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Regulatory Developments in ETFs

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The SEC's Liquidity Proposal and ETFs

On September 22, 2015, the U.S. Securities and Exchange Commission ("SEC") released its liquidity proposal (the "Liquidity Proposal").[1] For a general overview of the Liquidity Proposal, see our Client Alert entitled "What You Need to Know About the SEC's New Fund Liquidity Risk Management Proposal."[2] This article discusses the implications of the Liquidity Proposal for exchange-traded funds ("ETFs"), as well as ETF industry comments on the Liquidity Proposal.

Liquidity Risk Management Programs

New Rule 22e-4 under the Investment Company Act of 1940 (the "1940 Act") would require each open-end fund, including all open-end ETFs, to establish a liquidity risk management program, which must be approved by the fund's board of directors or trustees and incorporate specified required elements, including a detailed liquidity classification regime for portfolio holdings.[3] Each fund would be required to classify and continually review each portfolio position, based on six classification categories identifying the number of days that the position is "convertible to cash" at a price that does not materially affect the value of the asset immediately prior to sale.[4] The factors that must be considered for each asset in establishing its liquidity classification include:

- The existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity and quality of market participants.
- The frequency of trades or quotes for the asset and average daily trading volume of the asset.
- The volatility of trading prices for the asset.
- The restrictions on trading of the asset and limitations on transfer of the asset.
- The size of a fund's position in the asset relative to the asset's average daily trading volume and number of units of the asset outstanding (including how the timing of disposing of the position could create any market value impact).[5]

The Liquidity Proposal also codifies the SEC's existing guidance that a fund should invest no more than 15 percent of its total assets in "illiquid" assets, now referred to as the "15 percent standard asset limitation." A "15 percent standard asset" is defined as an asset that may not be sold or disposed of by a fund in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.[6]

ETF-specific Considerations in Liquidity Risk Management Programs

In arguing that ETFs organized as open-end funds should be subject to the Liquidity Proposal, the SEC acknowledged that "ETFs typically make in-kind redemptions of creation units, which can mitigate liquidity concerns for ETFs compared to mutual funds, if the in-kind redemptions are of a representative basket of the ETF's portfolio assets that do not alter the

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ETF's liquidity profile."[7] The SEC asserted, however, that

> a significant amount of illiquid securities in an ETF's portfolio can make arbitrage opportunities more difficult to evaluate because it would be difficult for market makers to price, trade, and hedge their exposure to, the ETF. The effective functioning of this arbitrage mechanism has been pivotal to the operation of ETFs and to the Commission's approval of exemptions that allow their operation. The liquidity of the ETF's portfolio positions is a factor that contributes to the effective functioning of the ETF's arbitrage mechanism and the ETF shares trading at a price that is at or close to the NAV of the ETF.[8]

The SEC further justified the application of the Liquidity Proposal to ETFs by arguing that if authorized participants ("APs") are unwilling or unable to trade ETF shares because of illiquidity in an ETF's portfolio, the ETF's shares may trade at a significant premium or a discount to net asset value ("NAV"). This, in turn, would impair the ETF's arbitrage mechanism, causing the ETF to function more like a closed-end fund.[9]

The Liquidity Proposal further noted that if APs redeem in cash rather than in-kind, the ETFs would need to ensure that they have adequate portfolio liquidity to meet redemptions.[10] The SEC acknowledged that when an ETF does permit an AP to redeem in cash, it typically requires the AP to pay a fee covering the costs of the liquidity it receives, and therefore does not necessarily create the same dilution concerns as mutual funds.[11] The SEC nonetheless cautioned that "[a]n ETF that typically pays redemption proceeds in kind should generally also consider that it has reserved the right to transact with authorized participants in cash, the circumstances in which it anticipates that it would pay redemption proceeds in cash, and how these policies impact its cash flow projections."[12]

The SEC therefore concluded that ETFs should be covered by proposed new Rule 22e-4:

> Like traditional open-end funds, the Commission believes that open-end ETFs could experience liquidity risk, and thus proposes to include open-end ETFs within the scope of rule 22e-4. As discussed above, the liquidity of an ETF's portfolio securities is a factor that contributes to the effective functioning of the ETF's arbitrage mechanism and the ETF shares trading at a price that is at or close to the NAV of the ETF. In addition, ETFs that permit authorized participants to redeem in cash, rather than in kind, and ETFs that typically redeem in cash, like traditional mutual funds, would need to ensure that they have sufficient portfolio liquidity (in conjunction with any other liquidity sources) to meet shareholder redemptions in cash. And especially in times of declining market liquidity, the liquidity of an ETF may be limited by the liquidity of the market for the ETF's underlying securities.[13]

Other ETF Issues in the Liquidity Proposal

Elsewhere in the Liquidity Proposal, the SEC commented on the use of ETFs by mutual funds as a liquidity risk management tool.[14] The SEC cautioned that shares of an ETF whose underlying securities are relatively less liquid may not be an effective liquidity risk management tool during times of liquidity stress.[15] The SEC indicated that mutual funds using ETFs as liquidity risk management tools should assess the liquidity of the ETFs' underlying securities in classifying an ETF's liquidity under proposed Rule 22e-4.[16]

The SEC excluded ETFs from opting into the "swing pricing" provisions of the proposed amendments to Rule 22c-1. The amendments would permit mutual funds (but not ETFs or money market funds) to use swing pricing as a method of adjusting NAV to pass on the costs of purchases or redemptions to the shareholders engaging in those transactions. The SEC's reason for excluding ETFs from the swing pricing is that "ETFs' purchase and redemption practices do not generally entail the risk of dilution as a result of authorized participants' purchase and redemption activity, and that swing pricing could impede the effective functioning of an ETF's arbitrage mechanism."[17] The SEC further argued that swing pricing could have an adverse effect on arbitrage: "If an ETF were to adopt swing pricing . . . an authorized participant would not know whether the ETF's NAV would be adjusted by a swing factor on any given day and therefore may not be able to assess whether an arbitrage opportunity exists."[18]

The Liquidity Proposal also proposed additional ETF disclosure in the SEC's proposed Form N CEN, which would require funds to provide census-type reporting and disclosure of fund information.[19] Specifically, the amendments to Form N-CEN would require an ETF to report whether it required an AP to post collateral to the ETF in connection with the purchase or redemption of ETF shares during the reporting period.[20] In the SEC's view, "[t]he requirement to post collateral for creating or redeeming ETF shares impacts the authorized participant's operating capital, which could, in turn, affect the ability and willingness of authorized participants to serve such ETFs or serve other market makers on an agency basis."[21]

It is noteworthy that the white paper on mutual fund liquidity (the "White Paper") that accompanied the Liquidity Proposal did not include any analysis of ETF liquidity.[22] According to the White Paper:

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> We exclude ETFs because their structure and method of redemption are significantly different from traditional open-end funds. For instance, only authorized participants are allowed to redeem from ETFs; redemptions from ETFs are often performed in-kind rather than in-cash; and the majority of ETFs are passively managed portfolios designed to track a benchmark. The topics of fund flows and liquidity are applicable to ETFs, but the significant differences between ETFs and traditional open-end funds would require a different empirical analysis for ETFs than conducted in this paper.[23]

Industry Comments

The Investment Company Institute ("ICI") comment letter on the Liquidity Proposal raised a number of issues with respect to ETFs.[24] First, the ICI questioned how the three-day liquid asset minimum would be applied by ETFs. The proposed new Rule 22e-4(a)(8) defines a "Three-Day Liquid Asset" as "any cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale." Proposed Rule 22e-4(a)(9) defines "Three-Day Liquid Asset Minimum" to mean "the percentage of the fund's net assets to be invested in three-day liquid assets." The proposed rule would prohibit an ETF from acquiring any less liquid asset if the ETF would have invested less than its Three-Day Liquid Asset Minimum in Three-Day Liquid Assets.[25]

The ICI cautioned that the proposed rule could force ETFs to choose between refusing in-kind purchases or violating the conditions of their SEC exemptive orders.[26] As the ICI explained:

> If the ETF falls below its three-day liquid asset minimum, the proposal would preclude the ETF from accepting any security deemed a less liquid asset. This restriction may conflict with the ETF's exemptive order, which may preclude the ETF from accepting an in-kind purchase that does not contain less liquid assets held by the ETF because the creation basket would not reflect a pro rata slice of the ETF's holdings. Even if circumstances under an ETF's exemptive order permitted the ETF to accept a non-pro rata slice of the ETF's portfolio securities, the ETF might still need to get exposure to less liquid assets to meet its investment objective and/or appropriately track its index.[27]

The ICI recommended instead that the proposed rule "permit ETFs to accept in-kind purchases with less liquid assets even if the ETF has fallen below its three-day liquid asset minimum."[28] In addition, although the ICI does not view basket flexibility as directly related to liquidity, it did urge the SEC to improve ETFs' basket flexibility by permitting ETFs to accept baskets that are consistent with an ETF's investment objective or its primary benchmark, but can vary from what the ETF currently holds (including securities that are not currently held by the ETF), and can vary between creation and redemption baskets.[29] The ICI argued that improved basket flexibility could improve tax efficiency by permitting an ETF to selectively redeem in-kind portfolio securities with large imbedded capital gains, and would also give fixed-income ETFs the ability to retain portfolio securities that the adviser believes the ETF should continue to hold.[30] The ICI argued that increased basket flexibility would not incent ETF sponsors to improperly favor particular APs.[31] Lastly, the ICI argued that ETFs should be permitted to pass on all transaction costs to APs through creation and redemption

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fees, and that such fees should not be limited by the 2 percent maximum redemption fee under Rule 22c-2.[32]

Other ETF industry participants echoed the ICI's comments. Invesco, for example, recommended that the SEC consider the in-kind nature of most ETF redemptions and exclude ETFs from the liquidity risk management program requirements:

> The classification proposal is based on time to convert portfolio holdings to cash and assets are not typically converted to cash by an ETF. When an authorized participant redeems in cash, the variable transaction fee that an ETF may impose to offset transaction costs should address both dilution and liquidity concerns. The three-day liquid asset minimum is particularly challenging, if not impossible, for an index ETF to meet because of the ETF's need to track the index.[33]

State Street Global Advisors was perhaps even more emphatic:

> The concept of liquidity is an entirely different consideration for ETFs which transact in-kind. There is simply no need for such ETFs to be able to convert their holdings to cash, and every holding in the ETF's portfolio is liquid in the sense that it can be distributed in exchange for a redemption to the only parties eligible to transact with the ETF (the authorized participants), who agree, and in most instances prefer, to receive such proceeds in-kind. The relative liquidity classification of each portfolio holding in such an ETF would be a largely meaningless exercise which would serve only to absorb time and resources which the ETF's manager could better expend elsewhere. Similarly, the establishment and maintenance of a three-day liquid asset minimum would be irrelevant for such ETFs, as every asset in the ETF's portfolio — regardless of the ability of the ETF to convert such asset to cash — could be used to satisfy a redemption.[34]

* * *

Given that the SEC in the Liquidity Proposal clearly acknowledged the significant differences in ETF liquidity risks compared with those of mutual funds, the SEC may have to modify the proposed rules to address the significant shortcomings identified by the ICI and other industry commenters. ■

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1 "Open-End Fund Liquidity Risk Management Programs," SEC Rel. No. 33-0022 (Sept. 22. 2015), available at https://www.sec.gov/rules/proposed/2015/33-9922.pdf.

2 Available at http://www.stradley.com/insights/publications/2015/10/client-alert-october-2015.

3 Significantly, ETFs are not proposed to be allowed to offer "swing pricing" under amendments to Rule 22c-1 in the Liquidity Proposal.

4 Proposed Rule 22e-4(a)(3). "Convertible to cash" means the ability to be sold, with the sale settled, within the stated number of days.

5 Proposed Rule 22e-4(b)(2)(i). The SEC recognized that to the extent a proposed factor is not applicable to a particular fund, the fund would not be required to consider that factor in assessing its liquidity risk. Liquidity Proposal at 109.

6 Proposed Rule 22e-4(a)(4). For this purpose, the fund does not need to consider the size of the fund's position in the asset or the number of days associated with receipt of proceeds of sale or disposition of the asset.

7 Liquidity Proposal at 14.

8 *Id.* at 15 (citations omitted).

9 *Id.* at 15-16 (citations omitted).

10 *Id.* at 17 (citations omitted). The Liquidity Proposal stated that the same factors also apply to exchange-traded mutual funds ("ETMFs").

11 *Id.* at nn. 30 & 44. To the extent ETFs conduct in-kind redemptions of APs or charge liquidity fees for cash redemptions, ETFs can mitigate the dilutive effects experienced by mutual funds in times of market liquidity stress, which can create incentives for early redemptions ("first-mover advantage"). *See* n. 49 and accompanying text.

12 *Id.* at 114.

13 *Id.* at 49-50.

14 *Id.* at 165.

15 *Id.* at 167.

16 *Id.*

17 *Id.* at 206-207. ETMFs would similarly be excluded from opting for swing pricing. *See* n. 458.

18 *Id.* at 207-208.

19 *Id.* at 263. The information elicited by Form N-CEN is designed to enhance the SEC's ability to carry out its regulatory functions, including risk monitoring and industry analysis.

20 *Id.* at 266.

21 *Id.* The SEC also appears to be concerned "whether, and to what extent, there may be concentration in the authorized participant framework for such ETFs."

22 "Liquidity and Flows of U.S. Mutual Funds," SEC Division of Economic and Risk Analysis White Paper (Sept. 22, 2015), available at https://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf.

23 *Id.* at 4.

24 Letter from Investment Company Institute (Jan. 13, 2016) ("ICI Letter"), available at https://www.sec.gov/comments/s7-16-15/s71615-59.pdf.

25 Proposed Rule 22e-4(b)(2)(iv)(C).

26 ICI Letter at 49.

27 ICI Letter at 49-50 (citations omitted).

28 *Id.* at 50. The ICI further noted that the regulatory conflict would be eliminated if the SEC were to follow the ICI's general recommendation that funds be permitted to formulate their own liquidity policies.

29 *Id.* at 50-51.

30 *Id.* at 52.

31 *Id.*

32 *Id.* at 53-54.

33 Letter from Invesco Advisers Inc. (Jan. 13, 2016) at 6. Invesco likewise agreed with the ICI that the 2 percent variable fee cap should be lifted for ETFs or, failing that, ETFs should be permitted to use swing pricing.

34 Letter from State Street Global Advisors (Jan. 13, 2016) at 2.

NYSE Arca Seeks to Adopt Generic Listing Standards for Active ETFs

The Rule 19b-4 Listing Approval Process

Over the course of the past year, NYSE Arca Inc. ("NYSE Arca") has sought the approval of a rule change to establish generic listing standards for actively managed exchange-traded funds("ETFs").[1] Currently, the national securities exchanges where ETFs are listed and traded (the "Exchanges," e.g., NYSE Arca, Nasdaq, BATS) have generic listing standards that allow index-based ETFs that can satisfy those standards to be listed and traded on the Exchange without specific approval from the U.S. Securities and Exchange Commission's ("SECs") Division of Trading and Markets.[2] In such instances, the Exchange can list the ETF with only a notification to the SEC.

On the other hand, actively managed ETFs, as well as index-based ETFs that are unable to satisfy the Exchange's generic listing standards, must obtain specific listing approval from the Division of Trading and Markets by filing a proposed rule change pursuant to Rule 19b-4 (a "19b-4 filing") under the Securities Exchange Act of 1934 (the "1934 Act") in order for the ETF to be listed and traded on the Exchange. The Rule 19b-4 filing is typically prepared by the Exchange based on information contained in the ETF's initial registration statement on Form N-1A. In the past, the typical practice was for the Exchange to preview the Rule 19b-4 filing with the SEC prior to the Exchange formally filing the Rule 19b-4 filing with the SEC. Several rounds of comments were often exchanged between the SEC and the Exchange/ETF issuer prior to the formal filing.

More recently, Exchanges have skipped the SEC preview for 19b-4 filings that do not pose novel issues or significant regulatory concerns. Once the formal 19b-4 filing has been made, the SEC has seven business days to reject it (typically only on technical grounds).[3] If the SEC does not reject the filing, the notice for the listing approval of the ETF will be issued by the SEC 15 calendar days after the date of the formal filing. Once the SEC issues the notice, it will take roughly a week for the notice to be published in the Federal Register.

Under normal circumstances, the Rule 19b-4 order will be issued 45 calendar days after the notice has been published. The SEC has the ability to extend the 45-day notice period for an additional 45 days, and has done so more frequently over the past few years. At the end of the 90-day period, the SEC can further delay the listing approval and institute proceedings to consider additional issues if it deems it necessary. If the SEC institutes proceedings, the SEC has an additional 90 days to review the proposal, plus a final option of extending the period for proceedings by 60 days. In sum, the issuance of the listing approval can take up to 240 days in total from the date

the notice of the rule change is first published in the Federal Register. Although it is not common, the SEC can also inform the Exchange that it will not approve the listing, at which point the Exchange would typically withdraw the filing (rather than receive an SEC order disapproving the listing). The 19b-4 listing approval process can therefore be a time-consuming and uncertain process.

Proposed NYSE Arca Generic Listing Standards for Active ETFs

NYSE Arca has proposed a rule change amending NYSE Arca Equities Rule 8.600 to adopt generic listing standards for Managed Fund Shares (the "Proposed Standards").[4] "Managed Fund Shares" effectively refer to actively managed ETFs.[5] Under the Proposed Standards, an actively managed ETF would be required to have a stated investment objective that must be adhered to under normal market conditions.

An actively managed ETF would also be required to disclose on its website certain information regarding its portfolio holdings, such as (1) the ticker symbol, (2) the CUSIP or other identifier, (3) a description of the holding, (4) the identity of the asset upon which a derivative is based, (5) the strike price for any options, (6) the quantity of each security or other asset held as measured by select metrics, (7) the maturity date, (8) the coupon rate, (9) the effective date, (10) the market value, and (11) the percentage weight of the holding in the portfolio. In addition, the Proposed Standards require that a Portfolio Indicative Value be widely disseminated by one or more major market data vendors at least every 15 seconds during the Core Trading Session (as defined in NYSE Arca Equities Rule 7.34).

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NYSE Arca Generic Listing Standards

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The Proposed Standards also impose certain standards on portfolios of actively managed ETFs, which vary according to security or asset type, including requirements with respect to market capitalization, trading volume, portfolio component weighting and principal amount outstanding, as well as issuer and diversity requirements. These portfolio standards are based in large part on the portfolio standards that apply to index-based ETFs listed on NYSE Arca pursuant to its generic listing standards,[6] as well as prior rule changes for specific actively managed ETFs.

The portfolio standards impose no limitation on the percentage of an actively managed ETF's portfolio that can be invested in listed derivatives, provided that at least 90 percent of the listed derivatives consist of futures, options and swaps whose principal market is a member of the Intermarket Surveillance Group("ISG") or is a market with which NYSE Arca has a comprehensive surveillance sharing agreement ("CSSA"). The portfolio standards require that no more than 20 percent of the ETF's assets be invested in over-the-counter derivatives.

The portfolio standards do not require that any portion of the ETF's equity portfolio comprising non-U.S. equity securities be listed on markets that are either a member of ISG or a market with which NYSE Arca has a CSSA. This is consistent with the requirements applicable to index-based ETFs holding non-U.S. equity securities that are listed and traded pursuant to NYSE Arca's generic listing standards, as well as the SEC's recent approval in May 2015 of the listing and trading on NYSE Arca of shares of the SPDR SSgA Global Managed Volatility ETF (the "SPDR SSgA Approval").[7] Instead, an actively managed ETF's investments in non-U.S. equity securities need only satisfy certain portfolio standards, which are based in large part on the portfolio standards that currently apply to index-based ETFs. Prior to the SPDR SSgA Approval, only a certain percentage (e.g., 10 percent) of an actively managed ETF's investments in exchange-traded equity securities could consist of equity securities whose principal market is not a member of ISG or a market with which NYSE Arca does not have a CSSA.

If the proposed rule change adopting generic listing standards for Managed Fund Shares were to be adopted, actively managed ETFs that satisfy those standards could be listed and traded on NYSE Arca without specific approval from the Division of Trading and Markets and with only a notification to the SEC, similar to index-based ETFs. This would allow actively managed ETFs to avoid the 19b-4 listing approval process and come to market with greater speed and certainty. ■

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1 On Nov. 18, 2015, BATS Exchange Inc. also filed a proposed rule change to establish generic listing standards for actively managed ETFs. *See* 1934 Act Rel. No. 76478 (Nov. 19, 2015), available at https://www.sec.gov/rules/sro/bats/2015/34-76478.pdf. On Jan. 4, 2016, the period for the SEC's action relating to the proposal was extended. *See* 1934 Act Rel. No. 76820 (Jan. 4, 2016), available at https://www.sec.gov/rules/sro/bats/2016/34-76820.pdf.

2 *See*, e.g., NYSE Arca Equities Rule 5.2(j)(3).

3 Section 916 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 19(b) of the 1934 Act, which governs the SEC's handling of proposed rule changes submitted by self-regulatory organizations("SROs") such as national securities exchanges. The amendments established new statutory deadlines applicable to the SEC's publication and review of proposed SRO rule changes.

4 *See* 1934 Act Rel. No. 76486 (Nov. 20, 2015), available at https://www.sec.gov/rules/sro/nysearca/2015/34-76486.pdf. On Nov. 23, 2015, NYSE Arca filed Amendment No. 1 to the proposed rule change, but ultimately withdrew this amendment. On Jan. 21, 2016, NYSE Arca filed Amendment No. 2 to the proposed rule change. See 1934 Act Rel. No. 76974 (Jan. 26, 2016), available at https://www.sec.gov/rules/sro/nysearca/2016/34-76974.pdf.

5 *See* NYSE Arca Equities Rule 8.600(c)(1), which defines "Managed Fund Share." NYSE Arca previously filed a proposed rule change in February 2015 to amend NYSE Arca Equities Rule 8.600 to adopt generic listing standards for Managed Fund Shares, but ultimately withdrew the proposed rule change in October 2015. *See* 1934 Act Rel. No. 76186 (Oct. 19, 2015), available at https://www.sec.gov/rules/sro/nysearca/2015/34-76186.pdf.

6 *See* NYSE Arca Equities Rule 5.2(j)(3).

7 *See* 1934 Act Rel. No. 75023 (May 21, 2015), available at https://www.sec.gov/rules/sro/nysearca/2015/34-75023.pdf.

SEC Exchange-Traded Products Release

Over the past decade, exchange-traded products("ETPs") have experienced explosive growth. Globally, a record $347 billion was invested in ETPs in 2015.[1] U.S. exchange-traded funds registered as investment companies ("ETFs") under the Investment Company Act of 1940 (the "1940 Act") experienced $242 billion in net creations in 2015, following net creations of $243 billion in 2014.[2] Despite failing to break the record domestically, the U.S. figures confirm that the migration toward ETPs and ETFs is here to stay.

Such rapid growth has drawn the attention of the U.S. Securities and Exchange Commission("SEC") to the possible risks that ETPs may pose to the investing public. Of particular concern to the SEC is the rise of new ETPs utilizing complex investment strategies that are not regulated as 1940 Act-registered ETFs.

In a release dated June 12, 2015 (the "Release"), the SEC sought comment on whether the current state of its ETP regulatory oversight still adequately protects market integrity while facilitating efficiency.[3] The topics of concern included reliance on arbitrage to establish ETP pricing; appropriateness of the exchange listing process; and broker-dealer sales practices in relation to investor understanding of ETPs.

Arbitrage

The Release acknowledged that exemptive and no-action relief for ETPs is predominantly based on the belief that arbitrage will keep the intraday market prices of an ETP relatively close to its net asset value ("NAV"). In practice, however, certain products appeared to be deviating more than anticipated. These deviations have prompted questions such as whether reliance on arbitrage still ensures sufficient market pricing in light of new complex strategies; how the liquidity of the underlying investments affects the arbitrage mechanism; whether the arbitrage mechanism is reliable in periods of market stress or extreme volatility; and whether there are any practical alternatives to the arbitrage mechanism.

Industry commentators on the Release focused on the role of portfolio transparency in facilitating arbitrage. Currently, all actively managed ETFs are required to post daily their full portfolio as of that day's settlement. However, not all index ETFs are required to post their portfolios. The industry appears to be divided over whether full portfolio transparency should be required for all ETFs.

T. Rowe Price, which is currently seeking exemptive relief for nontransparent, actively managed ETFs, argued that nontransparent ETFs, if approved, would have attributes that benefit both investors and asset managers.[4] T. Rowe Price believes that "knowledge of a fund's real-time portfolio holdings is not necessary for market makers to hedge their risk — rather, there is other information about the fund's portfolio that can be provided as a reasonable proxy for market participants to trade in ETF shares, keeping the non-transparent ETF's market price closely tied to its NAV."[5] Similarly, Vanguard argued that "[a] robust and efficient arbitrage mechanism does not require an ETF to disclose portfolio holdings on a daily basis."[6]

By contrast, Charles Schwab & Co. argued that "given the extent to which daily disclosures support both arbitrage and investment decisions, Schwab encourages the Commission to adopt consistent daily reporting requirements for the entire industry, regardless of exemptive relief or product structure."[7] Similarly, Eaton Vance urged the SEC to "exercise continued caution in the consideration of proposed new [actively managed ETF] structures that would not provide full daily disclosure of fund holdings."[8] BlackRock acknowledged that transparency of holdings and intraday indicative valuations ("IIVs") "facilitate market participants' ability to make accurate intraday valuation estimates," but appeared to stop short of urging the SEC to require full transparency.[9]

Industry commentators on the Release also focused on the role of IIVs in facilitating arbitrage. IIVs are used to provide intraday approximations of the per-share value of an ETF's portfolio securities, typically every 15 seconds. A number of commentators advocated improvements to the IIV mechanism. For example, Charles Schwab & Co. argued that "the IIV every 15 seconds seems antiquated in the evolving electronic trading world in which we are currently immersed."[10] Eaton Vance similarly pointed to "significant deficiencies in how the disseminated IIVs are calculated and little or no availability of historical IIV data."[11] Eaton Vance strongly encouraged the SEC to take measures to improve the quality of IIVs, noting that:

> IIVs as disseminated intraday for each ETF are notoriously poor indicators of current value to the point that experts on ETF trading often counsel disregarding them. The Commission has recently expressed concerns about the reliability of IIV's in current practice, noting the absence of uniform calculation standards and the frequent reliance on stale pricing data. IIVs for ETFs holding securities that trade principally outside the U.S. are routinely out of date for several hours and, depending on the cycle of weekly trading and holidays, may be stale for multiple days.[12]

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Exemptions and Listing Standards

Another goal of the Release involved determining whether the present barriers to offering ETP products in the market still effectively ensure compliance with the goals of the Securities Exchange Act of 1934 (the "Exchange Act"), or whether manipulation and circumvention are possible. Of concern is whether the precedent of exemptions and no-action relief still achieve their intended purposes in light of the various new complex ETP investment strategies and markets. The SEC noted that, in recent years, there has been a push to speed up the process to list new products on exchanges. Comment was requested on the current state of listing standards, the roles of the SEC and the self-regulatory organizations in this oversight, and what should be the chief concerns of listing standards.

Currently, most index ETFs are able to list on an exchange without special permission from the SEC so long as they comply with certain "generic listing standards." Active ETFs, however, are still required to obtain an SEC approval order prior to listing, as are any other ETFs that do not comply with the generic listing standards.[13] Moreover, all ETFs are required to operate under SEC orders providing exemptions from the 1940 Act, the terms and conditions for which have changed over the years, resulting in a lack of standardization in SEC relief. An ETF rule was proposed in 2008 that would have allowed for increased standardization but was never adopted. Industry participants who commented on this aspect of the Release appeared to uniformly support increased standardization.

The Investment Company Institute ("ICI") and a number of other industry participants called for standardization in ETF exemptive relief and exchange listing standards under the 1934 Act.[14] The ICI commented that "[t]he current listing process slows the launch of new ETFs, creates different rules for similar products depending on the approval vintage, deprives investors of new opportunities, and is an inefficient use of SEC resources."[15] The ICI strongly encouraged the SEC to take efforts to add certainty and uniformity to the ETF listing process, particularly through expanded generic listing standards, but cautioned the SEC "to be mindful that ETFs are subject to the considerable additional level of substantive regulation under the Investment Company Act."[16]

State Street similarly commented that "the current 19b-4 process unnecessarily slows the launch of innovative ETFs, thereby depriving investors of investment options."[17] BlackRock likewise commented that the current listing process had "significant shortcomings," stating that:

> Rule 19b-4, which implements the statutory requirements of Section 19(b), by its express terms covers rule changes related to "new derivative securities products", such as listed options and warrants. A long-standing Commission interpretation of Rule 19b-4 treats ETPs as equivalent to exchange-traded derivatives (and unlike closed-end funds) for purposes of the rule. In our view, subjecting ETPs to a process designed for listed options and warrants has led to confusion and potential misapplication of Commission resources. Because Rule 19b-4 was not written with ETPs in mind, it has no clear standards or requirements for exchange listings of ETPs. The absence of clear standards leads to a review process that, in BlackRock's experience, can be opaque.[18]

BlackRock argued that "ETFs that agree to maintain a sufficient level of diversification such that no holding will have a large weighting should qualify for more streamlined review."[19]

Retail Investor Understanding of ETPs

The Release questioned whether retail investors actually understood new ETPs with complex investment strategies. The Release sought comment on how broker-dealers are advertising ETPs to retail investors; the frequency with which retail investors buy or sell ETPs with complex investment strategies and the influence brokers have on such activity; and how brokers are meeting their obligations to customers when making recommendations.

A number of commentators remarked on the lack of standard classifications of ETPs as a cause of investor confusion.[20] Vanguard, for example, urged the SEC "to consider regulatory initiatives designed to help investors distinguish between highly regulated ETFs and less regulated ETPs in the marketplace."[21] BlackRock proposed its own risk-based categorization system.[22] ■

1 "Strongest of the Strong: Another Big Year for the ETF Industry," FOX BUSINESS (Jan. 6, 2016), available at http://www.foxbusiness.com/markets/2016/01/06/strongest-strong-another-big-year-for-etf-industry.html; Cinthia Murphy, "Monthly ETF Flows: ETF Asset Flows Just Misses Record in 2015," ETF.COM (Jan. 4, 2016), available at http://www.etf.com/sections/features-and-news/etf-asset-flows-just-misses-record-2015?nopaging=1.

2 *Id.*

3 Request for Comment on Exchange-Traded Products, 1934 Act Rel. No. 75165 (June 12, 2015), available at https://www.sec.gov/rules/other/2015/34-75165.pdf.

4 Letter from T. Rowe Price Associates Inc. (Aug. 18, 2015), available at http://www.sec.gov/comments/s7-11-15/s71115-30.pdf.

5 *Id.*

6 Letter from Vanguard (Aug. 17, 2015) ("Vanguard Letter"), available at http://www.sec.gov/comments/s7-11-15/s71115-27.pdf.

7 Letter from Charles Schwab & Co. Inc. and Charles Schwab Investment Management Inc. (Aug. 17, 2015) ("Schwab Letter"), available at http://www.sec.gov/comments/s7-11-15/s71115-28.pdf.

8 Letter from Eaton Vance Corp. (Aug. 17, 2015) ("Eaton Vance Letter"), available at http://www.sec.gov/comments/s7-11-15/s71115-24.pdf.

9 Letter from BlackRock Inc. (Aug. 11, 2015) ("BlackRock Letter"), available at http://www.sec.gov/comments/s7-11-15/s71115-10.pdf.

10 Schwab Letter, *supra* n. 7.

11 Eaton Vance Letter, *supra* n. 8.

12 *Id.* (internal citations omitted).

13 *See* "NYSE Arca Seeks to Adopt Generic Listing Standards for Active ETFs," included in this publication.

14 *See* Letter from Investment Company Institute (Aug. 17, 2015) ("ICI Letter"), available at http://www.sec.gov/comments/s7-11-15/s71115-22.pdf; *see also*, Schwab Letter, *supra* n. 7.

15 *Id.*

16 *Id.*

17 Letter from State Street Global Advisors (Aug. 17, 2015), available at http://www.sec.gov/comments/s7-11-15/s71115-26.pdf.

18 BlackRock Letter, *supra* n. 9.

19 *Id.*

20 *See, e.g.,* Schwab Letter, *supra* n. 7.

21 Vanguard Letter, *supra* n. 6.

22 BlackRock Letter, *supra* n. 9 (ETPs include ETFs, ETNs, Exchange Traded Commodities and Exchange Traded Instruments.); *see also* ETFGI LLP and Kaye Scholer LLP (Aug. 17, 2015), available at http://www.sec.gov/comments/s7-11-15/s71115-23.pdf (also proposing a standardized list and definitions of product designations).

Stradley Ronon provides clients with experienced guidance to help navigate the complex regulatory and market environments in which ETFs are developed, launched and operated.

On behalf of our ETF clients, we routinely:

- Organize and prepare materials for ETF board meetings.
- Consult on a variety of compliance related issues, including preparation of ETF and adviser compliance procedures.
- Negotiate and act as liaison with ETF service providers, such as custodians, fund administrators, transfer agents, distributors and compliance consultants.
- Prepare applications to obtain the necessary regulatory exemptions from the SEC.
- Draft and file SEC registration statements and related documentation.
- Prepare and submit applications for listings on securities exchanges, and advise clients on compliance with the exchanges' listing requirements and trading rules.
- Interact with the Financial Industry Regulatory Authority (FINRA) with respect to ETF marketing and advertising materials.
- Assist with SEC inquiries and examinations.
- Coordinate with foreign legal professionals and service providers for compliance with international securities laws, regulations and tax requirements.

In counseling our ETF clients, we regularly collaborate with other Stradley Ronon attorneys who focus on taxation, structuring and documenting derivatives transactions, and intellectual property and licensing matters. In addition, we assist ETF advisers with SEC regulatory filings and corporate structuring.

We also advise our open-end and unregistered investment company clients on a number of issues related to investing in ETFs, including board of directors' oversight, disclosure and operational matters.

Rethinking the ETP Ecosystem

The exchange-traded product ("ETP") industry's evolution and the difficulties posed with pricing new and existing products is coming under increasing scrutiny by the U.S. Securities and Exchange Commission ("SEC"), particularly after the market turmoil on August 24, 2015. These events prompted at least one SEC Commissioner to question "whether a change to the entire ETF ecosystem was necessary."[1]

On May 6, 2010, the "flash crash" saw $1 trillion in paper value temporarily wiped out from U.S. stock markets in a matter of minutes. In response, the "limit up-limit down ("LULD") mechanism was designed and implemented to prevent equity securities listed on U.S. exchanges from experiencing violent price movement in a short period of time. Under LULD, trading in an equity security would be halted once its price began to trade outside a specified price band based on recent prices.

These LULD rules were put to the test on August 24, 2015, when the market experienced extreme volatility in what was one of the worst days in U.S. stock market history. An SEC Research Note on the day's events confirmed reports that ETPs were disproportionately affected by LULD halts compared with corporate stocks — there were 1,058 LULD halts in 327 ETPs (with many halts recurring in the same ETPs), as opposed to 220 LULD halts in 144 non-ETPs.[2] Further highlighting the disparity, while 63.3 percent of ETPs declined by less than 10 percent, which was consistent with overall market declines that day, 19.2 percent of ETPs declined by more than 20 percent.[3] Only 4.7 percent of corporate stocks saw such a drop.[4] These LULD halts resulted in many ETPs trading at deep discounts compared to NAV, primarily due to delays in the process of reopening trading after halts.[5]

The SEC has begun to re-evaluate the reliance on arbitrage to adequately price ETPs, especially during times of unusual volatility.[6] After August 24, the SEC confirmed that its prior concerns have become critical issues.[7] SEC Commissioner Luis A. Aguilar, in separate speeches, expressed concern over the effects of algorithmic trading and posited several questions, including whether exchange-traded funds in particular should have separate LULD rules from corporate stocks to better accommodate arbitrage; whether certain market protections should be harmonized with the new LULD rules, such as market circuit breakers and the erroneous trade guidelines; and whether the roles of exchanges and market makers need to be adjusted for times of acute volatility.[8]

Similar concerns were echoed by SEC Commissioner Kara M. Stein on February 19. 2016.[9] In raising questions about possible causes of the volatility experienced by ETFs on August 24, 2015, she cautioned:

> Fundamentally, these questions lead to the same place — we need to take a holistic look at these products, their transparency, and how they interact in our capital markets. This should include not only looking at ETFs, but other exchange traded products that hold commodities, currencies or derivatives. These products are not traditional equity securities. They do not always behave in the same manner as equity securities. The attempt to fit such non-equity products into the rules designed for traditional equity securities has left potential gaps in investor protection and also raised questions about market integrity.[10]

In response to these challenges, Commissioner Stein suggested that the SEC should (1) review the roles of APs and market makers in facilitating ETF operations and trading, including whether there are a sufficient number of APs and market makers with adequate capacity; (2) enhance accountability and investor protection, particularly for those ETFs that pose the greatest risk to retail investors, and "assess whether certain products are even suitable for buy-and-hold investors"; (3) complete the SEC's review of the events of August 24 and take appropriate action, which could result in different trading rules for ETFs than for equities; and (4) "think about a roadmap for holistic regulation of ETFs and other exchange traded products, given their explosive growth and evolution," including "how these products may interact in the markets."[11]

ETP Ecosystem

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Given the SEC's concern over the events of August 24, 2015, look for new exchange rules relating to ETP trading in 2016. ■

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1 Louis A. Aguilar, Commissioner, SEC, Investor Advisory Committee Meeting: "How Can the Markets Best Adapt to the Rapid Growth of ETFs" (Oct. 15, 2015) ("Aguilar IAC Speech"), available at https://www.sec.gov/news/statement/how-can-markets-adapt-to-rapid-growth-etfs.html.

2 SEC Office of Analytics and Research, "Research Note: Equity Market Volatility on August 24, 2015," SEC Division of Trading and Markets (Dec. 2015) at 4, available at https://www.sec.gov/marketstructure/research/equity_market_volatility.pdf.

3 *Id.* at 17.

4 *Id.* at 5.

5 *Id.*

6 *See* "SEC Release on Exchange-Traded Products" in this publication.

7 *See* Mary Jo White, Chair, Investor Advisory Committee Meeting: "Opening Remarks to the Investor Advisory Committee" (Oct. 15, 2015), available at https://www.sec.gov/news/statement/white-investor-advisory-commitee-10-15-2105.html.

8 *See* Aguilar IAC Speech; *supra* n. 1; *see also,* Louis A. Aguilar, Commissioner, SEC, Equity Market Structure Advisory Committee Meeting: "Evolving Equity Markets Require Constant Attention" (Oct. 27, 2015), available at https://www.sec.gov/news/statement/aguilar-emsac-10-2015.html.

9 Kara M. Stein, Commissioner, SEC, SEC Speaks Conference, "What Lies Ahead? The SEC in 2016" (Feb. 19, 2016), available at https://www.sec.gov/news/speech/stein-sec-speaks-2016.html.

10 *Id.*

11 *Id.*

Established Money Managers Enter the ETF Market

2015 saw a number of established money managers enter the exchange-traded fund ("EFT") market. Some directly launched new ETF products, while others entered the ETF market through acquisitions.

New ETF Products by Established Money Managers

So-called "smart beta" products dominated new ETF issuances from established money managers in 2015.

Following the launch of its first two ETFs in 2014, **J.P. Morgan Investment Management** launched three new ETFs in 2015 — one U.S. domestic equity and two foreign equity — all based on factor indices.

In March 2015, **Capital Research and Management Co.** — investment adviser to the **American Funds** — received an order from the SEC to launch actively managed and index-based ETFs through **Capital Group ETF Trust**, although it did not file any ETF registration statements in 2015.

In July, **Principal Financial Group** listed its first ETF, **Principal EDGE Active Income ETF** — subadvised by **EDGE Asset Management**, a subsidiary of Principal.

In September, **Goldman Sachs Asset Management** launched two new **ActiveBeta ETFs** — a domestic large cap equity ETF and an emerging markets equity ETF — followed by a third international equity ActiveBeta ETF in November.

Also in September, **John Hancock** launched six **Multifactor ETFs** — two based on domestic market capitalization and four based on industry sectors. The factor-based indices for the ETFs were developed by **Dimensional Fund Advisors**, which also serves as subadviser to the ETFs.

Franklin Templeton filed an exemptive application with the SEC in October for an order to operate index ETFs, and in January 2016 filed its first registration statement for its suite of **LibertyQ** smart beta ETFs.

In December, **Legg Mason** launched three ETFs using Diversification Based Investing indices developed by its affiliate, **QS Investors**, which also serves as subadviser to the ETFs. At the same time, Legg Mason also launched a low volatility, high income domestic equity ETF, which was likewise subadvised by QS Investors and based on its proprietary index.

Other established money managers that may be considering a foray into ETFs in 2016 include **Nuveen Investments** and **Aberdeen Asset Management**.

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Established Money Managers

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ETF Acquisitions by Established Money Managers

In December 2014, **Janus Capital Group** completed its acquisition of VelocityShares. In addition to the ETFs managed by **VelocityShares** at the time of the acquisition, in November 2015 Janus filed registration statements for two small-cap index ETFs based on a proprietary quantitative methodology developed by its affiliate.

In April 2015, **Victory Capital Management** completed its acquisition of **Compass Efficient Model Portfolios**. At that time, Compass EMP managed five ETFs designed to track proprietary strategic beta indices that combine fundamental criteria with volatility weighting. Since that time, the rebranded **Victory CEMP ETFs** have launched an additional five strategic beta ETFs.

Also in April, **New York Life Investment Management** completed its acquisition of **IndexIQ**, which specializes in liquid alternative ETFs. IndexIQ was folded into NYLIM's **Mainstay Investments** subsidiary.

April also saw the completion of the acquisition by Virtus Investment Partners of **ETF Issuer Solutions**, a multimanager ETF platform for investment managers that typically serve as subadvisers and portfolio managers for the ETFs they manage. In August, the platform (now rebranded as Virtus ETF Solutions), launched **Virtus Newfleet Multi-Sector Unconstrained Bond ETF**, subadvised by Virtus affiliate **Newfleet Asset Management**.

In August, **Van Eck Global** entered into an agreement with **Yorkville ETF Advisers** and **Exchange Traded Concepts** to acquire two **Yorkville MLP ETFs**. In December, the SEC declared effective the registration statement on Form N-14 for the reorganization of the MLP ETFs into Van Eck's **Market Vectors ETFs**. The initial shareholder meeting for approval of the transaction was held on Jan. 19, 2016.

In September, **Catalyst Funds** announced an agreement to acquire **Huntington Asset Advisors**, which advises the two actively managed **Strategy Shares ETFs**. The transaction was completed in December, and the adviser was renamed **Rational Advisors**.

In October, **WisdomTree** announced that it would enter the exchange-traded commodity space through the acquisition of the sponsors of two **GreenHaven Commodity Funds**. WisdomTree retained **GreenHaven Advisors** as the subadviser to provide portfolio management services. The transaction was completed in January 2016, and the commodity funds were rebranded as **WisdomTree Continuous Commodity Index Fund** and **WisdomTree Coal Fund**.

In November, **AGF Management**, a Canadian investment management firm, agreed to acquire a 51 percent stake in **FFCM**, investment adviser to the **QuantShares** and **O'Shares ETFs**. The initial meeting for the ETF shareholders to approve the transaction was held on Jan. 20, 2016.

In December, **Oppenheimer Funds** completed its acquisition of **VTL Associates**, investment adviser to the **RevenueShares ETFs**. Now rebranded as the **Oppenheimer Factor Weighted ETFs**, the family of eight smart beta ETFs track broad-based market capitalization indices that have been reweighted by constituent revenues. ■