



Insights

SEC's New ETF Rule Is a Win for Issuers, Investors

Article

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On Sept. 26, the U.S. Securities and Exchange Commission adopted final Rule 6c-11 under the Investment Company Act of 1940, and certain form amendments that standardize the regulatory regime governing exchange-traded funds. In the future, most ETF issuers will no longer need to obtain individual exemptive relief from certain provisions of the 1940 Act and its rules in order to create and operate ETFs, but instead will be able to rely on the rule for generic ETF relief.

The SEC believes the rule provides a regulatory regime that is a consistent, transparent, and efficient regulatory framework for ETFs that not only reduces the costs and time incurred in obtaining orders, but also establishes a level playing field applicable to all ETFs relying on the rule. Therefore, the SEC hopes that the rule will facilitate expanded product competition among ETF providers, thereby spurring innovation that may lead to lower fees for investors, and increased investor choice.

The rule will become effective 60 days after its publication in the Federal Register, and will provide a one-year transition period for compliance with the new form requirements. As adopted by the SEC, Rule 6c-11 is quite similar to the earlier proposed version of the rule.

Requirements for Reliance on the Rule

To rely on the rule, an ETF must be a registered open-end management company issuing and redeeming creation units to and from authorized participants in exchange for a basket of securities and a cash-balancing amount, if any, and whose shares are listed on a national securities exchange and traded at market-determined prices.

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In addition, an ETF must comply with these requirements:

- Make certain prominent disclosures on its website;
- Reflect changes in the ETF's portfolio holdings in the first calculation of net asset value, or NAV, per share on the first business day following the trade date;
- Adopt and implement written policies and procedures that govern the construction of creation and redemption baskets, basket acceptances and custom baskets procedures;
- Comply with the prohibition of directly or indirectly providing leveraged or inverse returns of an index; and
- Maintain and keep records for a period of not less than five years, the first two years in an easily accessible place.

The ETF rule codifies most of the relief granted in prior orders.

The rule incorporates most of the important conditions and relief granted in the orders prior to the adoption of the rule that related to the formation and operation of ETFs. The SEC is rescinding exemptive relief — as of one year from the effective date of the rule — that it had previously granted to those ETFs that now may rely upon the rule, and also is rescinding exemptive relief given to master-feeder ETFs.

Scope of the Rule

Among other things, the rule permits compliant ETFs to:

- Redeem their shares only in creation units;
- List their individual shares bought and sold on a national securities exchange at current market prices rather than at NAV;
- Conduct in-kind transactions with certain affiliates of the ETF; and

- Under certain circumstances, delay making in-kind redemptions of foreign securities for a period of up to 15 days from the trade date if they cannot be delivered within the normal U.S. securities settlement period.

Affiliated Transactions

The Rule codifies exemptions from Sections 17(a)(1) and 17(a)(2) of the 1940 Act with respect to deposits and receipts of portfolio securities baskets by an affiliated person of an ETF (or an affiliated person of such person) solely by reason of:

- Holding with the power to vote 5% or more of an ETF's shares; or
- Holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF.

This relief is crucial to the operation of the ETF arbitrage mechanism. Were it not granted, no authorized participant, or AP, that is an affiliated person of the ETF due to its ETF shareholdings could engage in in-kind creations or redemptions of ETF portfolio securities baskets. This could limit the number of market participants able to engage in arbitrage transactions, thereby having a deleterious effect both on the trading of ETF shares and on efficient portfolio management.

Custom Baskets

The rule permits all ETFs to utilize custom creation and redemption baskets that either do not reflect a pro rata representation of an ETF's portfolio holdings, or that differ from the initial basket used in transactions on the same business day.

To rely upon this relief, compliant ETFs will be required to adopt:

- Policies and procedures governing the construction of a fund's baskets and the process to be used for the acceptance of such baskets generally; and
- Requirements for ETFs using custom baskets, including policies and procedures specifically covering the use of custom baskets.

Also, the rule requires that these policies and procedures specify the titles and roles of employees of the ETF's investment adviser who are required to review each custom basket for compliance with such policies and procedures.

Self-Indexing ETFs

The rule permits self-indexing ETFs and their current method of operations, without imposing any additional conditions or requirements.

Index and Active ETFs

The rule makes no distinction between index-based ETFs and fully transparent actively managed ETFs.

Fund of Funds

Existing ETF fund of funds relief is not being rescinded. Also, until the SEC issues a new rule governing fund of funds arrangements, a new ETF relying on the Rule that does not have individual relief may enter into fund of funds arrangements as described in recent Prior Orders, provided that such ETF satisfies their terms and conditions for relief.

The rule establishes additional procedural and disclosure requirements.

Record-Keeping for Baskets and APs

The rule requires ETFs to preserve and maintain copies of all written agreements between an AP and the ETF, or one of the ETF's service providers, that allow the AP to purchase or redeem creation units.

Also, the rule requires an ETF to maintain records of each basket exchanged with an AP specifying particular information, including:

- For each holding, a ticker symbol, CUSIP or other identifier, quantity, percentage weight of each holding composing the basket exchanged for creation units;

- Identification of a basket as a custom basket, if applicable, and a record stating that the custom basket complies with the ETF's custom basket policies and procedures;

- Cash balancing amounts, if any; and

- The identity of the AP conducting the transaction.

Website Disclosure of Portfolio Holdings

On a daily basis, an ETF will be required to prominently disclose on its free website the following data with respect to each of its portfolio holdings as of the close of business on the prior business day:

- Ticker symbol;
- CUSIP or other identifier;
- Description of such holding;
- Quantity of security/asset holding; and
- Percentage weight of that holding in the portfolio.

This data 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.

Additional Website Disclosure

Each ETF must also disclose publicly and prominently on its website the following information relating to its shares:

- Its NAV per share, market price and premium or discount, each as of the end of the prior business day;
- A table and chart identifying 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; and
- The median bid-ask spread over the most recent 30 calendar days.

The rule mandates that ETFs use the price that is the midpoint of the national best bid and national best offer to calculate median bid-ask spreads.

If an ETF experiences a premium or discount greater than 2% for more than seven consecutive trading days, it must disclose that fact, together with a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount. This disclosure must be maintained on the ETF's website for one year.

The rule eliminates certain requirements contained in prior orders.

Exemptive Orders

ETFs complying with the terms and conditions of the rule may operate without first obtaining an order. However, ETFs structured as unit investment trusts, leveraged/inverse ETFs, share class ETFs, nontransparent ETFs and master-feeder ETFs are not covered by the rule, and may continue to rely on their existing orders.

New funds that seek to include attributes of one or more noncovered funds, as well as new funds that

present unusual or novel issues of fact or law, must continue to obtain individual orders from the SEC.

Intraday Indicative Value

The rule eliminates the SEC's former requirement that every ETF publish an intraday estimate of its NAV per share. Nevertheless, the securities exchanges where ETF shares trade continue to require publication of an intraday indicative value at least every 15 seconds during regular trading hours. Thus, ETFs must comply with this intraday indicative value dissemination requirement until the individual exchanges remove it from their respective listing rules.

Specified Size of Creation Units

Many existing prior orders require that a creation unit must be comprised of a specific number of shares (e.g., 50,000). The rule does not mandate either a minimum or maximum size because the SEC has determined that ETFs are already properly incentivized to set their creation units in sizes that are appropriate for market demand.

The rule did not adopt certain requirements contained in the proposed rule.

Bid-Ask Spread Website Disclosure

The rule requires daily website disclosure of an 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.

Bid-Ask Spread Prospectus Disclosure and Interactive Calculator

The SEC did not adopt the requirement in the proposed rule that would have required an ETF to provide (1) 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 (2) 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 proposed rule's requirement that would have required ETFs to include a series of questions and answers 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 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.

The rule exempts ETFs from certain sections and rules of the Securities Exchange Act.

Compliant ETFs will be eligible for the redeemable securities exceptions in Rules 101(c)(4) and 102(d)(4) of Regulation M and 10b-17(c) under the Securities Exchange Act of 1934 in connection with secondary market transactions in ETF shares and creation or redemption of creation units.

In a companion order, the SEC exempted ETFs relying on the rule from the requirements of Section 11(d)(1) of the Exchange Act and Rules 10b-10, 15c1-5, 15c1-6 and 14e-5 thereunder, subject to certain conditions.

Conclusion

The ETF industry is largely pleased with the rule, given that it incorporates and standardizes the current ETF regulatory regime, thus making it unnecessary for most ETF issuers to obtain individual exemptive relief from the SEC in order to create and operate ETFs.

The rule also provides ETF issuers with additional flexibility, especially the ability to utilize custom creation and redemption baskets. Therefore the rule provides a consistent, transparent and efficient regulatory structure for ETFs, one that reduces costs and time formerly incurred in obtaining SEC relief.

Further, the rule establishes a level playing field applicable to all compliant ETFs. Therefore, it is hoped that the rule will facilitate expanded product competition among ETF providers and spur innovation that may lead to lower fees for investors, and increased investor choice.

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