
Exchange Traded Funds

Threat or Opportunity?

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Exchange Traded Funds

Threat or Opportunity?



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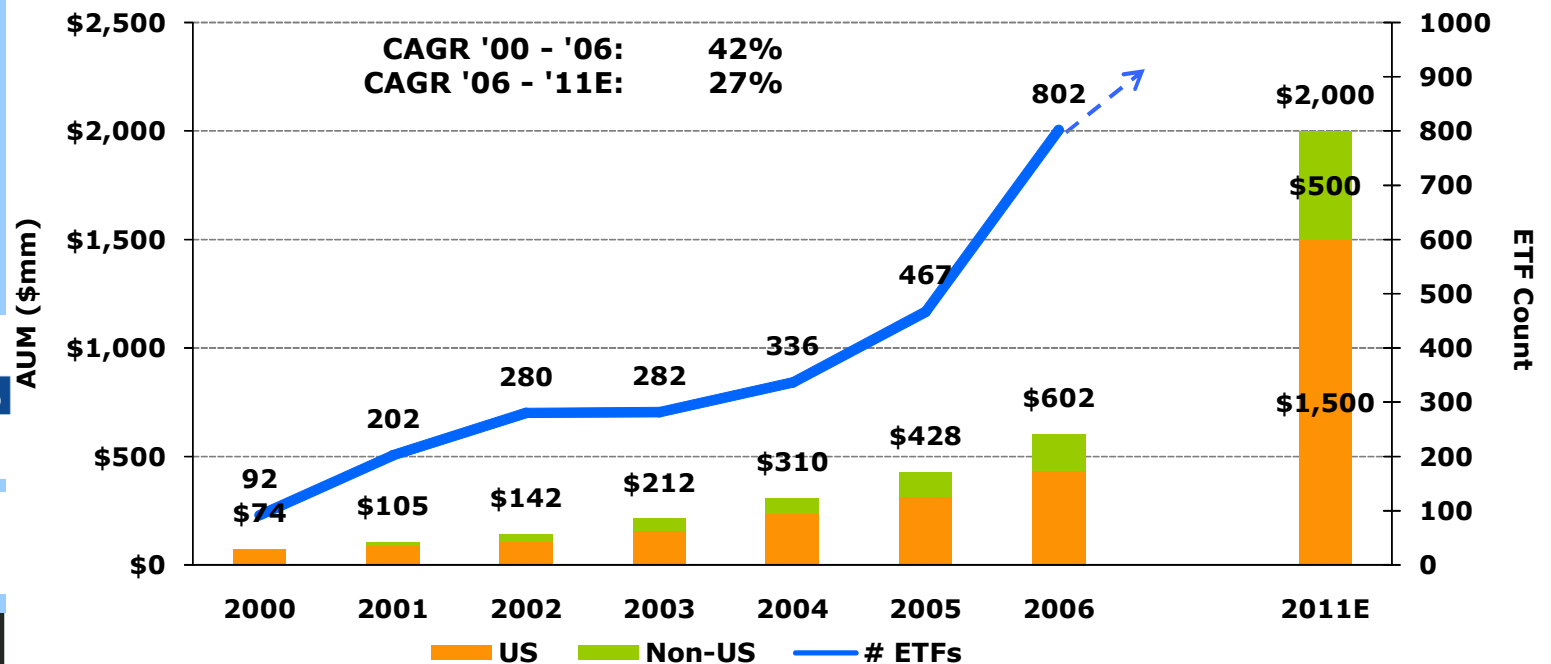
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Rapid Growth in the ETF Market

- ETF assets have grown at a significant rate in the last six years—at more than 40% annualized since 2000
- This growth is projected to continue at nearly 30% annualized through 2011
 - Only 64 ETF managers worldwide vs. 640 US mutual fund mgrs
 - More than 500 ETFs in registration; 80% set to launch in the US
 - Currently, all ETFs are indexed, with minimal DC market presence

Global ETF Assets and Fund Growth



Source: Morgan Stanley Research, Grail Partners

Note: includes UIT and closed-end products such as HOLDRS and exchange traded commodity and currency products



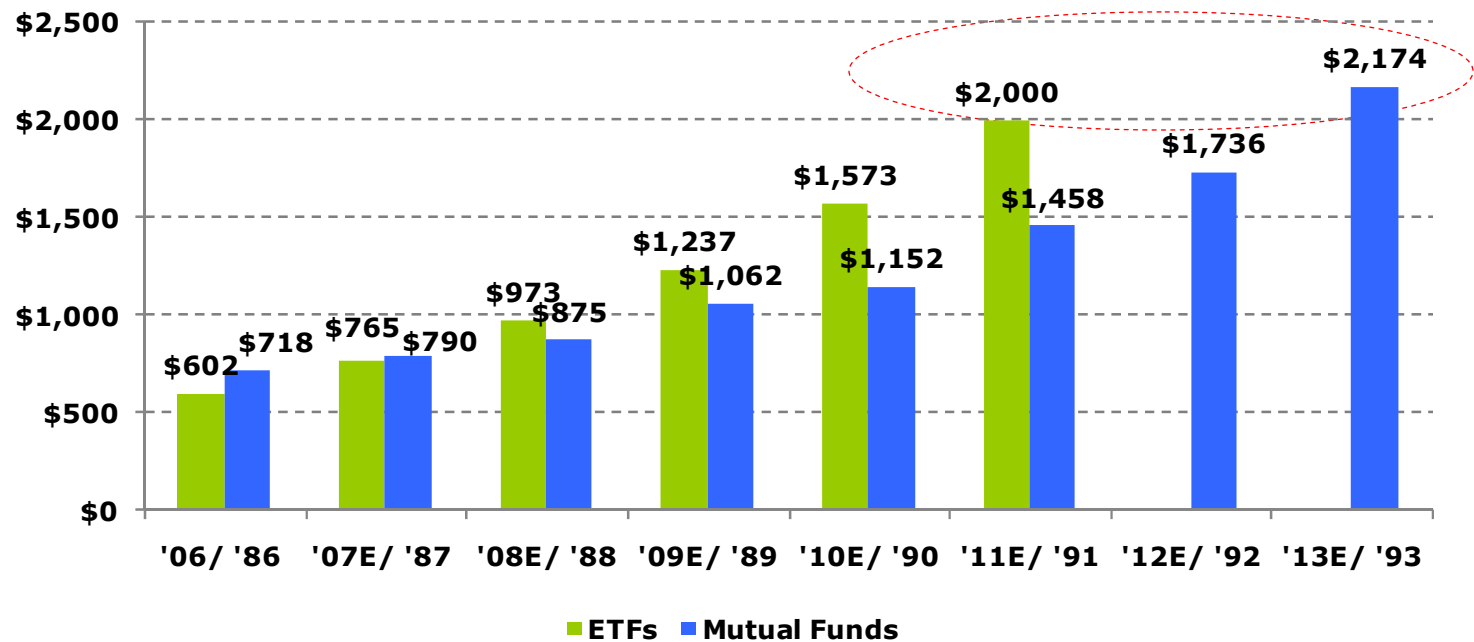
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Can ETFs reach \$2 trillion in by the end of 2011?

- At year end, ETFs should reach the AUM level of mutual funds in '87
 - From \$790 billion in '87, mutual funds took six years to crest \$2 tt
 - US economy experienced a major stock market crash (Black Monday '87) and five years of recession ('88 to '92)
 - The financial universe is bigger today—GDP \$6.5 tt ('87) vs. \$11.5 tt ('06)¹; US financial assets \$15 tt ('87) vs. \$52 tt ('06)²
- Can ETFs hit the goal by 2011 – you bet!
 - DC market and actively managed products to accelerate growth

ETF and Mutual Fund Assets



Source: Strategic Insight Simfund, Federal Reserve, Bureau of Economic Analysis, Grail Partners
 Notes: 1) in chained 2000 dollars; 2) includes Households, Non-Profit Organizations and Nonfinancial Businesses



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Structural Benefits of ETFs vs. Mutual Funds

- **Tax efficiency:** in-kind trading of fund shares between the authorized participant and the fund allows capital gains to be realized outside of the fund, and significantly reduces the fund's need to distribute gains
- **Low cost:** because an ETF is treated like an individual stock, transfer agency and other recordkeeping requirements are much lower than those of traditional mutual funds, allowing for reduced administrative costs
- **Investor protection/enhanced return:**
 - in-kind trading of ETF shares removes risk of harm from market timing
 - eliminates need to maintain cash to satisfy redemption requests
 - trading costs, which can often exceed 100 bps p.a., absorbed by transacting investor, not fund shareholders
- **Trading flexibility:** ETFs are traded like individual equities, allowing investors to short (without the up-tick rule) and buy on margin, as well as enabling options and derivatives to be based on the funds



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Investment Strategies Using ETFs

- **Cash equitization or sector exposure:** A portfolio manager can use an ETF to put excess cash to work in a broad market index, or alternatively seek exposure to niche themes without individual stock selection risk
 - ❑ SPDR S&P 500 ETF is most heavily traded
 - ❑ Niche categories like Precious Metals, Natural Resources and Europe Stock made top 10 ETF flows for 2006, but not in mutual fund top 10
- **Access to innovative indexing strategies:** The structural nature of ETFs favors fully-disclosed index strategies, resulting in the development of a range of new indexing strategies
 - ❑ Fundamental indexes weighting dividends, revenues, etc
 - ❑ Sector-specific approaches offering “concentrated diversification” in equity sectors (health care), commodities
- **Efficient tools for asset allocation implementation:** Products that imbed asset allocation—lifecycle funds, wrap fee accounts, etc.—are extremely popular among investors. ETFs offer low-cost, efficient instruments for implementing these strategies.
 - ❑ ETF wrap fee programs and funds-of-ETFs have proliferated; ETFs of ETFs are also on the horizon
 - ❑ Lifecycle strategies and other asset allocation offerings will be offered in ETFs directly as well



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Industry Competitors

- BGI and State Street control 80% of the US ETF market by assets
- New competitors are gathering assets at a rapid pace with more innovative index offerings

US ETF Asset by Sponsor

(\$billions)

<u>Sponsor</u>	<u>Brand Name</u>	<u>Funds</u>	<u>AUM</u>	<u>Launch</u>
1 Barclays	iShares, iPath ETN	124	\$252.08	2000
2 State Street	SPDRs, streetTRACKS	43	101.89	1993
3 Nasdaq/ BoNY	Cubes, BLDRS	6	27.17	2002
4 Vanguard	VIPERs	27	22.26	2004
5 Merrill Lynch	HOLDRS	17	10.08	1998
6 PowerShares	PowerShares	33	8.47	2002
7 Rydex	Rydex and Rydex Ultra	24	3.72	2003
8 ProFunds	ProShares	12	2.16	2006
9 WisdomTree	WisdomTree	30	1.52	2006
10 Deutsche Bank	PowerShares (Commodity)	2	0.84	2005
11 Victoria Bay	US Oil Fund	1	0.76	2006
12 Van Eck Funds	Market Vectors	10	0.70	2006
13 First Trust	First Trust	2	0.52	2005
14 Claymore	various	11	0.43	2006
15 Fidelity	Tracking Stock	1	0.13	2003
16 XShares	HealthShares	14	0.06	2007
		357	\$432.79	

Source: Morgan Stanley, Grail Partners

Note: This table does not reflect the impending transfer of ETFs from Nasdaq to PowerShares. Also, includes non-ETF exchange traded products, like HOLDRS, BLDRS. Data as of YE 2006; XShares data as of 3/07.



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Exchange Traded Funds

Structure and Regulatory Overview



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What Are ETFs

Q. What is an Exchange-Traded Fund (“ETF”)?

A. An EFT is (i) a registered open-end investment company, (ii) which operates as an index fund, (iii) that issues shares that are traded on a national securities exchange, and

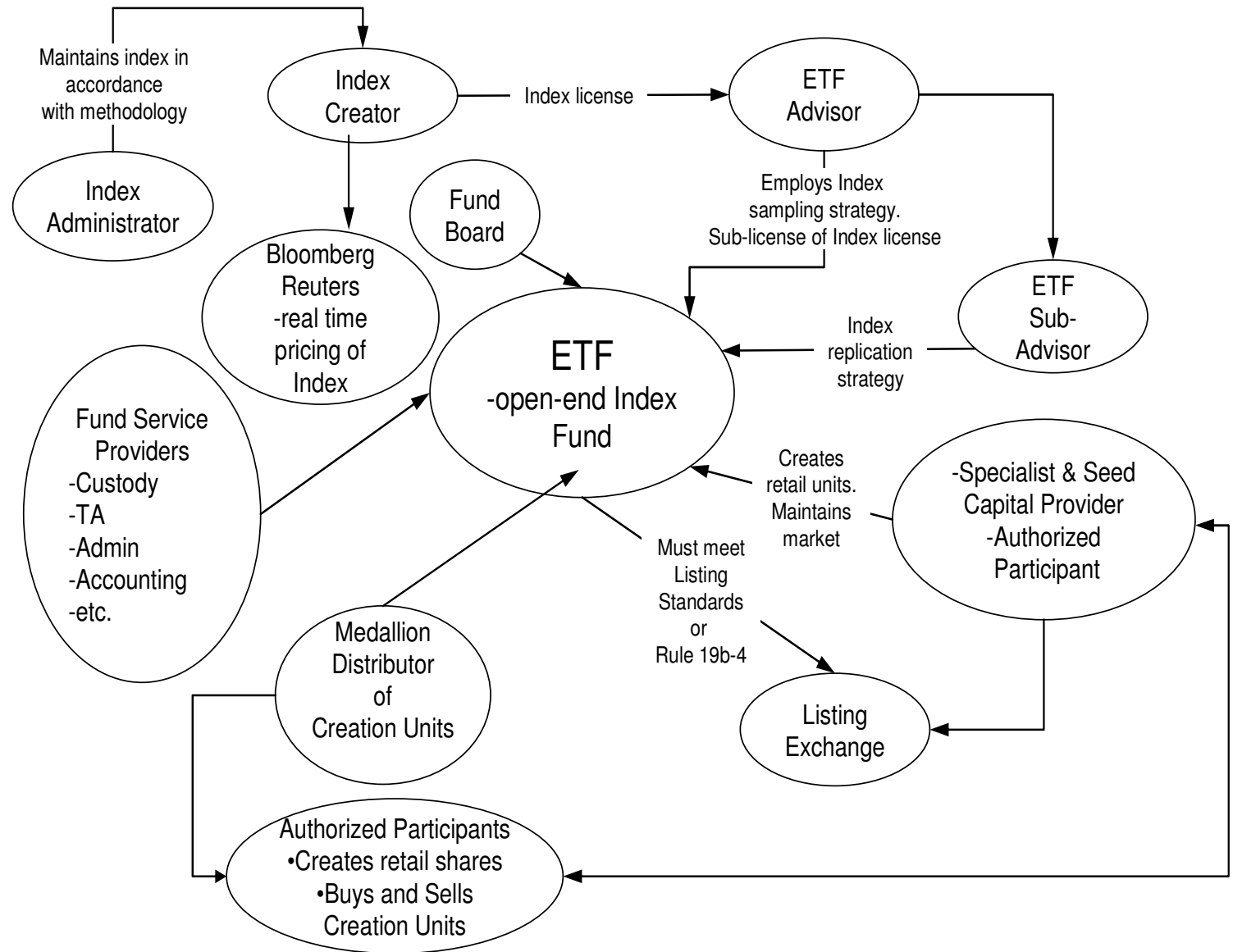
(iv) that violates multiple provisions of the Investment Company Act of 1940 and the Securities Exchange Act of 1934.



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Structure of an ETF



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Regulatory Structure

1. Need for '40 Act Relief

- Sections 2(a)(32) and 5(a)(1) – “redeemable security” definition
- Section 22(d) and Rule 22c-1 – retail trades do not occur at the next calculated NAV but at negotiated prices
- Section 24(d) – Prospectuses are not delivered to retail buyers, only to APs. A short product description is used for retail transactions.
- Section 17(a)(1) and 17(a)(2) – Creation Unit buyers may be affiliated (5% or more owners) and therefore in-kind purchase and redemption mechanism may be problematic.



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Regulatory Structure (cont'd)

2. Need for '34 Act Relief

- Rule 10a-1
- Rule 200(g) of Regulation SHO
- Rule 101 of Reg M

Manner in which ETFs trade violate a number of 1934 Act provisions

-Short sale tick rule. ETFs trade without regard to the "uptick" requirements of Rule 10a-1

-Requires brokers to mark short sales as "short exempt" if the seller is relying on an exemption to the "up-tick" requirements of Rule 10a-1

Relief permits brokers to mark such orders as "short"

-Prohibits a "distribution participant" or "affiliated purchaser" from bidding, purchasing or inducing a person to bid or purchase a security during the course of a distribution



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Regulatory Structure (cont'd)

- Rule 102 of Reg M
 - Prohibits “distribution participants” or “affiliated purchasers” from conducting certain market activity during a distribution

- Rule 14e-5
 - Prohibits a “covered person” from directly or indirectly purchasing or arranging for the purchase of securities during a tender offer

- Rule 10b-17
 - Requires an issuer, other than an open-end investment company issuing redeemable securities, to give notice of certain specified actions



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How to Obtain 34 Act Relief

Portfolio must conform to Generic Relief standards:

1. The ETF shares are issued by an open-end investment company or unit investment trust registered with the Commission under the Investment Company Act;
2. The EFT consists of a basket of twenty or more Component Securities, with no one Component Security constituting more than 25% of the total value of the ETF;
3. At least 70% of the ETF must be comprised of Component Securities that meet the minimum public float and minimum average daily trading volume thresholds under the “actively-traded securities” definition found in Regulation M for excepted securities during each of the previous two months of trading prior to formation of the relevant ETF; provided, however, that if the ETF has 200 or more Component Securities, then 50% of the Component Securities must meet the actively-traded securities thresholds;



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How to Obtain 34 Act Relief (cont'd)

4. ETF shares are to be issued and redeemed in Creation Unit aggregations of 50,000 shares or such other amount where the value of a Creation Unit is at least \$1 million at the time of issuance;
5. The ETF must be managed to track a particular index all of the components of which have publicly available last sale trade information. The intra-day proxy value of the ETF per share and the value of the "benchmark" index must be publicly disseminated by a major market data vendor throughout the trading day; and

Or, the Fund needs to file Exemptive/No Action Request with the Commission.



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Opportunities Abound



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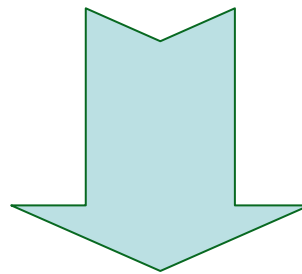
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Mutual Fund Managers Participating in ETFs

- Vanguard: Offering about 30 ETFs as well as traditional investor and institutional shares
- AIM: On board via acquisition of Powershares with over 70 investment opportunities through style, industry, commodities, currencies, specialty access and broad market ETFs
- Rydex/Profunds: Enhanced index strategies in broad market and sector ETFs



However, most major mutual fund providers are still seeking a solution...



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ETFs – A Tool, not a Threat

- Structure Affords Built-in Advantages to Providers
 - Lower Cost of Operation
 - Improved Trading Transparency
 - Tax Efficiency
 - Compliance
- Opportunity to Showcase Quality Management
 - Model/Algorithm-Based
 - Active/Semi-Active?
- Portfolio Building Block
 - Equitization of Cash
 - Efficient Sector/subsector/microsector exposure



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XShares Group LLC

- Formed November 2005
- Sponsor and Advisor formed August 2006
- Received 1940 Act Exemptive Relief December 2006
- First “White-Label” Initiative, TD Ameritrade, November 2006
- HealthShares Launched January 23, 2007
- 14 ETFs currently listed on the NYSE (approx. \$80 mm AUM)
- Additional Products in Registration
 - Independence Target Date Funds (expected April 2007)
 - StateShares Exchange Traded Funds (expected May 2007)
- Additional Products Under Development
 - Chicago Climate Exchange
 - Elliott Wave
 - The Ranking Service



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ETFs: The XShares Solution

- Unique IP to Create ETF within an Existing Fund's Scope
- Permit Actively Managed Funds and SMAs to be Free to Fulfill their Investment Mandate
- Expansion of Product Offerings and Brand Extension by Fund Management Companies into ETF Market
- Most Strategies can be Implemented Without Further 1940 Act Relief
- Protection of operating margins
- Additional Revenue Opportunities to Internalize Product Support Functions
- Existing Solution for 401K and Pension Plan Inclusion



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Turnkey Creation

- Index Creation or Licensing
- Index Calculation
- 1940 ACT Exemptive Order
- Prospectus Creation and Filing
- Underwriting
- Listing, Specialists and 19b4
- Seed Capital
- Sales and Marketing
- Development of Internal Wholesale Group
- Engaged Graphic Design Team
- Marketing Materials, Print on Demand
- Unique Marketing Channels
- Website Development and Integration



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Amerivest: A Case Study

- Amerivest Investment Management is a wholly owned subsidiary of TD Ameritrade
- First true Lifecycle Fund, no layered fees
- Zacks IFE Index Creation Highest Quality IP
- Mergent to Calculate Index in Real Time
- Unique Sub Advisory Arrangement With Amerivest as the Sub Advisor
- Distribution Leverage
- Planned Launch April 2007 on the NYSE
- BNY Custodian and Fund Administration
- BNY Investment Management to perform Investment Management Services



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XShares – Strategic Partner/Resource

- Complete Team of ETF Experts
 - Operations
 - Legal
 - Reporting/Financial
 - Marketing
 - Compliance/Regulatory
- Offers Financial Institutions Entering the ETF Market
 - Speed to Market
 - Brand Fidelity
 - Superior Execution



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