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Exchange-Traded Funds Alert

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OCTOBER 2019

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A Closer Look at the New ETF Rule

On September 25, 2019, the U.S. Securities and Exchange Commission (the SEC) adopted new Rule 6c-11 (the Rule) under the Investment Company Act of 1940 (1940 Act) to provide exchange-traded funds (ETFs) with the regulatory exemptions necessary to permit their operations.[1]

Immediately after the Rule adoption, Stradley Ronon issued an ETF Alert with a high-level overview of the Rule.[2] We also conducted a webcast discussing the Rule that can be accessed at https://www.stradley.com/insights/events/2019/etf-rule-webcast-october-15-2019.

This ETF Alert provides a more in-depth discussion of the Rule, the related disclosure amendments (Disclosure Amendments), and an SEC exemptive order granting relief under the Securities Exchange Act of 1934 (1934 Act) relating to ETFs (1934 Act Order).[3]

Specifically, this ETF Alert addresses the following topics:

- Scope of Rule and the Fate of Prior Orders
- Exemptive Relief Granted Under the Rule
- Conditions to Relief
    - Website Disclosures
    - In-Kind Baskets
- Additional Items of Interest
- Disclosure Amendments
- Exemptions Under the 1934 Act

For a concise summary of the significant regulatory changes discussed in this ETF Alert, please see the Comparative Table of Regulatory Changes, available at https://www.stradley.com/-/media/files/publications/2019/10/comparison-table-etf-alert-october-2019.pdf.

Please let us know if you have any questions about this significant ETF development or this ETF Alert.

I. Scope of Rule and the Fate of Prior Orders

Because ETF operations do not fit neatly within certain provisions of the 1940 Act, ETF sponsors have obtained individual exemptive orders from the SEC to permit ETF operations. Over the last 25 years, the SEC has granted more than 300 of these exemptive orders (Prior Orders). The Rule provides the basic exemptive relief necessary for most actively managed and index-based ETFs to operate without obtaining an exemptive order. In addition, one year after the effective date of the Rule, most of the Prior Orders will be rescinded, as described below.

A. ETFs Required to Rely on the Rule

The Rule defines an ETF as a registered open-end management company that issues and redeems creation units[4] to and from authorized participants[5] in exchange for baskets[6] and a cash balancing amount[7] (if any), and whose shares are listed on a national securities

exchange and traded at market-determined prices.

Notably, the Rule does not distinguish between index-based and actively managed ETFs. The Rule also does not distinguish between index-based ETFs that track unaffiliated indexes (Unaffiliated Index ETFs) and so-called “self-indexing” ETFs, which are ETFs based on indexes provided by index providers that are affiliated with the ETF sponsor (Affiliated Index ETFs). As a result, all ETFs relying on the Rule will be subject to the same requirements.[8]

The SEC’s rationale for this approach is that ETFs, whether index-based or actively managed, do not present significantly different concerns under the provisions of the 1940 Act from which the Rule grants relief. With respect to Affiliated Index ETFs, the SEC noted that existing federal securities laws adequately address any special concerns, including the potential ability of an affiliated index provider to manipulate an underlying index to the benefit or detriment of an Affiliated Index ETF.

As with the SEC’s general approach to the Rule, part of the reasoning for not distinguishing between most types of ETFs is to level the playing field among market participants and to provide a more consistent regulatory framework. For example, as discussed further below, one of the conditions to the Rule is that all ETFs relying on the Rule must provide full portfolio transparency daily.[9] Prior Orders required actively managed and Affiliated Index ETFs to publish their portfolios daily, but did not require Unaffiliated Index ETFs to make such disclosures (even though that has been an industry practice). The SEC noted that adopting across-the-board treatment is consistent with the SEC’s regulation of other types of open-end funds, which does not distinguish between index-based and actively managed funds. In addition, the SEC believes that it would be unreasonable to create a meaningful distinction between index-based and actively managed ETFs within the Rule given the proliferation of highly customized, methodologically complicated indexes, which have blurred the line between index-based and active ETFs.

While the Rule covers most ETFs, the Rule excludes unit investment trust (UIT) ETFs, Leveraged/Inverse ETFs, Share Class ETFs, Master-Feeder ETFs, and Non-Transparent ETFs, each as defined and discussed in Section IV.A below.

B. Effective Date of the Rule and Impact on Prior Orders

The Rule becomes effective on December 23, 2019. ETFs may begin to rely on the Rule as of the effective date, so long as they can comply with all the provisions of the Rule. Existing ETFs may continue to rely on their Prior Orders until December 23, 2020, one year after the effective date of the Rule, at which time Prior Orders issued to ETFs that are covered by the Rule will be rescinded.[10] At that point, most ETFs will be subject to the common regulatory framework of the Rule rather than to the varying terms and conditions contained in individual Prior Orders.[11]

The portions of Prior Orders containing relief from Section 12(d)(1) of the 1940 Act to allow registered investment companies to purchase shares of ETFs in excess of the otherwise applicable limits (the ETF relief) would not be rescinded, as discussed further in Section IV.C below.[12]

II. Exemptive Relief Granted Under the Rule

As a general matter, the exemptive relief provided by the Rule effectively corresponds to the relief previously provided by the Prior Orders.

A. Treatment of ETF Shares as “Redeemable Securities”

Because ETF shares are not individually redeemable under normal circumstances, the Prior Orders granted exemptive relief from the definition of “redeemable security” in Section 2(a)(42) of the 1940 Act and from the definition of “open-end company” in Section 5(a)(1) of the 1940 Act. With the Rule, the SEC took a different approach by explaining that because ETF shares can be redeemed in creation units, ETF shares are most appropriately classified as “redeemable securities.” As a technical matter, therefore, the Rule does not grant relief from Sections 2(a)(32) or 5(a)(1) because such relief is not necessary.

The Adopting Release further noted that the SEC views all ETF shares, including shares of ETFs that do not rely on the Rule, as eligible for the “redeemable securities” exceptions in Rules 101(c)(4) and 102(d)(4) of Regulation M and Rule 10b-17(c) under the 1934 Act, as well as for the “registered open-end investment company” exemption in Rule 11d1-2 under the 1934 Act. Accordingly, ETFs no longer need to rely on class relief previously granted by the SEC and the SEC staff from those provisions of the 1934 Act, which were subject to various terms and conditions. This relief is addressed in greater detail in Section VI below in the discussion of exemptions from the 1934 Act.

B. Trading of ETF Shares at Market-Determined Prices

The Rule provides exemptions from Section 22(d) of the 1940 Act and Rule 22c-1 under the 1940 Act to permit secondary market trading of ETF shares at market-determined prices. The SEC believes that such exemptions are appropriate because the conditions of the Rule promote

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an effective arbitrage mechanism that helps maintain a close alignment between the ETF market price and net asset value (NAV) in most circumstances.

C. Affiliated Transactions

The Rule provides exemptions from Sections 17(a)(1) and (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 an affiliated person of such person) solely by reason of (i) holding with power to vote 5% or more of an ETF's shares or (ii) holding with power to vote 5% or more of any investment company that is an affiliated person of the ETF.[13]

The SEC noted that several commenters recommended expanding the Section 17(a) relief discussed above to cover additional types of affiliated relationships, such as exempting broker-dealers that are affiliated with the ETF's adviser or permitting an ETF's adviser or its affiliates to transact with the ETF to provide in-kind seed capital to the ETF. While acknowledging that permitting additional types of affiliated entities to transact with the ETF could provide additional benefits to an ETF, the SEC ultimately determined to not expand the scope of its prior exemptive relief with respect to affiliated transactions. The SEC stated that such expansion would constitute novel Section 17(a) relief that would require careful consideration of whether the current protections embedded in its relief sufficiently address any risks posed by such transactions with these additional categories of affiliates. The SEC noted that such additional exemptions could be considered within its regular exemptive applications process.

D. Additional Time for Delivering Redemption Proceeds

The Rule grants relief from Section 22(e) of the 1940 Act to permit an ETF to delay delivery of a foreign investment[14] included in an in-kind redemption basket for more than seven days if local market holidays and/or extended delivery cycles for that particular foreign investment prevent timely delivery, as long as the ETF delivers such foreign investment as soon as practicable, but in no event later than 15 days after tender to the ETF.[15]

The SEC made clear that this exemption permits a delay in the delivery of a foreign investment only if the foreign investment is being transferred in kind as part of the basket. While mutual funds may likewise invest in foreign investments that are subject to local market holidays and/or extended delivery cycles that may prevent timely delivery, mutual funds typically deliver redemption proceeds in cash, not in kind. Similarly, ETFs transacting in cash or that substitute cash in lieu of these types of foreign investments in a basket do not require an exemption from Section 22(e) of the 1940 Act and may not rely on the relief.

Unlike the proposed rule, the Rule does not contain a sunset provision that limits the Section 22(e) relief to 10 years from the Rule's effective date. The SEC stated that while it continues to believe that technological innovation and changes in market infrastructure and operations should lead to further shortening of settlement cycles, it recognized that (i) these developments may be gradual and difficult to predict and (ii) settlement within seven days

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may continue to pose challenges even in light of such developments due to certain local market holidays.

III. Conditions to Relief

The Rule is subject to four conditions:

1. The ETF must make various website disclosures;

2. The ETF must calculate NAV on the basis of its portfolio holdings as of the close of business on the prior business day (T+1 accounting requirement);

3. The ETF must implement written policies and procedures relating to baskets and, if applicable, custom baskets; and

4. Leveraged/Inverse ETFs cannot rely on the Rule.

Of these conditions, the required website disclosures and basket procedures are the most complex and are detailed below.

A. Website Disclosures

The Rule requires the following information to be disclosed publicly and prominently on the ETF's website:[16]

- Before the opening of regular trading on the primary listing exchange of the ETF shares, the following information (as applicable) for each portfolio holding that will form the basis of the next calculation of current NAV per share:
  - ticker symbol
  - CUSIP or other identifier
  - description of holding
  - quantity of each security or other asset held
  - percentage weight of the holding in the portfolio;

- NAV per share, market price, and premium or discount, each as of the end of the prior business day;

- A table and line graph 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 30 calendar days.

Portfolio Holdings Disclosure

The Rule requires an ETF to disclose the portfolio holdings that will form the basis for each calculation of NAV per share in a standardized format, on each business day before the opening of regular trading of the primary listing exchange of the ETF's shares. Unlike the proposed rule, and consistent with existing exemptive orders, the Rule does not require an ETF to disclose its portfolio holdings before the ETF starts accepting orders. This change accommodates purchase and redemption orders received on T-1, which commenters on the rule proposal indicated are important for ETFs that invest in foreign securities.

The Rule requires an ETF to disclose standardized information regarding each portfolio holding.[17] Unlike the proposed rule, this information is not required to be presented in the manner prescribed by Article 12 of Regulation S-X. Rather, an ETF is required to disclose the following information for each portfolio holding on a daily basis: (1) ticker symbol; (2) CUSIP or other identifier; (3) description of holding; (4) quantity of each security or other asset held; and (5) percentage weight of the holding in the portfolio. Commenters on the proposed rule expressed concerns that the Article 12 requirements were overly burdensome and unnecessary to achieve the SEC's goal of facilitating effective arbitrage.

The Adopting Release provides that a description of the holding should include, for example, for debt securities, the security's name, maturity date, coupon rate, and effective date, where applicable. To indicate the quantity of a security or other asset held, the ETF generally should use the measure typically associated with quantifying that class of security, such as number of shares for equity securities, par value for debt securities, number of units for securities that are measured in units (such as UITs), and dollar value for cash. For derivatives, an ETF generally should provide both the notional value of the derivative and number of contracts.

Under the Rule, the portfolio holdings that form the basis for the ETF's next calculation of current NAV per share must be the ETF's portfolio holdings as of the close of business on the prior business day. Changes in an ETF's holdings of portfolio securities would

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therefore be reflected on a T+1 basis. The Rule does not require ETFs to disclose intraday changes in portfolio holdings.

Unlike the proposed rule, the Rule does not require an ETF to post information on its website regarding one published basket that it would exchange for orders to purchase or redeem creation units. Commenters had expressed concerns that some investors may confuse the published basket information with an ETF's portfolio holdings information. The SEC noted that market participants that use basket information currently have access to such information through the National Securities Clearing Corporation, an intermediary, or the ETF itself, and that such requirement would provide little additional value to market participants assessing the existence of arbitrage opportunities.

NAV, Market Price, and Premium or Discount

The Rule requires an ETF to post on its website the ETF's current NAV per share, market price, and premium or discount, each as of the end of the prior business day. This requirement was adopted as initially proposed and is consistent with existing exemptive orders except that the Rule includes a definition of "market price" that differs from the definition applicable to existing exemptive orders. The Rule defines "market price" as (i) the official closing price of an ETF share or (ii) if it more accurately reflects the market value of an ETF share at the time as of which the ETF calculates current NAV per share, the price that is the midpoint of the national best bid and national best offer (NBBO) as of that time.

Although not required in the Rule, an ETF may include context alongside the premium or discount disclosure on the ETF's website, as applicable. For example, an ETF could add footnote disclosure where premium or discount information is affected by differences between the trading hours of the markets for the portfolio securities and the trading hours for the ETF shares.

Table and Line Graph of Premiums or Discounts

The Rule requires an ETF to post on its website both a table and line graph showing the ETF's premiums and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year (or life of the ETF, if shorter). The tabular disclosure shows investors how often the ETF traded at a premium or discount, and the graphic disclosure shows investors the degree of those deviations. This requirement was adopted as initially proposed.

Premium or Discounts Greater than 2%

The Rule requires an ETF whose premium or discount was greater than 2% for more than seven consecutive trading days to post that information on its website, along with a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount. This information is required to be posted on the trading day immediately following the day on which the ETF's premium or discount triggered the disclosure requirement (i.e., on the trading day immediately following the eighth consecutive trading day on which the ETF had a premium or discount greater than 2%). This must be maintained on the ETF's website for at least one year following the first day it was posted. The SEC provided examples of factors that could be reasonably believed to have materially contributed to a premium or discount, such as (i) that many of an ETF's portfolio securities are traded on foreign markets that are closed during the U.S. trading day or (ii) that the markets on which the ETF's underlying securities are traded were closed due to extended holidays or for other reasons. This requirement was adopted as initially proposed, except that the Rule also contains a requirement to include a statement that the ETF's premium or discount, as applicable, was greater than 2% percent.

Median Bid-Ask Spread

The Rule requires daily website disclosure of the ETF's median bid-ask spread calculated over the most recent 30-day period. The median bid-ask spread is required to be computed by (i) identifying the ETF's NBBO as of the end of each 10 second interval during each trading day of the last 30 calendar days, (ii) dividing the difference between each such bid and offer by the midpoint of the NBBO, and (iii) identifying the median of those values.

This requirement differs from the proposed rule in that the Rule requires (i) disclosure of the median bid-ask spread over only the most recent 30 calendar days rather than the most recent fiscal year, (ii) the use of NBBO for computing the bid-ask spread (in an effort to make the computation more uniform and increase consistency and comparability of the disclosures across ETFs), and (iii) website disclosure only, as opposed to disclosure on both an ETF's website and in its prospectus. Commenters had noted that a shorter look-back period may show a more representative spread level, particularly for a newly launched ETF, and the SEC concluded that a 30-day look-back period strikes an appropriate balance between reflecting only very short-term fluctuations and

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reflecting information that is no longer representative of current execution costs. Commenters had also expressed concerns about the overemphasis of bid-ask spread data by including such data on both an ETF's website and in an ETF's prospectus.

B In-Kind Baskets

Another condition for relying on the Rule is that an ETF must "adopt and implement written policies and procedures that govern the construction of baskets and the process that will be used for the acceptance of baskets."[18] The SEC stated that these policies and procedures should:

- Cover the methodology that the ETF will use to construct baskets;
- Detail the circumstances under which the basket may omit positions that are not operationally feasible to transfer in kind;
- Detail when the ETF would use representative sampling of its portfolio to create its basket, and how the ETF would sample in those circumstances; and
- Detail how the ETF would replicate changes in the ETF's portfolio holdings as a result of the rebalancing or reconstitution of the ETF's underlying securities market index, if applicable.[19]

The Rule also provides that ETFs may use "custom baskets," which is perhaps the most significant departure from previous exemptive relief. Older ETF exemptive orders did not place significant restrictions on the composition of baskets, nor did they limit ETF baskets to a pro rata representation of the ETF's portfolio holdings. Over time, the SEC imposed increasing restrictions on basket construction, including limitations on an ETF's ability to substitute cash in lieu of some or all of the ETF's portfolio securities and the requirement that an ETF's basket correspond pro rata to its portfolio holdings, subject to limited exceptions.[20] As the SEC acknowledged, the result was that the changing limitations on basket construction may have created a disadvantage for newer ETFs subject to the more stringent restrictions on baskets.

Under the Rule, a "custom basket" is defined as either "(i) [a] basket that is composed of a non-representative selection of the exchange-traded fund's portfolio holdings; or (ii) [a] representative basket that is different from the initial basket used in transactions on the same business day."[21]

Although the SEC did not define a "non-representative selection," based on the definition of custom basket, it appears that this type of custom basket may only consist of a selection of an ETF's "portfolio holdings." The Adopting Release further notes that non-representative custom baskets "include, but are not limited to, baskets that do not reflect":

- A pro rata representation of the ETF's portfolio holdings;[22]
- A representative sampling of the ETF's portfolio holdings; or
- Changes due to a rebalancing or reconstitution of the ETF's securities market index, if applicable.

The other type of custom basket concerns "representative baskets," which the SEC also did not define. However, the examples cited above are presumably representative baskets. The Adopting Release states that examples of a representative basket that is different from a same-day initial basket include situations where:

- An ETF exchanges a basket with either the same or another authorized participant that reflects a representative sampling that differs from the initial basket;[23] or
- An ETF substitutes cash in lieu of a portion of basket assets for a single authorized participant.

As a condition for relying on the Rule, if an ETF uses custom baskets, its policies and procedures also must:

- Set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the exchange-traded fund and its shareholders, including the process for any revisions to, or deviations from, those parameters;[24] and
- Specify the titles or roles of the employees of the exchange-traded fund's investment adviser who are required to review each custom basket for compliance with those parameters.

The Adopting Release states that custom basket policies and procedures should:

- Provide specific parameters regarding the methodology and process that the ETF would use to construct or accept each custom basket;

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- Describe the ETF's approach for testing compliance with the custom basket policies and procedures and assessing (including through back testing or other periodic reviews) whether the parameters continue to result in custom baskets that are in the best interests of the ETF and its shareholders;

- Establish a process that the ETF will adhere to if it wishes to make any revisions to, or deviate from, the parameters; and

- Be consistently applied, and include reasonable controls designed to prevent inappropriate differential treatment among authorized participants.[25]

Within these parameters, the SEC suggested that ETFs have flexibility in designing custom basket policies and procedures to cover "the wide range of circumstances that may arise relating to custom baskets," including:

- Tailoring custom basket policies and procedures to address different risks and requirements for different types of custom baskets;

- Developing tailored procedures for when an ETF uses cash substitutions that differ from the procedures it uses when substituting securities and other positions;

- Addressing different considerations for custom baskets depending on the direction of the trade (i.e., whether the custom basket is being used for a creation or a redemption); and

- Covering operational circumstances that make the inclusion of certain portfolio securities and other positions in a basket operationally difficult (or impossible), while facilitating portfolio management changes in a cost- and tax-efficient manner.

While acknowledging that cash substitutions in custom baskets might not raise the same concerns as securities substitutions, the SEC noted that cash substitutions could still raise concerns of overreaching by authorized participants, particularly if an authorized participant were to demand cash redemptions during a period of market stress. The SEC believes that the custom basket policies and procedures provide sufficient flexibility to address the different risks of cash and securities substitutions, and suggested that an ETF could "design custom basket policies and procedures with more streamlined requirements for certain cash substitutions that present lower risks."[26]

An ETF's custom basket policies and procedures will also be required to specify the employees of an ETF's investment adviser who are required to review each custom basket for compliance with the parameters for the construction and acceptance of custom baskets. The SEC commented that:

> the adviser is in the best position to determine which employee (or employees) are responsible for determining whether an ETF's custom baskets comply with the custom basket policies and procedures depending on its own structure, strategy, and other relevant circumstances (including whether the ETF is sub-advised). The ETF's adviser (and personnel) are familiar with the ETF's portfolio holdings and are able to assess whether the process and methodology used to construct or accept a custom basket is in the best interests of the ETF and its shareholders and whether a particular custom basket complies with the parameters set forth in the custom basket policies and procedures.[27]

In creating ETF custom basket policies and procedures, ETF sponsors may wish to consider the interaction of those procedures with other 1940 Act requirements. For example, in detailing the parameters for constructing custom baskets, and allowing revisions to or deviations from those parameters, custom basket policies and procedures might address the effect of custom baskets on:

- Liquidity risk management procedures;

- Concentration limitations;

- Diversification requirements (including tax diversification);

- Investments in other investment companies (including with respect to the Fund of Funds Rule Proposal, if and when adopted);

- Ownership of securities-related businesses; or

- Exchange listing standards (generic or otherwise).

Lastly, one significant difference of the Rule from the proposing release is the withdrawal of the proposed requirement that an ETF post information regarding one basket that it would exchange for orders to purchase or redeem creation units on its website each business day. The SEC believes that "requiring ETFs to provide daily website disclosure of portfolio holdings . . . will provide market participants with the necessary tools

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to determine if an arbitrage opportunity exists and to hedge the ETF's portfolio."[28] However, the Rule will require ETFs to maintain certain information regarding each basket exchanged with an authorized participant as part of its recordkeeping requirements.[29]

IV. Additional Items of Interest

A. ETFs Excluded from the Rule

As noted above, the Rule excludes the following types of ETFs from relying on the Rule.

Because an ETF operating under the Rule must be classified as a "management company" under Section 4 of the 1940 Act, any ETF that is organized as a UIT ETF is excluded from the Rule.[30] Existing UIT ETFs can continue to operate pursuant to the terms of their Prior Orders, and the SEC noted that it could review proposals from new UIT ETF sponsors through the exemptive applications process.[31]

The SEC's primary rationale for excluding UIT ETFs from the Rule is twofold: (i) there appears to be limited sponsor interest in developing UIT ETFs and (ii) including UIT ETFs would complicate the Rule. With respect to the second point, the SEC noted that UIT ETFs would require different exemptive relief and different Rule conditions because of the nature of the UIT structure. For example, the Rule conditions with respect to the use of custom baskets require ongoing management and board oversight, which would not be possible with UIT ETFs.

Leveraged/Inverse ETFs

The Rule specifically excludes Leveraged/Inverse ETFs from relying on the Rule through a condition that states that an ETF may not seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.[32] Existing Leveraged/Inverse ETFs can continue to operate pursuant to the terms of their Prior Orders. However, the SEC noted that the SEC staff has not supported new exemptive orders for Leveraged/Inverse ETFs since 2009.

The SEC provides several reasons for excluding Leveraged/Inverse ETFs from the Rule. First, the SEC noted that Leveraged/Inverse ETFs pursue strategies that require them to rebalance their portfolios as frequently as daily in order to maintain a constant leverage ratio, which can result in performance that differs significantly from some investors' expectations of how index investing generally works. Second, the SEC noted that it is evaluating the use of derivatives by registered funds generally, including in connection with its potential re-proposal of Rule 18f-4 under the 1940 Act.[33] As a result, the SEC stated that it is premature to permit sponsors to form and operate Leveraged/Inverse ETFs in reliance on the Rule without first addressing the investor protection purposes and concerns underlying Section 18 of the 1940 Act.[34]

In excluding Leveraged/Inverse ETFs from the Rule, the SEC declined to specify the period of time over which an ETF must seek to deliver leveraged or inverse returns of an index to be covered by the Rule's exclusion. Accordingly, ETFs that seek to deliver leveraged or inverse returns of an index will be excluded from the Rule whether they seek to deliver those leveraged or inverse returns daily or over some other predetermined period of time. In addition, the performance amplification factor or "multiple" by which the Leveraged/Inverse ETF seeks to provide returns relative to the index does not need to be evenly divisible by 100 – any ETF that seeks to provide investment results that correspond to the performance of an index by any specified multiple or inverse multiple will be excluded from relying on the Rule. The Rule also prohibits an ETF from indirectly providing returns of a Leveraged/Inverse ETF, such as by embedding leverage in its underlying index.[35]

Share Class ETFs

The Rule does not provide relief for ETFs that are offered as classes of shares of an open-end fund.[36] Rule 18f-3 allows open-end funds to issue multiple classes of shares provided that each class, among other requirements, has the same rights and obligations as each other class (except for arrangements for shareholder services or distribution of securities, and related expenses). Because the rights and obligations of the shareholders in an ETF class, such as the right to redeem ETF shares in creation units only, differ in certain respects from those of investors in mutual fund share classes, Share Class ETFs require additional relief from Sections 18(f)(1) and 18(i) of the 1940 Act.

Even though the Rule does not provide this additional relief, the SEC noted that ETF sponsors may continue to request the necessary relief from Sections 18(f)(1) and 18(i) of the 1940 Act through the exemptive application process. However, the SEC suggested that it may subject such applications to a careful review based on concerns that an ETF class and a mutual fund class may generate different costs to the portfolio, but cause all of the fund's shareholders to bear such costs, regardless of the class of shares they hold. Existing Share Class ETFs can continue to operate pursuant to the terms of their Prior Orders.

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Master-Feeder ETFs

The Rule does not cover master-feeder arrangements in which a feeder fund issues ETF shares, which would require additional exemptive relief under Section 12(d)(1)(E) and Section 17(a) of the 1940 Act. Although Prior Orders have routinely provided such relief, the SEC indicated that it is concerned that a mutual fund feeder might generate more costs than an ETF feeder at the master fund level, which would cause all feeder fund shareholders to bear such costs. The SEC also noted that only one ETF currently appears to operate in this manner. As a result, the SEC is rescinding the master-feeder relief granted to all ETFs that did not rely on the relief in their Prior Orders as of the date of the ETF rule proposal (June 28, 2018). With respect to any Prior Order that permits an existing ETF feeder, the SEC will amend the relevant Prior Order so that it does not permit any new master-feeder structures. The SEC indicates that it could consider the special concerns relating to Master-Feeder ETFs through future exemptive applications.

Non-Transparent ETFs

The Rule does not cover Non-Transparent ETFs, which are actively managed ETFs that do not publish their portfolios daily.[37] Because Non-Transparent ETFs do not provide daily portfolio transparency, they cannot meet the conditions of the Rule and are, therefore, outside of the scope of the Rule. Non-Transparent ETFs will be permitted to operate pursuant to the terms of their exemptive orders.

B. Elimination of Requirement to Disseminate Intraday Indicative Value.

The Rule does not require an ETF to disseminate an intraday estimate of its NAV per share (an intraday indicative value or IIV), which had been a standard requirement in ETF exemptive orders. The SEC determined that the IIV is not necessary to support the arbitrage mechanism for ETFs that provide daily portfolio holdings disclosure because market participants can use the portfolio holdings information to calculate their own intraday values and determine if arbitrage opportunities exist. The SEC also expressed concerns regarding the accuracy and reliability of the IIV for ETFs investing in certain asset classes.

Despite removing the IIV requirement, the SEC recognized that intraday information accurately reflecting the current value of an ETF's shares can be important to retail investors and encouraged the ETF industry to undertake efforts to develop tailored intraday value metrics for ETFs holding different asset classes targeted at retail investors. ETF listing standards at the various national securities exchanges also currently still include an IIV requirement, though the SEC noted comments on the proposed rule encouraging it to work with the exchanges to remove these listing requirements in light of the absence of an IIV requirement in the Rule.

C. Fund of Funds Arrangements

As noted above, the SEC did not rescind the relief granted under existing exemptive orders from Section 12(d)(1) of the 1940 Act and Sections 17(a)(1) and (2) of the 1940 Act that allows registered investment companies to purchase shares of ETFs in excess of otherwise applicable limits (fund of funds relief). The SEC noted that it is currently considering the Fund of Funds Rule Proposal, which could rescind that relief in the future.

The SEC observed, however, that new entrants to the ETF market relying on the Rule would be at a disadvantage without the fund of funds relief. The SEC therefore stated that such ETFs may enter into fund of funds arrangements without obtaining a new exemptive order provided that the ETFs satisfy the terms and conditions of the fund of funds relief in existing exemptive orders issued to other parties. This relief will be available only until the effective date of a new SEC rule permitting registered funds to acquire the securities of other registered funds in excess of the limits in Section 12(d)(1), including Rule 12d1-4 if adopted.

D. Classification System for Exchange-Traded Products

The SEC considered whether to implement a naming system for exchange-traded products in order to address possible investor confusion, but determined that further examination and discussion are needed prior to any such implementation. The SEC observed that the term "ETF" is generally associated with exchange-traded products regulated under the 1940 Act and concluded that Leveraged/Inverse ETFs and UIT ETFs therefore should not be required to use a naming convention that does not include the term "ETF." The SEC encouraged market participants to continue engaging with their investors, with each other, and with the SEC on the issue of nomenclature for exchange-traded products.

V. Disclosure Amendments

The SEC also adopted amendments to Form N-1A and Form N-8B-2 in connection with the Rule, as well as related amendments to Form N-CEN.[38] The Disclosure Amendments are designed to provide investors with additional information regarding ETF trading and associated costs, with certain modifications from the proposal intended to mitigate some of the operational challenges identified by the comment letters. For example, ETFs relying on the Rule will not be required to provide median bid-ask spread disclosure in their prospectuses and will instead be required to provide more recent bid-ask

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spread information on their websites, as discussed above.[39] The SEC also adopted amendments to Form N-1A that will require ETFs that are not within the scope of the Rule to provide certain additional disclosures regarding ETF trading costs in order to help ensure consistent disclosures for ETFs relying on the Rule and ETFs operating pursuant to individualized exemptive relief in order to help investors compare products.

A. Amendments to Form N-1A

The SEC adopted several amendments to Form N-1A that will require new disclosures regarding ETF trading and related costs. Consistent with the proposed rule, the Disclosure Amendments include new narrative disclosures designed to highlight that investors may pay certain fees that are not reflected in the fee table in Item 3 of Form N-1A for ETFs, such as bid-ask spreads, brokerage commissions, and fees paid to financial intermediaries. The amendments to Item 3 also include clarification that the fees and expenses described in item 3 may apply to investors who buy, hold and sell shares of an ETF. In response to concerns raised in feedback on the proposal, the SEC determined not to adopt proposed requirements to disclose quantitative information illustrating the hypothetical impact of bid-ask spreads on investments and to provide an interactive bid-ask calculator on the ETF's website. Instead, the SEC only required ETFs relying on the Rule to provide disclosure of median bid-ask spreads on their websites.

The proposed amendments would have added new disclosure requirements in Item 3 formatted as a series of questions and answers (Q&A), including a description of bid-ask spreads generally, as well as information regarding the specific costs associated with trading shares of an ETF, such as brokerage commissions, bid-ask spread costs, and potential costs attributable to premiums and discounts. In light of commenters' concerns that the extent of trading cost disclosures proposed to be required in Item 3 could obscure other key information regarding other fees and expenses and potentially give bid-ask spread disclosures undue prominence, the Disclosure Amendments move the narrative disclosure to Item 6, which provides investors with information regarding the purchase and sale of fund shares. The SEC also agreed with commenters that ETFs and their investors may benefit from flexibility in the manner of presenting the required information, and accordingly, the Disclosure Amendments permit ETFs to use formats other than Q&As to present this information.

The Disclosure Amendments also streamline several of the narrative disclosure requirements originally proposed. First, the ETF's summary prospectus or summary section will cross-reference the ETF's website, which will be required by the Rule to disclose an ETF's NAV per share, market price, premium or discount, and bid-ask spread information.[40] In an effort to eliminate some of the length associated with the proposed disclosure requirements, the amendments to Form N-1A will require an ETF to state that an investor may incur costs attributable to the difference between the highest price a buyer is willing to pay to purchase shares of the ETF (bid) and the lowest price a seller is willing to accept for shares of the ETF (ask) when buying or selling shares in the secondary market (the bid-ask spread).

The Disclosure Amendments also eliminate certain ETF disclosures that the SEC believes are no longer necessary or are duplicative of disclosure required in reports on other forms. For example, the Disclosure Amendments remove the requirement that an ETF specify the number of shares it will issue or redeem in exchange for the deposit or delivery of basket assets, as this disclosure is largely duplicative of information provided in reports on Form N-CEN. In addition, the Disclosure Amendments eliminate several disclosure requirements in Items 3, 6, 11, and 27 of Form N-1A that applied only to ETFs that issue or redeem shares in creation units of less than 25,000 shares. The Disclosure Amendments also eliminate the premium and discount disclosure requirements in Items 11(g)(2) and 27(b)(7)(iv) of Form N-1A for ETFs relying on the Rule or for ETFs not covered by the Rule that choose to comply with the website disclosure requirements relating to premiums and discounts in the Rule.[41]

B. Amendments to Form N-8B-2

As discussed above, the operations of UIT ETFs will continue to be governed by their Prior Orders rather than the Rule. Nonetheless, the SEC believes it is important for ETFs to provide consistent disclosure to investors, regardless of the ETF's classification under the 1940 Act. Accordingly, the amendments to Form N-8B2 are intended to mirror the disclosure requirements added to Form N-1A, as discussed above. As with other ETFs that are not within the scope of the Rule, these amendments will give UIT ETFs the option to forgo certain disclosures relating to bid-ask spreads and premiums and discounts provided that the ETF conforms with the corresponding website disclosure requirements in the Rule.

C. Amendments to Form N-CEN

The Disclosure Amendments also include amendments to Form N-CEN, the structured form that requires registered funds to provide census-type information to the SEC on an annual basis. Item C.7 of Form N-CEN requires management companies to report whether they relied on certain rules under the 1940 Act during the reporting period. As proposed, the Disclosure Amendments add a new

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requirement that will collect specific information on which ETFs are relying on the Rule. While Form N-CEN already requires funds to report if they are an ETF, the SEC noted that the new requirement will allow it to better monitor reliance on the Rule and to support its accounting, auditing, and oversight functions. Consistent with the proposal, the amendments also harmonized the definition of "authorized participant" in Form N-CEN with the definition in the Rule, deleting references to the Depository Trust Company in order to eliminate the need for future amendments if additional clearing agencies become registered with the SEC.[42]

D. Compliance Date for Disclosure Amendments

The compliance date for the Disclosure Amendments will be December 22, 2020 (425 days after publication in the Federal Register). All registration statements, post-effective amendments, and reports on these forms filed on or after the compliance date must comply with the Disclosure Amendments. Accordingly, to the extent an ETF's annual update filing occurs prior to the compliance date, the new disclosure items would not be applicable to the ETF until the ETF files its next post-effective amendment following the compliance date.

VI. Exemptions Under the 1934 Act

Although the regulatory focus placed on ETFs is mainly on exemptive relief from the 1940 Act, ETFs and broker-dealers who engage in certain transactions in ETF shares also need relief from various provisions of the 1934 Act in order to operate efficiently. Over the years, ETFs have requested relief from Rules 101 and 102 of Regulation M (governing market transactions during an ongoing distribution); Section 11(d)(1) of the 1934 Act and Rule 11d1-2 under the 1934 Act (governing extension of credit on ETF shares); 1934 Act Rules 10b-10 (broker confirmations), 10b-17 (untimely announcement of record dates), 14e-5 (prohibition of purchases outside of a tender offer), 15c1-5 (disclosure of control by broker dealers), and 15c1-6 (disclosure of interest in a distribution by a broker dealer); and Rule 200(g) of Regulation SHO (marking orders long or short).

In response, the SEC and its staff have granted relief to ETFs both individually and on a class-wide basis.[43] This 1934 Act relief, which evolved organically over time, grew to encompass a variety of different conditions and requirements that were sometimes inconsistent, and which often became less germane as regulatory and market comfort with the ETF structure grew. For example, an equity index ETF was required to have a minimum of 20 or more component securities with no one component representing more than 25% of the portfolio in order to have regulatory relief from Regulation M's trading restrictions. In contrast, fixed income index ETFs were required to have at least 13 component securities, with no component security (excluding treasury securities) representing more than 30% of the portfolio with the top five components representing 65% or less of the portfolio. However, transparent active ETFs had no minimum portfolio requirements in order to receive relief from Regulation M.

Similarly, relief from the 1934 Act provisions could sometimes be inconsistent with the generic listing standards applicable to ETFs. For example, the component requirements applicable to equity index funds (20 securities) were in excess of the equivalent minimum component requirement of the generic listing standards (13 securities).[44] The various relief also reflected minimum creation unit sizes that could vary depending on the vintage of the relief.[45] And the SEC subsequently gave relief from minimum creation unit sizes for purposes of Regulation M and Rule 10b-17,[46] but not for the other elements of the 1934 Act relief.

The result of this iterative regulatory process was a highly complex, diffuse set of administrative orders and interpretations that were neither centrally codified nor harmonized. After encouragement from commenters, the SEC has attempted to harmonize much of this 1934 Act regulation through a combination of Rule provisions and the 1934 Act Order.

First, as noted above, the SEC made clear that shares of ETFs that rely on the Rule are "redeemable securities" within the meaning of the 1940 Act, and will automatically be able to rely on pre-existing exceptions contained in Rules 101 and 102 of Regulation M, Rule 10b-17, and Rule 11d1-2. The SEC went a step further, however, and took an interpretive position that all ETFs should be treated as having issued "redeemable securities" regardless of whether they rely on the Rule.[47] The effect of this approach is to treat all ETFs, not just those that rely on the Rule, as being open-end management investment companies for not only these rules, but for all other purposes.[48]

Second, the SEC issued the companion 1934 Act Order, a class-wide exemptive order to entities relying on the Rule from the bulk of the remaining 1934 Act rules for which relief has been granted in the past. Under the terms of the 1934 Act Order, the SEC granted relief from Section 11(d)(1) and Rules 10b-10, 15c1-5, 15c1-6, and 14e-5 to broker-dealers and certain other persons, as applicable, that engage in certain transactions with ETFs relying on the Rule, subject to the following conditions:

- A transaction must involve an ETF that satisfies Rule 6c-11;
- Other than with respect to Rule 14e-5, the transaction must involve an ETF that meets the diversification requirements contained in Section 851(b)(3)(B) of the Internal Revenue Code applicable to a regulated investment company (RIC); and
- The transactions must meet a variety of rule-specific conditions that are intended to apply the rules to ETFs while taking into account the unique nature of ETFs' distribution and redemption provisions.[49]

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The SEC noted that, with the exception of Rule 14e-5 and Section 11(d)(1), this exemptive relief is available solely for primary market transactions (i.e., transactions involving the purchase or redemption by or through an Authorized Participant), and not for secondary market transactions.[50] ETFs that do not rely on the Rule may continue to rely on the existing no-action and exemptive relief applicable to these provisions.[51]

Finally, although some commentators also requested that the SEC expand relief granted to ETF insiders and large shareholders from certain reporting requirements imposed by Section 13(d) and Section 16 of the 1934 Act,[52] the SEC declined to do so.[53] In this regard, the SEC noted that the Section 13(d) and Section 16 relief was primarily conditioned on there being "no material deviation between the ETF's secondary market price and NAV." This existing requirement is consistent with the regulatory approach underlying the Rule, and therefore the SEC felt that broadened relief was inappropriate in this area.

With respect to relief under the 1934 Act, the key take-aways from the Rule and the 1934 Act Order include the following:

- The relief for ETFs from Rules 101 and 102 of Regulation M, Rule 10b-17 and Rule 11d1-2 is very broad and is now effectively unconditional.
- The diversification requirement that is a condition to relief from Section 11(d)(1) and Rules 10b-10, 15c1-5, and 15c1-6 requires an ETF to "meet[ ] the diversification requirement applicable to a regulated investment company in Internal Revenue Code…."[54]
- Both the 1934 Act Order and the Rule eliminate any minimum creation unit size or value and portfolio construction or diversification requirements (other than RIC diversification), thus harmonizing the 1934 Act relief with the 1940 Act relief provided by the Rule.
- The 1934 Act relief does not address exchange listing standards, and any portfolio limitations imposed by the listing standards remain intact.
- A broker-dealer relying on the exemptions from Section 11(d)(1) cannot receive cash compensation from the Fund Complex. As a result, such broker-dealer cannot receive revenue sharing and still extend margin to its clients pursuant to the exemption from Section 11(d)(1).

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[1] *See* Exchange-Traded Funds, Release No. IC-33646 (Sept. 25, 2019), 84 Fed. Reg. 57,162 (Oct. 24, 2019) https://www.sec.gov/rules/final/2019/33-10695.pdf (Adopting Release).

[2] *See* Exchange-Traded Fund Alert, SEC Adopts Exemptive Rule for Exchange-Traded Funds, https://www.stradley.com/insights/publications/2019/09/exchange-traded-funds-alert-september-2019.

[3] *See* Order Granting a Conditional Exemption from Exchange Act Section 11(d)(1) and Exchange Act Rules 10b-10, 15c1-5, 15c1-6, and 14e-5 for Certain Exchange Traded Funds, SEC Release No. 34-87110 (Sept. 25, 2019).

[4] As defined in subsection (a)(1) of the Rule, "creation unit" means a specified number of ETF shares that the ETF will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount if any. See Rule 6c-11(a)(1). In a change from the Prior Orders, the Rule does not prescribe a minimum number of shares in a creation unit. Additionally, the Rule's definition of "creation unit" will require an ETF to specify a single number of ETF shares composing a creation unit. Although an ETF could not use variable creation unit sizes under this definition, an ETF could change its specified creation unit size as conditions change over time.

[5] As defined in subsection (a)(1) of the Rule, "authorized participant" means a member or participant of a clearing agency registered with the SEC, which has a written agreement with the ETF or one of its service providers that allows the authorized participant to place orders for the purchase and redemption of creation units. See Rule 6c-11(a)(1).

[6] As defined in subsection (a)(1) of the Rule, "basket" means the securities, assets or other positions in exchange for which an ETF issues (or in return for which it redeems) creation units. See Rule 6c-11(a)(1). Although the parenthetical on redemptions in the definition of "basket" suggests that the basket is received by the ETF from the authorized participant in a redemption, the definition of "creation unit" makes clear that, in a redemption, the basket is delivered to the authorized participant by the ETF in exchange for a creation unit of ETF shares delivered to the ETF by the authorized participant. Accordingly, the parenthetical in the definition of "basket" might be better read simply as "or redeems."

[7] As defined in subsection (a)(1) of the Rule, "cash balancing amount" means an amount of cash to account for any difference between the value of the basket and the net asset value of a creation unit. See Rule 6c-11(a)(1).

[8] It remains to be seen whether and how the SEC will continue to observe these distinctions for purposes of registration statement disclosure.

[9] *See* Rule 6c-11(c)(1)(i).

[10] Recent ETF exemptive orders include a condition that they automatically expire on the effective date of the Rule. The SEC is amending those Prior Orders to enable ETFs to continue to rely on the Prior Orders for up to one year after the effective date of the Rule.

[11] As discussed below, Prior Orders granted to UIT ETFs, Leveraged/Inverse ETFs, Share Class ETFs and Non-Transparent ETFs will not be rescinded. In addition, the SEC will not rescind relief that permits Master-Feeder ETFs for Master-Feeder ETFs that have already relied on such relief as of June 28, 2018, the date of the proposing release for the Rule.

[12] In December 2018, the SEC proposed new Rule 12d1-4 under the 1940 Act applicable to fund of funds arrangements and proposed to

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rescind the exemptive orders granting relief for certain fund of funds arrangements, including the relief from Sections 12(d)(1)(A) and (B) that has been included in ETF exemptive orders. See Fund of Funds Arrangements, Release No. IC-33329 (Dec. 19, 2018), 84 Fed. Reg. 1286 (Feb. 1, 2019) (Fund of Funds Rule Proposal).

[13] The SEC also confirmed that the relief extends to any entities that are affiliated with the ETF by virtue of holding more than 25% of the ETF's shares or more than 25% of any investment company that is an affiliated person of the ETF, as was expressly stated in previously granted ETF exemptive orders.

[14] As defined in subsection (a)(1) of the Rule, "foreign investment" means any security, asset, or other position of the ETF issued by a foreign issuer as that term is defined in Rule 3b-4 under the 1934 Act, and that is traded on a trading market outside of the United States. See Rule 6c-11(a)(1). As a result, the definition does not limit the exemption to securities, but includes other investments that may not be considered securities. In addition, in contrast to the proposed rule, the SEC is not requiring the investment to have "no established U.S. public trading market," which could have made the exemption unavailable in situations where a foreign issuer also issued the security in the United States.

[15] In a change from the Prior Orders, the Rule does not require an ETF to disclose in its registration statement the foreign holidays that it expects may prevent timely delivery of foreign securities, and the maximum number of days that it anticipates it will need to deliver the foreign securities.

[16] *See* Adopting Release at 68 n.225 (stating "an ETF should not establish restrictive terms of use that would effectively make the disclosures unavailable to the public or otherwise difficult to locate. For example, the required website disclosure should be easily accessible on the website, presented without encumbrance by user name, password, or other access constraints, and should not be subject to usage restrictions on access, retrieval, distribution or reuse. However, this requirement does not preclude the ETF from making other, unrelated sections of its website private or password protected.").

[17] Under subsection (a)(1) of the Rule, "portfolio holdings" include securities, their cash holdings, and holdings that are not securities or assets, including short positions or written options. See Rule 6c-11(a)(1); see also Adopting Release at 74 n.249.

[18] Rule 6c-11(c)(3). The Adopting Release states that ETF basket policies and procedures would be considered to be compliance policies and procedures for purposes of Rule 38a-1 of the 1940 Act. Adopting Release at 91 n.307 and accompanying text.

[19] *See* Adopting Release at 86 n.292 and accompanying text. The Adopting Release states that this requirement is expected to "protect against overreaching and other abusive practices in circumstances where an ETF uses a basket that does not reflect a pro rata slice of the ETF's portfolio holdings." *Id.* at 86.

[20] *See Id.* at 80 n.278 and accompanying text. According to the Adopting Release, these restrictions were intended "to address the risk that an authorized participant could take advantage of its relationship with the ETF and pressure the ETF to construct a basket that favors an authorized participant to the detriment of the ETF's shareholders." *Id*. at 82. The actual scope and magnitude of this risk, as opposed to the mere possibility of occurrence, was never publicly articulated by the SEC or its Staff.

[21] Rule 6c-11(a)(1).

[22] *See* Adopting Release at 92 n.310 and accompanying text (noting that "[a] basket that is a pro rata representation of the ETF's portfolio holdings, except for minor deviations when it is not operationally feasible to include a particular instrument within the basket, generally would not be considered a 'custom basket' except to the extent different baskets are used in transactions on the same business day.").

[23] *See Id.* at 92 n.311 and accompanying text (noting that an ETF's use of a same-day custom basket with a different representative sampling requires consideration of whether the effect of the change in sampling on the ETF's portfolio is in the best interests of the ETF and its shareholders).

[24] *See* Rule 6c-11(c)(3). The Adopting Release confirms that the "'best interests of the ETF and its shareholders' is not intended to apply to each ETF shareholder individually, but rather to the ETF's shareholders generally." Adopting Release at 88 n.298 and accompanying text.

[25] *See* Adopting Release at 87. While an ETF is not required to adopt custom basket policies and procedures, without such policies and procedures the ETF would not have the flexibility to use a custom basket – e.g., a non-pro rata basket or a different basket than the same-day initial basket – in the event it became necessary for it to do so.

[26] *Id.* at 94 n.318 and accompanying text.

[27] *Id.* at 90 n.305 and accompanying text (noting that "[a]n investment adviser has a fiduciary duty to act in the best interests of a fund it advises.").

[28] *Id.* at 95 n.326 and accompanying text.

[29] *See* Rule 6c-11(d)(2). The recordkeeping requirements in the Rule also will require the ETF to maintain and preserve all written agreements between an authorized participant and the ETF or one of its service providers that allows the authorized participant to place creation and redemption orders.

[30] UITs are investment companies that do not have a board of directors, corporate officers, or an investment adviser. See Section 4(2) of the 1940 Act.

[31] Note, however, that the Disclosure Amendments will require UIT ETFs to provide trading cost disclosures similar to those provided by other ETFs that are subject to the Rule. See infra Section V.

[32] *See* Rule 6c-11(c)(4).

[33] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (Dec. 11, 2015), https://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

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[34] The SEC likewise did not adopt enhanced website or other disclosure requirements for Leveraged/Inverse ETFs, noting that any potential disclosure changes for Leveraged/Inverse ETFs should be addressed separately for all leveraged/inverse registered funds.

[35] *See* Rule 6c-11(c)(4).

[36] Note, however, that the Disclosure Amendments will require Share Class ETFs to provide additional trading cost disclosures similar to those provided by other ETFs that are subject to the Rule. *See* infra Section V.

[37] The SEC recently granted the first exemptive order to permit the operations of an active ETF that would not publish its portfolio daily. See Precidian ETFs Trust, Release Nos. IC-33440 (April 8, 2019) (notice) and IC-33477 (May 20, 2019) (order). For more information about this development, see Fund Alert, SEC Moves Toward Approval of First Non-Transparent Active ETF, https://www.stradley.com/insights/publications/2019/04/fund-alert-april-9-2019.

[38] Form N-1A is the registration form used by open-end funds to register under the 1940 Act and to offer their securities under the Securities Act of 1933. Form N-8B-2 is the registration form under the 1940 Act for UITs which are currently issuing securities and is used for registration of ETFs organized as UITs. Although ETFs organized as UITs are not included within the scope of the Rule, the amendments to Form N-8B-2 would subject UITs to the same disclosure requirements imposed on ETFs structured as open-end funds.

[39] The amendments to Form N-1A also provide an ETF that does not rely on the Rule with the option of providing the information required by the Rule on its website or the median bid-ask spread over the ETF's most recent fiscal year in its prospectus.

[40] *See* supra Section III.A.

[41] *See* Form N-1A, Items 11(g)(2) and 27(g)(2). Similar amendments were made to Form N-8B-2 to extend the premium/discount disclosure requirements to UIT ETFs.

[42] *See* Form N-CEN, Item E.2.

[43] *See, e.g.*, Clifford Chance US LLP, SEC No-Action Letter (Oct. 24, 2006) ("Equity Class Relief"); Willkie Farr & Gallagher, LLP, SEC No-Action Letter (April 9, 2007) ("Fixed Income Class Relief"); Paul, Hastings, Janofsky and Walker LLP, SEC No-Action Letter (June 27, 2007) ("Mixed Class Relief"); Securities Industry Association, SEC No-Action Letter (Nov. 21, 2005); WisdomTree Trust, SEC No-Action Letter (May 9, 2008); SEC Staff Legal Bulletin No. 9 (Oct. 27, 1999) (revised Sept. 10, 2010).

[44] *See, e.g.*, NYSE ARCA Equity Rule 5.2-E(j)(3).

[45] *See* Equity Class Relief and Fixed Income Class Relief (requiring creation unit aggregations for index funds 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); WisdomTree Trust, SEC No-Action Letter (May 9, 2008) (noting active transparent ETF with 50,000 shares with no minimum value); AdvisorShares Trust, SEC No-Action Letter (June 16, 2011) (noting active transparent ETF with 25,000 shares with a minimum market value of $1.25 million).

[46] *See, e.g.*, Order Granting Limited Exemptions from Exchange Act Rule 10b-17 and Rules 101 and 102 of Regulation M to Certain Index-Based ETFs Pursuant to Exchange Act Rule 10b-17(b)(2) and Rules 101(d) and 102(e) of Regulation M, SEC Release No. 34-82234, at 5 n.4 (Dec. 7, 2017) ("John Hancock Order").

[47] *See* Adopting Release at 36-37 (stating, "After considering comments, we are clarifying that we view securities of all ETFs, including those that do not rely on rule 6c-11, as eligible for the redeemable securities exceptions in rules 101(c)(4) and 102(d)(4) of Regulation M and rule 10b-17(c) under the Exchange Act in connection with secondary market transactions in ETF shares and the creation or redemption of creation units and the exemption in rule 11d1-2 under the Exchange Act for securities issued by a registered open-end investment company or unit investment trust.").

[48] *See* Adopting Release at 35 n.98 (noting "ETFs that are management companies and operate in reliance on rule 6c-11 and those that operate in reliance on an exemptive order would equally be subject to the Act and our rules as open-end funds.").

[49] Most of these rule-specific conditions relate to complying with existing requirements of the rules as modified by the 1934 Act Order, or providing additional information to investors upon request. However, the exemption applicable to Section 11(d)(1) is conditioned on the absence of cash compensation flowing from a "Fund Complex" (which includes the ETF and its investment adviser, among other entities) to a broker-dealer.

[50] The SEC made clear that the exemptions contained in Rules 101(c)(4) and 102(d)(4) of Regulation M and Rules 10b-17(c) and 11d1-2 under the 1934 Act are applicable to both primary and secondary market transactions. See Adopting Release at 36-37 (noting exemptions were "in connection with secondary market transactions in ETF shares and the creation or redemption of creation units. ...").

[51] *See* Adopting Release at 38 n.110 (stating "ETFs that do not operate in reliance on rule 6c-11 and currently have relief from the Exchange Act provisions discussed above may continue to rely on such relief.").

[52] *See* PDR Services Corporation, SEC No-Action Letter (Dec. 14, 1998); Select Sector SPDR Trust, SEC No-Action Letter (May 6, 1999).

[53] *See* Adopting Release at 38.

[54] Note that the condition does not require an ETF to be taxed as a RIC, only that it meet the diversification requirement. Consequently, ETFs that are taxed as C Corporations and that rely on the Rule would still arguably be able to avail themselves of the exemptive relief provided that their portfolio was otherwise diversified in accordance with Sub-Chapter M of the Internal Revenue Code.

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