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SEC Moves Toward Approval of First Non-Transparent Active ETF

On April 8, 2019, the Securities and Exchange Commission (SEC) issued a notice of its intention to grant exemptive relief requested by Precidian Funds LLC (Precidian) to permit the first "non-transparent" actively managed exchange-traded funds (ETFs).[1] To date, all actively managed ETFs have been required to publish their full portfolios on a daily basis.[2] Precidian filed an application with the SEC seeking exemptions from certain provisions of the Investment Company Act of 1940 (1940 Act) to allow "ActiveShares ETFs" – ETFs that would publish intraday values of their portfolios at one second intervals rather than disclose their portfolio holdings on a daily basis.

What are the key features of ActiveShares ETFs?

ActiveShares ETFs would have two key structural features:

"Verified Intraday Indicative Value" or "VIIV." Each ActiveShares ETF would disseminate a VIIV, reflecting the value of its portfolio holdings.[3] The VIIV would be calculated every second during the trading day, and the VIIV calculation would be subject to specific and uniform parameters across all ActiveShares ETFs.[4] Each ActiveShares ETF would only invest in certain securities that are traded on a U.S. exchange, contemporaneously with the ActiveShares ETF's shares.[5]

Authorized Participant Representatives. ActiveShares ETFs would sell and redeem their shares in creation units to authorized participants (APs) only through unaffiliated broker-dealers acting on an agency basis for the APs (AP Representatives). On each day, an ActiveShares ETF would disclose to each AP Representative the basket securities that the ActiveShares ETF would exchange for its shares, which would generally represent a pro rata slice of the ETF portfolio. For creations, an AP would deliver to its AP Representative the cash necessary to purchase the basket securities to be exchanged for the shares of the ActiveShares ETF. For redemptions, the ActiveShares ETF would deliver basket securities to the AP Representative, who would then sell them in exchange for cash on behalf of the AP. The AP Representative would know, but keep confidential, the identity and weightings of the basket securities it exchanges for the shares on behalf of the APs. The AP therefore could engage in arbitrage transactions through the AP Representative without obtaining information about the portfolio holdings of the ActiveShares ETF.

Precidian asserts that the combination of the VIIV and the ability to create and redeem shares through the AP Representative should allow for the ETF shares to trade at market prices close to net asset value, which has been one of the primary SEC concerns in evaluating ETF applications.

Other Notable Conditions. In addition to structural features, the exemptive application also commits ActiveShares ETFs to certain additional protective measures.

- ActiveShares ETFs would provide certain public disclosures to explain to investors how the ActiveShares ETFs differ from traditional ETFs. Each ActiveShares ETF would

(i) inform investors that the ActiveShares ETFs' bid-ask spreads and premiums/discounts may be larger than those for traditional ETFs due to the lack of transparency, thus making trading in the ActiveShares ETFs' shares more expensive; (ii) disclose that market participants may attempt to reverse engineer the VIIV to identify an ActiveShares ETF's trading strategy, which, if successful, could increase opportunities for trading practices that may disadvantage the ActiveShares ETF and its shareholders; and (iii) include a legend on the outside cover of its prospectus, and on its website and any marketing materials, that would highlight the differences between ActiveShares ETFs and fully transparent actively managed ETFs as well as the above costs and risks.

- ActiveShares ETFs would comply with the requirements of Regulation Fair Disclosure, prohibiting the ActiveShares ETFs' selective disclosure of any material nonpublic information.[6]

- ActiveShares ETFs and their investment adviser would take remedial actions as necessary if the ActiveShares ETFs do not function as anticipated and would provide to the SEC staff periodic reports containing such information as the staff may request in connection with the staff's ongoing monitoring of the ActiveShares ETFs.[7]

How did Precidian get here?

Precidian had previously filed an exemptive application for a non-transparent active ETF based on a different proposal that had contemplated an intraday indicative value (IIV) that would be disseminated at 15-second intervals and would serve as the primary pricing signal to market participants. In 2014, the SEC issued a notice preliminarily taking the position that the proposal did not provide an adequate substitute for full portfolio transparency in facilitating effective arbitrage because the proposal did not provide sufficient information to allow market makers to assess effectively whether real-time arbitrage opportunities existed with respect to the ETF shares.[8]

Precidian withdrew its previous application and, on December 22, 2014, filed an application in which it sought to address the SEC's concerns through the VIIV, as discussed above. Precidian subsequently amended the application on seven occasions, ultimately resulting in the current application, which was filed on April 4, 2019.[9]

What's next?

The SEC notice indicates that the SEC intends to issue the order granting the relief unless a request for a hearing is received by the SEC by May 3, 2019. If a hearing is requested, then the SEC would have to determine whether to hold a hearing or deny the hearing request and grant the relief.

In addition to the exemptive order, ActiveShares ETFs would need to finalize and have an effective registration statement before any public offering. Also, a national securities exchange would need to submit a listing application to the SEC under Rule 19b-4 under the Securities Exchange Act of 1934 to obtain approval to list and trade ActiveShares ETFs.

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The Precidian exemptive application also notes that numerous asset managers have entered into agreements to license certain intellectual property relevant to the ActiveShares ETFs so that those asset managers may offer their own ActiveShares ETFs. As explained in the application, the licensed investment advisers may apply for separate exemptive orders by filing applications that incorporate by reference all the terms and conditions in the Precidian application.

In addition, there are a number of exemptive applications under the 1940 Act that are still pending with the SEC and that propose other approaches to actively managed ETFs that would not publish their portfolios on a daily basis. The SEC did not signal in its notice to Precidian how it would address those other applications.

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[1] Precidian ETFs Trust, et al., Investment Company Act Release No. 33440 (April 8, 2019, https://www.sec.gov/rules/ic/2019/ic-33440.pdf).

[2] The SEC also has proposed a new exemptive rule to permit the operation of actively managed ETFs that would publish their full portfolios on a daily basis. For more information on the proposed ETF rule, please see Stradley Ronon's Fund Alert (https://www.stradley.com/insights/publications/2018/07/etf-alert-july-31-2018).

[3] For purposes of the VIIV, all portfolio securities would be valued at the mid-point between the current national best bid and national best offer as disseminated by the Consolidated Quotation System or UTP Plan Securities Information Processor.

[4] Specifically, each ActiveShares ETF would employ a primary and a secondary calculation engine to provide two independently calculated pricing streams. Each ActiveShares ETF would also employ a pricing verification agent to continuously compare the two data streams from the calculation engines on a real time basis. Each ActiveShares ETF would adopt procedures governing the calculation and dissemination of the VIIV.

[5] Each ETF would invest only in ETFs and exchange-traded notes, common stocks, preferred stocks, American depositary receipts, real estate investment trusts, commodity pools, metals trusts, currency trusts and futures. The ETF may also invest in cash and cash equivalents. No ETF would purchase securities that are illiquid investments (as defined in Rule 22e-4 under the 1940 Act) at the time of purchase, borrow for investment purposes, or hold short positions.

[6] ETFs are not otherwise subject to Regulation Fair Disclosure.

[7] For example, prior to launch, ActiveShares ETFs would establish certain thresholds for their levels of premiums/discounts and spreads, so that, for at least the first three years after the launch of the ActiveShares ETFs, upon an ActiveShares ETF's crossing a threshold, the ActiveShares ETF's board of directors would meet and the investment adviser would present the board with recommendations for appropriate remedial measures.

[8] Precidian ETFs Trust, et al., Investment Company Act Release No. 31300 (Oct. 21, 2014, https://www.sec.gov/Archives/edgar/data/1499655/999999999714014497/filename1.pdf). Specifically, the SEC stated that the IIV was not reliable as the primary pricing signal for the ETF's portfolio, especially during stressed or volatile market conditions, because the IIV (i) would have provided stale data, given the 15-second intervals; (ii) would not have been subject to meaningful standards, given that there were no uniform methodology requirements for its calculation; and (iii) would have been of limited value for asset classes that cannot be easily and accurately priced.

[9] Precidian ETFs Trust, et al., File No. 812-14405 (as filed April 4, 2019, https://www.sec.gov/Archives/edgar/data/1396289/000114420419018151/tv518160_40-appa.htm).