

Exchange-Traded Funds Alert

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SEC Adopts Exemptive Rule for Exchange-Traded Funds

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 exemptions necessary to permit their operations.¹ Previously, ETF sponsors were required to obtain individual exemptive orders from the SEC to operate index-based or actively managed ETFs. In addition to streamlining the regulatory process, the Rule is intended to level the regulatory playing field for most ETFs and facilitate greater competition and innovation among ETF sponsors.

As discussed below, the Rule adopts many of the provisions originally proposed.² However, the Rule and the related disclosure amendments do not contain some of the more burdensome disclosure requirements that were originally contemplated.

This alert provides a quick initial summary of the major features of the Rule. We plan to issue an additional alert to discuss the Rule in greater detail and provide an analysis of the Rule's impact on current ETF operations. We also will follow-up with details about a Stradley webinar to discuss the Rule, which we have scheduled for October 15, 2019. Please let our ETF team know if you have any questions about the Rule or this alert.

What does the Rule cover?

The Rule provides relief for almost all actively managed and index-based ETFs. The Rule does not include relief for (i) share class ETFs; (ii) master-feeder ETFs; (iii) leveraged/inverse ETFs; (iv) ETFs that are structured as unit investment trusts (UITs) under the 1940 Act; (v) exchange-traded products that are not registered under the 1940 Act (e.g., exchange-traded products that do not invest primarily in securities); and (vi) non-transparent ETFs.³ The Rule does not distinguish between index-based and actively managed ETFs.

Existing ETF exemptive orders will be rescinded one year after the effectiveness of the Rule, except for orders that permit share-class ETFs, leveraged/inverse ETFs, UIT ETFs, and non-transparent ETFs. The Rule also rescinds relief that permits master-feeder ETFs, except with respect to existing master-feeder ETFs that already relied on such relief as of June 28, 2018.

The Rule does not rescind any relief granted under existing exemptive orders from Section 12(d)(1) of the 1940 Act or Sections 17(a)(1) and (2) of the 1940 Act, which allow registered investment companies to purchase shares of ETFs in excess of otherwise applicable limits (fund of funds relief). The SEC is currently considering a separate rule proposal relating to funds of funds, which could rescind that relief in the future.⁴ With respect to ETFs that may rely on the Rule but that have not previously obtained fund of funds relief, the Adopting Release takes an unusual regulatory approach by stating that such ETFs may enter into fund of funds arrangements without obtaining a new order provided that such ETFs satisfy the terms and conditions of the fund of funds relief in existing exemptive orders issued to other parties.

What are the key provisions of the Rule and the related disclosure changes?

- *Custom basket flexibility.* The Rule provides ETFs with the flexibility to issue and redeem shares in exchange for “custom baskets” of securities (i.e., baskets that contain a non-representative selection of the ETF’s portfolio holdings or that differ from other baskets on the same business day) if the ETF has adopted written policies and procedures that: (i) set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for any revisions to, or deviations from, those parameters; and (ii) specify the titles or roles of the employees of the ETF’s investment adviser who are required to review each custom basket for compliance with those parameters. This flexibility was included in the proposed rule and was generally welcomed as one of the most attractive aspects of the rule proposal because many ETF exemptive orders do not contain such relief.
- *Full, daily portfolio transparency.* The Rule requires website disclosure (in a standardized manner) of an ETF’s full portfolio holdings on each business day before the opening of regular trading on the ETF’s primary listing exchange. Unlike the proposed rule, 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.
- *Treatment of ETF shares as “redeemable securities.”* ETFs relying on the Rule will be considered to issue “redeemable securities” within the meaning of Section 2(a)(32) of the 1940 Act. As a result, ETFs relying on the Rule will be 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 Securities Exchange Act of 1934 (1934 Act) and the “registered open-end investment company” exemption in Rule 11d1-2 under the 1934 Act. As a result, ETFs no longer need to rely on previously granted class relief from those provisions of the 1934 Act.
- *Additional time for delivering redemption proceeds.* The Rule grants relief from Section 22(e) of the 1940 Act to permit an ETF to delay satisfaction of an in-kind redemption request for more than seven days if local market holidays and/or extended delivery cycles for foreign investments prevent timely delivery, as long as the ETF delivers such foreign investments as soon as practicable, but in no event later than 15 days after tender to the ETF.⁵ Unlike the proposed rule, the Rule does not contain a sunset provision that limits such relief to 10 years from the Rule’s effective date.
- *Exemptions for in-kind transactions with affiliated persons.* The Rule provides exemptions from Sections 17(a)(1) and 17(a)(2) of the 1940 Act in order to permit in-kind purchases and redemptions 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 five percent or more of an ETF’s shares; or (ii) holding with the power to vote five percent or more of any investment company that is an affiliated person of the ETF. The SEC did not expand this relief to include persons affiliated with the adviser to an ETF, as some commenters had encouraged, although the SEC indicated that it could consider such exemptions through the regular exemptive applications process.
- *No dissemination of intraday indicative value.* The Rule does not require an ETF to disseminate an intraday estimate of its net asset value (NAV) per share (an intraday indicative value or IIV), which had been a standard requirement in ETF exemptive orders. Even though the Rule does not include this requirement, ETF listing standards at the various national securities exchanges still include such a requirement.
- *Creation unit sizes.* The Rule does not mandate a minimum or maximum creation unit size, and therefore ETFs will have the flexibility to establish their own creation unit size. In addition, the Rule provides that on the day of a reorganization, merger, conversion, or liquidation, an ETF may sell or redeem individual shares and transact with investors who are not authorized participants.
- *Website disclosure.* In addition to full portfolio holdings disclosure, an ETF must publicly disclose on its website: (i) the ETF’s NAV, market price, and premium or discount, each as of the end of the prior business day; (ii) a table and line graph showing certain premium and discount data for the most recently completed calendar year and most recently completed calendar quarters since that year (or life of the ETF, if shorter); (iii) if an ETF’s premium or discount exceeds two percent for more than seven consecutive trading days, a statement that the ETF’s premium or discount, as applicable, is greater than two percent and a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount; and (iv) the median bid-ask spread over the most recent 30 calendar days. This differs from the proposed rule in that the Rule (i) does not require an ETF to post information regarding one published basket that it would exchange for orders to purchase or redeem creation units; and (ii) requires disclosure of the median bid-ask spread over only the most recent 30 calendar days rather than the most recent fiscal year.
- *Form N-1A amendments.* The Form N-1A amendments include requirements for narrative disclosures relating to ETF trading costs, including bid-ask spreads. Unlike the proposed Form N-1A amendments, the final amendments: (i) do not require an ETF to disclose information regarding how ETF shares trade and the associated costs as part of the ETF’s fee table; (ii) do not require hypothetical bid-ask spread examples

in an ETF's prospectus and an interactive calculator; and (iii) permit ETFs to provide the required narrative disclosures in formats other than Q&As. Other Form N-1A amendments include (i) requiring a statement that investors may be subject to other fees not reflected in the fee table, such as brokerage commissions and fees to financial intermediaries; (ii) requiring ETFs that do not rely on the Rule to disclose median bid-ask spread information on their websites or in their prospectus; (iii) excluding ETFs that provide premium/discount disclosures on their website under the Rule from the premium/discount disclosure requirements in Form N-1A; and (iv) eliminating disclosures relating to creation unit size and disclosures applicable only to ETFs with creation unit sizes of less than 25,000 shares.⁶

When is the Rule effective?

The Rule becomes effective 60 days after publication in the Federal Register. ETFs may begin to rely on the Rule on such effective date, so long as they can comply with the provisions of the Rule, although existing ETFs may continue to rely on their existing exemptive orders until the effective date of the rescission one year after the effective date of the Rule. The compliance date for amendments to Form N-1A is 425 days after the Rule is published in the Federal Register (i.e., one year after the effective date of the Rule). Accordingly, all registration statements and post-effective amendments on Form N-1A filed on or after the compliance date must comply with the amendments.

What is the exemptive order that was issued under the 1934 Act?

In addition to adopting the Rule, the SEC also issued an exemptive order under the 1934 Act providing relief from certain requirements under the 1934 Act with respect to ETFs relying on the Rule.⁷ The Order seeks to harmonize previous relief provided to broker-dealers and other persons engaging in certain transactions in securities of ETFs. Commenters on the rule proposal expressed concern that some of the previous relief under the 1934 Act was subject to conditions that could be duplicative or inconsistent with other requirements applicable to ETFs. Although the Order still contains specific requirements relating to the

various elements of the relief, the Order generally seeks to reduce complexity by eliminating requirements such as a minimum number of shares in creation units and diversification requirements different from the diversification requirements applicable to a regulated investment company in the Internal Revenue Code.

¹ Exchange-Traded Funds, Release No. IC-33646 (Sept. 25, 2019), <https://www.sec.gov/rules/final/2019/33-10695.pdf> (Adopting Release).

² For more information on the original rule proposal, please see Stradley's Fund Alert "SEC Proposes Exemptive Rule for Exchange-Traded Funds" (<https://www.stradley.com/insights/publications/2018/07/etf-alert-july-31-2018>).

³ In May 2019, the SEC granted an exemptive order permitting the first non-transparent active ETFs. For more information on that development, please see Stradley's 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>).

⁴ In December 2018, the SEC proposed new Rule 12d1-4 under the 1940 Act applicable to fund of funds arrangements and proposed to 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 FR 1286 (Feb. 1, 2019).

⁵ As was proposed, 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.

⁶ The SEC also adopted certain amendments to Form N-8B-2 that will require UIT ETFs to provide certain additional disclosures regarding trading costs.

⁷ 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, Release No. 34-87110 (Sept. 25, 2019), <https://www.sec.gov/rules/exorders/2019/34-87110.pdf> (Order).

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