

Chapman Client Alert

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Current Issues Relevant to Our Clients

Securities and Exchange Commission Adopts Long-Awaited ETF Rule

On September 26, 2019, the Securities and Exchange Commission (“SEC”) adopted Rule 6c-11 under the Investment Company Act of 1940 (the “1940 Act”) and amendments to Form N-1A and Form N-8B-2 that overhaul the patchwork regulatory framework that currently governs the \$3.32 trillion ETF industry. The adopted rule and form amendments (collectively, the “ETF Rule”) are largely similar, but not identical, to the versions that were proposed in June 2018 (the “Proposed Rule”).

The ETF Rule substantially replaces the current regime under which each ETF sponsor is required to obtain its own individual exemptive relief from certain provisions of the 1940 Act in order to offer and operate an ETF. It is the SEC’s stated position that the ETF Rule establishes a regulatory framework that: (1) reduces the expense and delay currently associated with forming and operating certain ETFs unable to rely on existing orders; and (2) creates a level playing field for ETFs that can rely on the ETF Rule. As such, the SEC hopes the ETF Rule will enable increased product competition among ETF providers, which may lead to lower fees for investors, encourage financial innovation and increase investor choice in the ETF market.

In addition to the rule and form amendments under the 1940 Act, the SEC expressed its intent to soon issue an exemptive order that harmonizes certain related relief under the Securities Exchange Act of 1934 (the “Exchange Act”). In particular, the order provides exemptive relief to broker-dealers and other persons from certain requirements under the Exchange Act with respect to ETFs relying on the ETF Rule.

The full text of the ETF Rule is available [here](#). The SEC staff also released a fact sheet that is available [here](#). The ETF Rule will become effective 60 days after publication of the Rule in the Federal Register; however, there will be a one-year transition period for compliance with the new form requirements. The following is a brief summary of some of the most notable components of the ETF Rule. We will provide a more detailed analysis of the ETF Rule in the coming weeks.

- **Removal of Exemptive Order Requirement.** The ETF Rule will allow ETFs that satisfy certain conditions to operate without obtaining an exemptive order from the

SEC. The SEC is also rescinding the exemptive relief (as of one year from the effective date of the Rule) it has issued to ETFs that fall within the scope of the ETF Rule. ETFs structured as unit investment trusts, leveraged/inverse ETFs, share class ETFs or non-transparent ETFs are not covered by the ETF Rule but will be able to continue to rely on their existing exemptive relief. Funds that wish to adopt these excluded structures will still be required to seek exemptive relief from the SEC.

- **Custom Baskets.** All ETFs will now be able to construct creation and redemption baskets in a manner other than as a pro rata representation of the securities comprising the ETF’s portfolio. This flexibility was previously only available to the early entrants to the ETF market. To utilize this increased flexibility, ETFs will be required to adopt: (i) policies and procedures governing the construction of baskets and the process that would be used for the acceptance of baskets generally; and (ii) heightened process requirements for ETFs using custom baskets, including policies and procedures specifically covering the use of custom baskets. The ETF Rule also requires these policies and procedures to specify the titles and roles of employees of the ETF’s investment adviser who are required to review each custom basket for compliance with the parameters set forth in the policies and procedures.
- **Website Disclosure.** Along with the portfolio holdings disclosure discussed in more detail below, the following information must be disclosed publicly and prominently on an ETF’s website:
 - The ETF’s net asset value (“NAV”) per share, market price and premium or discount, each as of the end of the prior business day;

- A table and chart showing the number of days the ETF's shares traded at a premium or discount during the most recently completed calendar year and calendar quarters of the current year;
 - For ETFs whose premium or discount was greater than 2% for more than seven consecutive trading days, disclosure that the premium or discount was greater than 2%, along with a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount; and
 - Median bid-ask spread over the most recent thirty calendar days.
- Removal of Intraday Indicative Value ("IIV") Dissemination Requirement. ETFs will no longer be required **by the SEC** to disseminate an intraday estimate of their NAV per share. However, the exchanges on which ETF shares trade also currently require ETFs to disseminate an IIV at least every 15 seconds during regular trading hours. ETFs will be required to comply with this IIV dissemination requirement until such time as the exchanges amend their rules to remove this requirement.
 - Portfolio Holdings Disclosure. On a daily basis, ETFs will be required to disclose on their website the following information for each of its portfolio holdings as of the close of business on the prior business day: (1) ticker symbol; (2) CUSIP or other identifier; (3) description of holding; (4) quantity of security/asset; and (5) percentage weight of the holding in the portfolio. For investments without a common securities identifier, the ETF must provide a brief description of the investment to allow an investor to effectively hedge the position. For instance, for a debt security, an ETF should include the security's name, maturity date, coupon rate and effective date. This information must be provided on each business day, along with any cash balancing amount, before the opening of regular trading on the ETF's primary listing exchange.
 - Affiliated Transactions. The ETF Rule provides exemptions from Sections 17(a)(1) and 17(a)(2) of the 1940 Act with regard to the deposit and receipt of baskets by a person who is an affiliated person of an ETF (or who is an affiliated person of such a person) solely by reason of: (i) holding with the power to vote 5% or more of an ETF's shares; or (ii) holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF. Without this relief, an authorized participant or other market participant that becomes an affiliated person of the ETF due to its holdings would be prevented from engaging in arbitrage using an in-kind basket, which, in turn, could have the adverse effect of limiting the pool of market participants that could engage in arbitrage.
 - Creation Unit Size. The ETF Rule does not mandate a maximum or minimum creation unit size as the SEC determined that ETFs are already properly incentivized to establish creation unit sizes that are appropriate for market demand. Existing exemptive orders impose a minimum creation unit size on some issuers.
 - Recordkeeping. ETFs must now preserve and maintain copies of all written agreements between an authorized participant and the ETF (or one of the ETF's service providers) that allow the authorized participant to purchase or redeem creation units. Additionally, the ETF Rule requires an ETF to maintain records setting forth the following information for each basket exchanged with an authorized participant: (i) ticker symbol, CUSIP or other identifier, description of holding, quantity of each holding, and percentage weight of each holding composing the basket exchanged for creation units; (ii) if applicable, an identification of the basket as a "custom basket" and a record stating that the custom basket complies with the ETF's custom basket policies and procedures; (iii) cash balancing amounts (if any); and (iv) the identity of the authorized participant conducting the transaction.
- Additionally, we have provided a brief summary below of some of the notable differences between the Proposed Rule and the final ETF Rule.
- T-1 Orders. The Proposed Rule would have required an ETF to disclose its portfolio holdings information before the ETF started accepting orders for the purchase and redemption of creation units. This would have prevented certain ETFs from accepting creation or redemption orders shortly after the U.S. market closed on the previous day ("*T-1 Orders*"). The ETF Rule changed that deadline and instead requires portfolio holdings information to be disclosed on an ETF's website on each business day before the opening of regular trading on the ETF's primary listing exchange. This change will allow ETFs to continue to utilize T-1 Orders. T-1 Orders allow ETFs, authorized participants and other market participants to place orders for the purchase and sale of portfolio securities

in non-U.S. markets with hours that do not overlap (or have limited overlap) with U.S. market hours when those markets are open. An ETF that holds Japanese equities, for example, may permit authorized participants to submit T-1 Orders (between 4:00 pm E.T. and 5:00 pm E.T.) to allow for trading in the underlying Japanese securities before the Japanese market closes (2:00 am ET).

- *Bid-Ask Spread Website Disclosure*. The ETF Rule requires daily website disclosure of the ETF's median bid-ask spread calculated over the most recent 30-day period. The Proposed Rule would have required an ETF to disclose the median bid-ask spread for the ETF's most recent fiscal year on its website and in its prospectus. The ETF Rule also mandates that ETFs use the price that is the midpoint of the national best bid and national best offer.
- *Bid-Ask Spread Prospectus Disclosure*. The SEC did not adopt the requirement from the Proposed Rule that would have required an ETF to provide (i) examples in the ETF's prospectus showing how bid-ask spreads impact the return on a hypothetical investment for both buy-and-hold and frequent traders; and (ii) an

interactive calculator in a clear and prominent format on the ETF's website that would allow an investor to customize the hypothetical bid-ask spread calculations to its specific investing situation.

- *Q&A Prospectus Disclosure*. The SEC did not adopt the requirement from the Proposed Rule that would have required ETFs to include a series of questions and answers—or Q&As—in the ETF's summary prospectus that would have provided investors with narrative disclosure regarding ETF trading and associated costs, as well as quantitative disclosures regarding bid-ask spreads. Instead, the ETF Rule allows ETFs to include narrative disclosure to this effect in the statutory prospectus (as opposed to the summary prospectus) and allows this disclosure to deviate from the Q&A format.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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