of the risks of active manage-
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ment, such as poor bond selection. Indexing may also help increase after-tax performance by keeping portfolio turnover low in comparison to actively managed investment companies. On a monthly basis, an income distribution (representing net interest income earned on the Fund’s portfolio) will be paid by the Fund. On an annual basis, the Fund will distribute any net realized capital gains, which are likely to be de minimus. In general, the proceeds from the maturity of a bond are reinvested into the fund. For what are known, generally speaking, as “target date” bond funds, BFA will start with bonds with a set maturity (for example 2020) and will only buy bonds that mature on that date. Once such bonds mature, the respective funds close and then the proceeds from such matured bonds will be distributed to the investors of the fund.

Markit iBoxx® USD Liquid Investment Grade Index (the “Underlying Index”): The Underlying Index is a rules-based index consisting of liquid, U.S. dollar-denominated, investment-grade corporate bonds for sale in the United States, as determined by the index provider. The Underlying Index is designed to provide a broad representation of the U.S. dollar denominated liquid investment-grade corporate bond market. The Underlying Index is a modified market-value weighted index with a cap of 3% on each issuer. There is no limit to the number of issues in the Underlying Index, but, as of Dec. 31, 2013, the Underlying Index included approximately 1,152 constituents.

The Underlying Index may include large-, mid- or small-capitization companies, and components primarily include consumer services, financials, and oil and gas companies. The Underlying Index is a subset of the Markit iBoxx USD Corporate Bond Index, an index of more than 1,100 investment-grade bonds. Bonds in the Underlying Index are selected from the universe of eligible bonds in the Markit iBoxx USD Corporate Bond Index using defined rules.

Currently, the bonds eligible for inclusion in the Underlying Index include U.S. dollar-denominated corporate bonds that:

- Are issued by companies domiciled in countries classified as developed markets by the index provider.
- Are rated investment grade by Fitch Ratings, Inc., Moody’s Investors Services or Standard & Poor’s Ratings Services.
- Are from issuers with at least $2 billion outstanding face value.
- Have at least $750 million of outstanding face value.
- Have at least three years to maturity.

ABOUT THE AUTHORS

Robert Carcano is senior counsel at the NAIC Capital Markets and Investment Analysis Office. He provides legal, regulatory and analytical support to the Securities Valuation Office and the Structured Securities Group. He is a graduate of the Dickinson School of Law (J.D.), the Fordham University Graduate School of Arts and Science, (master’s degree in comparative politics), and Fordham University, Fordham College (bachelor’s degrees in history and political science). Before joining the NAIC in 1991, Carcano was a senior analyst in the Structured Finance Group of Moody’s Investors Service, where he performed legal and credit analysis of a variety of structured securities. Prior to his assignment with Moody’s, Carcano was with the boutique investment banking operation of the Financial Services Corporation of New York City, where he was engaged in asset-based financing, economic development lending and industrial development bond financing.

Kevin Driscoll joined the NAIC Securities Valuation Office in July 1993. As a senior analyst, he has responsibility for credit tenant loans, structured notes, principal-protected notes, replication (synthetic asset) transactions, exchange-traded funds and military housing transactions. He is a member of SVO Senior Credit Committee and has made educational presentations to the regulatory community.

Driscoll was formerly with the Office of the Comptroller of the Currency (OCC), serving as a credit examiner in the Northeast District for two years. In that capacity, he was responsible for the examination of nationally chartered community, regional and multinational banks’ loan portfolios. Prior to the OCC, Driscoll served in various credit functions for Chrysler Capital, Citicorp and the Irving Trust Company (now Bank of New York). He earned a bachelor’s degree and an MBA from Syracuse University.

Julie Gann is the senior manager of accounting and reporting in the NAIC Financial Regulatory Services Division. Since joining the NAIC in February 2001, her duties have included assisting with developing uniform and comprehensive guidance to statutory accounting principles, monitoring the development of the International Accounting Standards Board’s (IASB) International Financial Reporting Standards (IFRS), providing technical advisory services for statutory and generally accepted accounting principles (GAAP) accounting, researching and answering questions related to financial examination issues, and overseeing updates and maintenance to the Financial Condition Examiners Handbook. Gann earned bachelor’s degrees in accounting and business administration from William Jewell College. She is a certified public accountant (CPA), and has earned the designation of fellow, life management institute (FLMI); associate, insurance regulatory compliance (AIRC); and associate, reinsurer administration (ARA). She is also a member of the American Institute of Certified Public Accountants (AICPA) and the Missouri Society of CPAs (MSCPA).
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