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Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware

SEC Proposes Exemptive Rule for Exchange-Traded Funds

I. Introduction and Executive Summary

At an open meeting on June 28, 2018, the Securities and Exchange Commission (Commission or SEC) unanimously proposed new exemptive Rule 6c-11 (the Rule) under the Investment Company Act of 1940 (1940 Act) to permit the operations of most types of exchange-traded funds (ETFs).[1] The Rule would permit ETF sponsors to bring ETFs to market without having to obtain individual exemptive orders under the 1940 Act from the Commission. The Rule also would establish common regulatory standards for ETFs by rescinding most of the existing ETF exemptive relief issued over the last 26 years, which had some variations in terms and conditions. The Commission also proposed certain disclosure amendments to Form N-1A and Form N-8B-2 relating to ETFs, as well as related amendments to Form N-CEN.

The major features of the proposed Rule are described in greater detail below, but among the notable takeaways:

- The Rule would have the effect of leveling the regulatory playing field for most ETFs.
- The Rule would cover most ETFs that are registered as open-end management investment companies under the 1940 Act. The Rule would not cover:
  - ETFs that offer exchange-traded classes of shares (Share Class ETFs);
  - ETFs that operate as feeder funds in a master-feeder arrangement (Master-Feeder ETFs);
  - ETFs that seek to provide returns that exceed the performance of a market index by a specified multiple, or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time (Leveraged ETFs);
  - ETFs that are structured as unit investment trusts under the 1940 Act (UIT ETFs); and
  - Exchange-traded products that are not registered under the 1940 Act (e.g., exchange-traded products that do not invest in securities).

[1] Exchange-Traded Funds, Release No. IC-33140 (June 28, 2018), 83 Fed. Reg. 37,332 (July 31, 2018), https://www.sec.gov/rules/proposed/2018/33-10515.pdf (Proposing Release).

- Existing ETF exemptive relief would be rescinded, except for orders that permit Share-Class ETFs, Leveraged ETFs, and UIT ETFs. In addition, any existing Master-Feeder ETFs could continue to rely on their prior exemptive orders.

- The Rule would primarily relate to the basic ETF structure, and would not distinguish between index-based and actively managed ETFs. Prior exemptive orders provided for such distinctions, and included some different requirements for index-based and actively managed ETFs. Such distinctions would remain relevant for other regulatory processes, such as registration under the 1940 Act and exchange listing.

- The Rule would require ETFs to publish their full portfolios daily on the ETF's website, and prescribes the format for such portfolio disclosure. Although most ETFs currently publish their portfolios daily, prior exemptive orders did not require full portfolio transparency for ETFs that track indexes provided by index providers that are not affiliated with the ETF sponsor (Unaffiliated Index ETFs).

- The Rule would provide greater flexibility for the construction of the in-kind baskets of securities and assets (Baskets) that ETFs generally require in connection with the purchase and redemption of large aggregations of shares (Creation Units) in transactions directly with the ETF. In recent years, ETF exemptive orders have been very prescriptive with respect to the parameters for Baskets. The Rule would permit ETFs to adopt procedures that would govern the construction of standard Baskets, as well as custom baskets.

- The Rule would provide for greater disclosure of the bid-ask spreads at which ETF shares trade in the secondary market.

The Proposing Release was published in the Federal Register on July 31, 2018, and comments on the Rule are due on or before October 1, 2018.

II. Scope of the Proposed Rule and Its Effect on Prior Orders

A. ETFs Relying on the Rule Must Be Classified As "Management Companies"

The Rule would define an ETF as a registered open-end management company that issues and redeems Creation Units to and from Authorized Participants in exchange for Baskets of securities, assets, or other positions, and a cash balancing amount (if any), and whose shares are listed on a national securities exchange and traded at market-determined prices.[2] One of the consequences of this definition would be that an ETF operating under the Rule must be classified as a "management company" under Section 4 of the 1940 Act, and therefore would not include UIT ETFs.

The SEC's rationale behind excluding UIT ETFs from the Rule is twofold: (i) there appears to be limited sponsor interest in developing UIT ETFs, and (ii) because of the unmanaged nature of the UIT structure, different conditions would be required than for ETFs that are classified as management companies. For example, because UITs are not governed by a board of directors, they could not implement the board oversight requirements necessary to rely on the provisions of the Rule relating to Baskets, which are discussed in more detail below. As a result, UIT ETFs would continue to operate pursuant to their exemptive orders.

The SEC requests comment on whether the Rule should apply to UIT ETFs, and, if so, whether UIT ETFs should be subject to the same conditions proposed for ETFs classified as management companies.

B. No Distinction Between Index-Based and Actively Managed ETFs

The Rule proposes a set of conditions that would apply to all ETFs, whether index-based or actively managed, and therefore does not distinguish between the types of ETFs. As a result, the Rule also does not propose any distinction

[2] Rule 6c-11(a). An "Authorized Participant" is defined under the Rule as a member or participant of a clearing agency registered with the Commission 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.

between 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). The SEC's rationale 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 proposes to grant relief.

As part of the SEC's general approach to the Rule, part of the reasoning for not distinguishing between index-based and actively managed ETFs is to level the playing field among market participants, and to provide a more consistent regulatory framework. For example, one of the proposed conditions to the Rule is that all ETFs would be required to provide full portfolio transparency daily.[3] Exemptive orders have required actively managed and Affiliated Index ETFs to publish their portfolios daily, but Unaffiliated Index ETFs have not been required to disclose their full portfolio holdings daily. The SEC notes that this across-the-board treatment would be consistent with the SEC's regulation of other types of open-end funds, which does not distinguish between index-based and actively managed funds.

The SEC requests comment on whether certain distinctions should be made in the Rule, such as whether the Rule should include a condition for an index-based ETF to invest at least 80 percent of its assets in the component securities of its underlying index. The SEC also asks for comments on whether distinctions should be made for Affiliated Index ETFs, such as a requirement to adopt policies and procedures to limit information sharing between portfolio managers and index management staff. The Proposing Release also requests comment on how an "index provider" should be defined to the extent Affiliated Index ETFs were to be distinguished in the Rule.

C. Leveraged ETFs and Share Class ETFs Excluded From the Rule

1. Leveraged ETFs

The Rule would exclude Leveraged ETFs from relying on the Rule.[4] Leveraged ETFs could continue to operate pursuant to the terms of their exemptive orders.

The SEC provides several reasons for excluding Leveraged ETFs. First, the SEC notes that Leveraged ETFs pursue strategies that require them to rebalance their portfolios daily, which can result in performance that differs significantly from some investors' expectations of how index investing generally works. Second, the SEC notes that it is evaluating, as part of its broader consideration of the use of derivatives by registered funds, certain issues that may arise under Section 18 of the 1940 Act, specifically in connection with its potential re-proposal of Rule 18f-4 under the 1940 Act.[5] As a result, the Proposing Release notes that the SEC does not believe it is appropriate to permit Leveraged ETFs to operate under the Rule at this time. The Proposing Release also notes that an ETF may not indirectly seek to launch a Leveraged ETF under the Rule, such as by embedding leverage in an underlying index.

The SEC requests comment on whether the proposed condition to the Rule excluding Leveraged ETFs is appropriate, and whether Leveraged ETFs should be permitted to operate in reliance on the Rule. If so, the SEC requests comment on whether the Rule should permit a specific multiple of index returns for Leveraged ETFs, such as up to +/-300 percent. The SEC also requests comment on whether the use of "a fixed period of time" effectively describes the daily reset mechanism of Leveraged ETFs, or whether a different description should be used.

2. Share Class ETFs

The Rule also would not provide relief from Sections 18(f)(1) or 18(i) of the 1940 Act, or expand the scope of Rule 18f-3 under the 1940 Act, to permit open-end funds to offer classes of exchange-traded shares. Rule 18f-3

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[3] Rule 6c-11(c)(1)(i)(A).
[4] Rule 6c-11(c)(4).
[5] 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.

allows mutual 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 differ in certain respects from those of investors in the mutual fund's other share classes – ETF shares are redeemable in Creation Units only, for example – additional relief from Section 18 would be necessary. As proposed, the Rule would not provide this additional relief, although the SEC notes that ETFs could continue to request the necessary relief from Sections 18(f)(1) and 18(i) of the 1940 Act through the exemptive application process. The Proposing Release also notes that any existing Share Class ETFs could continue to operate pursuant to the terms of their exemptive orders, which would not be rescinded.

The SEC requests comment on whether the Rule should include exemptions from Sections 18(f)(1) and 18(i) of the 1940 Act, or whether Rule 18f-3 should be expanded, to permit Share Class ETFs.

D. Effect of the Rule on Prior Orders

The Proposing Release proposes to rescind exemptive relief previously issued to ETFs that would be permitted to rely on the Rule. The proposed rescission would occur one year after the effective date of the Rule and would be limited to the portions of the exemptive orders related to the formation and operation of an ETF (the ETF relief). The Rule would not rescind any relief granted under those 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. The SEC also proposes to rescind relief that permits Master-Feeder ETFs, except with respect to Master-Feeder ETFs that already rely on such relief as of the date of the Proposing Release. As previously noted, exemptive orders granted to Leveraged ETFs, Share Class ETFs, and UIT ETFs would not be rescinded.

The SEC's rationale for proposing to rescind the ETF relief under existing orders is primarily to level the playing field between market participants. Further, the Proposing Release states that the relief and related conditions in the Rule are largely consistent with the ETF relief granted in recent orders, and in some cases, the Rule provides more flexibility. For example, some ETF complexes have less flexible conditions relating to the composition of their Baskets than would be permitted by the Rule, as discussed further below.

The SEC requests comment on whether the one-year grace period for continuing to rely on exemptive orders is appropriate, and whether ETFs would face significant challenges in complying with the conditions of the Rule rather than their existing exemptive relief. The SEC also requests comment on whether ETFs should be able to continue to rely on their existing exemptive relief instead of the Rule.

III. Exemptive Relief Under the Proposed Rule

The Rule generally would provide exemptions from certain provisions of the 1940 Act that are consistent with prior exemptive orders, with some differences noted below.

A. Treatment of ETF Shares As "Redeemable Securities"

Unlike traditional open-end mutual funds, ETF shares generally are redeemable directly from the ETF at net asset value (NAV) only in Creation Units. As a result, ETF sponsors have sought exemptive relief from the definition of "redeemable security" in Section 2(a)(32) and the definition of "open-end company" in Section 5(a)(1) of the 1940 Act to permit ETFs to register as open-end management investment companies and issue individual shares that are redeemable only in Creation Units.[6] The Rule would take a different approach by simply classifying shares of an ETF relying on the Rule as a "redeemable security" within the meaning of Section 2(a)(32), which would result in the ETF being classified as an "open-end company" under Section 5(a)(1) without the need for any exemptive relief.[7]

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[6] Section 2(a)(32) defines "redeemable security" as any security that allows the holder to receive his or her proportionate share of the issuer's current net assets upon presentation to the issuer. Section 5(a)(1) defines an "open-end company" as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer."
[7] Rule 6c-11(b)(1).

In addition to exemptions from various provisions of the 1940 Act, ETFs also require exemptive or no-action relief from certain provisions of the Securities Exchange Act of 1934 (the 1934 Act) that govern, among other things, certain activities of broker-dealers related to the distribution of ETF shares. Currently, most ETFs are able to rely on class relief that has been issued by the SEC and its staff, provided the ETFs meet certain conditions. Under the Rule, ETFs would become 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 in connection with secondary market transactions in ETF shares and the creation or redemption of Creation Units. Similarly, ETFs could rely on the "registered open-end investment company" exemption in Rule 11d1-2 under the 1934 Act. ETFs would therefore no longer need to rely on the applicable class relief from these provisions of the 1934 Act. Under the Rule, however, ETFs would still require relief from certain other provisions of the 1934 Act. In the Proposing Release, the SEC requests comment as to whether the Rule should exempt ETFs from these other provisions, namely Section 11(d)(1) of the 1934 Act and Rules 10b-10, 15c1-5, 15c1-6 and 14e-5 under the 1934 Act.

B. Trading of ETF Shares at Market-Determined Prices

Investors may purchase and sell individual ETF shares from and to dealers on the secondary market at market-determined prices (i.e., at prices other than those described in the prospectus or based on NAV). ETFs therefore require relief from Section 22(d) of the 1940 Act and Rule 22c-1 under the 1940 Act.[8] Consistent with prior ETF exemptive orders, the Rule would provide exemptions from these provisions.[9]

C. In-Kind Transactions With Affiliated Persons

Purchases and redemptions of Creation Units are typically effected in-kind, and Sections 17(a)(1) and 17(a)(2) of the 1940 Act prohibit these in-kind purchases and redemptions by affiliated persons of the ETF.[10] Consistent with prior ETF exemptive orders, the Rule would provide exemptions from Sections 17(a)(1) and 17(a)(2) with regard to in-kind purchases and redemptions by a person who is an affiliated person of an ETF (a first-tier affiliate) or who is an affiliated person of such a person (a second-tier affiliate) solely by reason of: (i) holding with the power to vote 5 percent or more of an ETF's shares or (ii) holding with the power to vote 5 percent or more of any investment company that is an affiliated person of the ETF.[11] In the Proposing Release, the SEC requests comment as to whether the Rule should extend relief to parties that are affiliated persons of an ETF for other reasons, such as a broker-dealer that is affiliated with the ETF's investment adviser.

D. Additional Time for Delivering Foreign Investments As Redemption Proceeds

Section 22(e) of the 1940 Act generally prohibits a registered open-end management investment company from postponing the date of satisfaction of redemption requests for more than seven days after the tender of a security for redemption. Local market delivery cycles for transferring foreign investments, together with local market holiday schedules, can sometimes require a delivery process in excess of seven days for ETFs that hold foreign investments and satisfy redemptions of Creation Units through delivery of Baskets. The Rule would grant relief from Section 22(e) to permit an ETF to delay satisfaction of a redemption request for more than seven days if local market holidays and/or extended delivery cycles for transferring foreign investments to redeeming Authorized Participants prevents timely delivery of the foreign investments included in the ETF's redemption Basket, as long as the ETF delivers such foreign

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[8] Section 22(d), among other things, prohibits investment companies, their principal underwriters and dealers from selling a redeemable security to the public except at a current public offering price described in the prospectus. Rule 22c-1 generally requires that a dealer selling, redeeming or repurchasing a redeemable security do so only at a price based on its NAV.

[9] Rule 6c-11(b)(2).

[10] Sections 17(a)(1) and 17(a)(2) generally prohibit an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security or other property to or purchasing any security or other property from the company. Under Section 2(a)(3) of the 1940 Act, an affiliated person of another person includes, among others: (i) any person directly or indirectly owning, controlling, or holding with power to vote, 5 percent or more of the outstanding voting securities of such other person; (ii) any person 5 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by such other person; and (iii) any person directly or indirectly controlling, controlled by, or under common control with such other person. Under Section 2(a)(9) of the 1940 Act, a control relationship is presumed when one person owns more than 25 percent of another person's outstanding voting securities.

[11] Rule 6c-11(b)(3).

investments as soon as practicable, but in no event later than 15 days after the tender of the Creation Unit to the ETF.[12] The "as soon as practicable" language is designed to minimize any unnecessary settlement delays and would permit a delay only to the extent that additional time for settlement is actually required.

This approach differs from prior ETF exemptive orders in that the delay would only be permitted with respect to the specific foreign investments in the ETF's redemption Basket and not the entire redemption Basket. The Section 22(e) relief in the Rule also includes a sunset provision whereby it would expire 10 years from the Rule's effective date. The Proposing Release explains that such a provision was appropriate in light of technological innovation and changes in market infrastructure and operations that will lead to further shortening of settlement cycles.

IV. Conditions for Reliance on the Proposed Rule

In order to rely on the Rule, an ETF would be required to comply with certain conditions, some of which are embedded within the definition of "exchange-traded fund," and some of which are specifically identified as "Conditions" to the Rule. In general terms, the key conditions are listed below, followed by a more detailed description of the various conditions:

- Shares issued in Creation Units: The ETF must issue (and redeem) Creation Units to (and from) Authorized Participants in exchange for Baskets and a cash balancing amount, if any.

- Shares listed on an exchange: The ETF's shares must be listed on a national securities exchange and trade at market-determined prices.

- Full portfolio disclosure on ETF website:

  - Before the opening of regular trading on each business day, the ETF must disclose prominently on its website (i) the portfolio holdings that will form the basis of the next calculation of current NAV, and (ii) the description, amount, value, and unrealized gain/loss for each such portfolio holding in the manner prescribed for fund financial statements.

  - The ETF must reflect changes in the ETF's portfolio holdings in the first calculation of NAV per share on the first business day following the trade date.

- Additional ETF website disclosures: the ETF must make certain additional disclosures on its website, including:

  - A Basket used for purchases and redemptions of Creation Units, and any cash balancing amount;

  - The ETFs' NAV, market price, and premium or discount of the market price against the NAV, each as of the prior business day;

  - A table and line graph showing certain premium and discount data; and

  - If the premium or discount exceeds 2 percent for more than seven consecutive trading days, a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount.

- Written policies regarding Basket construction: An ETF must adopt and implement written policies and procedures that govern the construction of Baskets, including procedures for any custom baskets.

In a departure from the relief provided by ETF exemptive orders, the Rule would not require the dissemination of an intraday indicative value (IIV), which is a per share approximation of the current value of an ETF share that is

[12] Rule 6c-11(b)(4). The Rule defines "foreign investment" as 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) for which there is no established U.S. public trading market (as that term is used in Item 201 of Regulation S-K under the Securities Act of 1933 (Securities Act)).

disseminated frequently throughout the trading day. The Commission noted that with the proposed full portfolio holdings disclosure, market participants would be able to calculate estimated intraday values of the ETF portfolio holdings using their own methodologies.

In addition, the Rule would not include a standard condition to exemptive orders requiring an ETF to identify itself in sales literature as an ETF that does not sell or redeem individual shares and to explain that investors may purchase or sell individual ETF shares through a broker via a national securities exchange. This exemptive order condition was designed to help prevent investors, particularly retail investors, from confusing ETFs with mutual funds. Given that ETFs have been available for over 26 years, and the market has developed a familiarity with the product, the Commission no longer believes this condition is necessary. Accordingly, no corresponding marketing disclosure requirement is proposed to be included in the Rule.

A. Issuance and Redemption of Creation Units

Consistent with prior exemptive orders, the Rule would require an ETF to issue (and redeem) Creation Units to (and from) Authorized Participants in exchange for Baskets and a cash balancing amount, if any.[13] The Rule would not mandate a maximum or minimum Creation Unit size. While the Rule would require an ETF generally to issue and redeem shares only in Creation Units, the Rule would permit an ETF to sell or redeem individual shares on the day of consummation of a reorganization, merger, conversion, or liquidation.[14] This is consistent with prior exemptive orders that permitted ETF shares to be individually redeemable in connection with the termination of an ETF.

B. Listing on a National Securities Exchange

Consistent with prior exemptive orders, the Rule would require an ETF to issue shares that are listed on a national securities exchange and traded at market-determined prices.[15] The Rule would not include an exemption for ETFs whose shares are suspended or delisted. As such, an ETF that is delisted from a national securities exchange would no longer be eligible to rely on the Rule and would be required to meet individual redemption requests within seven days pursuant to Section 22(e) of the 1940 Act or liquidate.

C. Full Portfolio Disclosure

The Rule would require full portfolio transparency for all ETFs relying on the Rule by requiring all ETFs to disclose prominently on their website, which would be publicly available and free of charge, the portfolio holdings that would form the basis for each calculation of NAV per share. Such disclosure would be required to be made each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF begins accepting orders for the purchase or redemption of creation units.[16]

As noted above, actively managed and Affiliated Index ETFs are required to publish their portfolios each day under their exemptive orders, but ETF exemptive orders do not require Unaffiliated Index ETFs to make this disclosure. Nevertheless, the Commission noted in the Proposing Release that Unaffiliated Index ETFs that would rely on the Rule have elected to publish their full portfolios as a standard industry practice.

The Rule also would require the portfolio holdings that form the basis for an ETF's NAV calculation to be the ETF's portfolio holdings as of the close of business on the prior business day.[17] Pursuant to this condition, changes in an ETF's portfolio holdings would be reflected on a T+1 basis.

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[13] Rule 6c-11(a), definition of "exchange-traded fund."
[14] Rule 6c-11(c)(5).
[15] Rule 6c-11(a), definition of "exchange-traded fund."
[16] Rule 6c-11(c)(1)(i)(A).
[17] Rule 6c-11(c)(2).

The Rule would define portfolio holdings as "the securities, assets or other positions held by the exchange-traded fund." As such, an ETF would be required to disclose its holdings that are not securities or assets, including cash holdings, short positions, or written options. Unlike prior exemptive orders, the Rule would specify the manner in which portfolio holdings would be presented on the ETF's website and would require that the ETF present the description, amount, value, and/or unrealized gain/loss (as applicable) in the manner prescribed by Article 12 of Regulation S-X for each portfolio holding required to be disclosed.[18]

Consistent with prior exemptive orders, the Rule would not require disclosure of intraday changes in the portfolio holdings of the ETF or advance disclosure of portfolio trades.

D. Other Required Website Disclosures

The Rule would require ETFs to disclose certain additional information in an easily accessible location on their websites. As required by ETF exemptive orders, the website disclosures proposed by the Rule would include a "snapshot" of the ETF's current NAV per share, market price, and premium or discount, each as of the end of the prior business day.[19] The Commission believes this disclosure would help investors better understand the risk that an ETF's market price may be higher or lower than the ETF's NAV per share and allow investors to compare this information across ETFs.[20]

In addition, the Rule would require that ETFs disclose on their websites historical information about the extent and frequency of an ETF's premiums and discounts. In particular, the Rule would require 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.[21] Alternatively, for new ETFs that do not yet have this information, the Rule would require the ETF to post this information for the life of the ETF. The Rule also would require any ETF whose premium or discount was greater than 2 percent 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.[22]

Pursuant to the Rule, an ETF also would be required to publish on its website one Basket that it would accept in exchange for orders to purchase or redeem Creation Units to be priced based on the ETF's next calculation of NAV per share each business day.[23]

The Commission also requests comment regarding ways to better inform investors about intraday deviations between an ETF's market price and the NAV per share and/or the contemporaneous value of its portfolio.

E. Basket Policies

1. Standard Baskets

When an Authorized Participant purchases a Creation Unit from an ETF, the Authorized Participant generally deposits a Basket of securities and other assets identified by the ETF for that day that is representative of the ETF's portfolio. If an Authorized Participant redeems a Creation Unit from an ETF on that day, the Authorized Participant generally receives the same Basket. Under the Rule, an ETF would be required to adopt and

[18] Rule 6c-11(vi).
[19] Rule 6c-11(c)(1)(ii).
[20] For purposes of the website disclosure as well as new prospectus disclosure discussed below, the term "market price" is defined by reference to the official closing price of an ETF share; however, ETFs would also be permitted to use a price that is the midpoint of the national best bid and national best offer (NBBO) calculated as of the time NAV per share is calculated, if it is more accurate. This differs from the current definition in Form N-1A, which is proposed to be removed.
[21] Rule 6c-11(c)(1)(iii) and (iv).
[22] Rule 6c-11(c)(1)(v). The proposal notes that disclosure of information about ETFs' premiums and discounts is intended to promote transparency regarding the significance and/or persistence of deviations between market price and NAV per share, and thus enable investors to make more informed investment decisions.
[23] Rule 6c-11(c)(1)(i)(B).

implement written policies and procedures governing the construction of standard Baskets and the process that would be used for the acceptance of standard Baskets.[24]

According to the Proposing Release, the policies and procedures should cover the methodology that the ETF would use to construct Baskets. For example, the policies and procedures should explain the circumstances when a Basket may omit positions that are not operationally feasible to transfer in-kind. The Proposing Release states that the policies and procedures should detail when and how the ETF would use representative sampling of its portfolio to create a Basket, as well as how an index-based ETF would effect changes in the ETF's portfolio holdings as a result of the rebalancing or reconstitution of its underlying index.

2. Custom Baskets

The Rule also proposes to provide ETFs with significant additional flexibility regarding the ability to accept or deliver "custom baskets." As defined in the Rule, a "custom basket" would be either a Basket that is composed of a non-representative selection of the ETF's portfolio holdings, or different Baskets used in transactions on the same day. If the ETF wishes to use a custom basket, then the ETF's policies and procedures must (i) include 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 such parameters.[25]

a. Background

The ability to use "custom baskets" under the Rule would represent flexibility that was not generally available under most prior ETF exemptive orders. Depending on when an ETF sponsor received its respective individual exemptive order, its ETFs may enjoy more or less flexibility than other ETF groups with respect to the ability to use custom baskets. For example, early exemptive relief placed relatively few restrictions on custom basket creations and redemptions. However, for the past several years, the SEC placed strict limitations on the composition of Baskets, generally requiring Baskets to correspond pro rata to the positions in the ETF's portfolio, except in certain delineated circumstances. The Rule is designed, in part, to level the playing field with respect to this aspect of exemptive relief.

The SEC's historical reluctance toward permitting custom baskets stems from the risk that an Authorized Participant could abuse the flexibility inherent in custom baskets. For example, theoretically, an Authorized Participant could take advantage of its relationship with the ETF and pressure the ETF to construct a unique basket used only by the Authorized Participant, to the detriment of the ETF's other shareholders. In so doing, an Authorized Participant could place unwanted securities into an ETF's portfolio during a creation (i.e., "dumping") or selectively take securities from an ETF's portfolio during a redemption (i.e., "cherry picking"). In either situation, as the SEC notes in the Proposing Release, the remaining shareholders would be disadvantaged because they would be left holding shares of an ETF comprised of a relatively less liquid or desirable portfolio.

However, as the SEC acknowledges in the Proposing Release, custom baskets could provide a number of meaningful benefits to ETFs, including:

- Better performance: With custom basket flexibility, an ETF may need to satisfy fewer redemptions in cash, which could cause the ETF to avoid holding larger cash positions and experiencing "cash drag" on its returns.

- More efficient transactions: ETFs with custom basket flexibility may hold fewer securities within their Baskets when transacting in kind, making it easier and more affordable for Authorized Participants to assemble Baskets, and thereby creating tighter bid-ask spreads and potentially more efficient arbitrage.

[24] Rule 6c-11(c)(3).
[25] Rule 6c-11(c)(3)(i).

- Greater tax efficiency: ETFs using custom baskets may have the ability to adjust holdings efficiently and minimize cash redemptions, thereby allowing them to avoid realizing capital gains.

b. Procedures

To reduce the risk that an Authorized Participant may cherry pick, dump or engage in other abuses, the Rule would require an ETF to adopt policies and procedures with respect to the use of custom baskets. The Proposing Release suggests that effective custom basket policies and procedures should include information on the methodology and process that the ETF would use to construct or accept a custom basket and the ETF's approach for testing compliance with the custom basket policies and procedures and how it assesses (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. The Proposing Release also recommends that ETFs consider adopting reasonable controls designed to prevent inappropriate differential treatment among Authorized Participants. Additionally, an ETF would be required to create a record stating that each custom basket complies with the ETF's custom basket policies and procedures.[26]

The SEC seeks comment on the parameters (if any) that should be placed on board oversight of the policies and procedures governing the construction of custom baskets, and whether the Rule's definition of custom baskets is appropriate. Additionally, the SEC seeks comments on whether the policies and procedures should require more specific, bright line information (e.g., a minimum number of positions for a custom basket), rather than a more general "best interest" standard.

V. Disclosure Requirements

The Commission also proposes amendments to Form N-1A and Form N-8B-2 in connection with the Rule.[27] The amendments are intended to provide investors who purchase and sell ETF shares on the secondary market with additional information regarding ETF trading costs to ensure that investors have full information regarding the total costs associated with their investment in an ETF. For example, the Proposing Release notes that while an ETF may have a lower expense ratio than a comparable mutual fund, an ETF investor will be subject to certain unique costs associated specifically with ETFs, such as the bid-ask spread and premiums and discounts from the ETF's NAV. In addition, the Commission is proposing related amendments to Form N-CEN.

A. Amendments to Form N-1A

The Commission proposes several amendments to Form N-1A in connection with the Rule which would require new disclosure regarding ETF trading information and related costs and would consolidate disclosures in the prospectus regarding ETF trading costs. The amendments include new narrative disclosures designed to clarify that there are 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. In addition, ETFs would be required to disclose quantitative information illustrating the hypothetical impact of bid-ask spreads on investments and to provide an interactive calculator on the ETF's website providing investors with the ability to customize these calculations.

The proposed amendments include a new section in Item 3 formatted as a series of questions and answers (Q&A), which the Commission believes would help facilitate an investor's understanding of certain terminology and cost calculations and provide helpful background on ETF trading.[28] Examples of new disclosure items

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[26] Rule 6c-11(d)(2)(ii)

[27] 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); Form N-8B-2 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 would not be included within the scope of the Rule, as proposed, the proposed amendments to Form N-8B-2 would subject UITs to the same disclosure requirements imposed on ETFs structured as open-end funds.

[28] See proposed amendment to Item 3 of Form N-1A. Like all information disclosed in Items 2, 3, or 4 of Form N-1A, the information disclosed in amended Item 3 would have to be tagged and submitted in a structured data format.

include a description explaining 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. The proposed Q&A also would explain that the bid-ask spread can change throughout the day due to the supply of or demand for ETF shares, the quantity of shares traded, and the time of day the trade is executed, among other factors. Additionally, the proposed amendments would require an ETF to calculate and disclose its median bid-ask spread over the most recently completed fiscal year. The median spread would be required to be calculated by using trading data from each trading day of the ETF's prior fiscal year. Finally, the new Q&A section would be required to include a cross-reference to new website disclosures required under the proposal, including the new interactive calculator.[29]

The proposal also would eliminate certain ETF disclosures that the Commission believes are no longer necessary or are duplicative of disclosure contained in the proposed changes to Item 3.[30]

B. Amendments to Form N-8B-2

As discussed above, the operations of UIT ETFs would continue to be governed by their respective exemptive relief rather than the Rule. Nonetheless, the Commission believes it is important for ETFs to provide consistent disclosure to investors, regardless of the ETF's classification under the 1940 Act. Accordingly, the proposed amendments to Form N-8B2 are intended to mirror the disclosure requirements proposed to be added to Form N-1A.

C. Amendments to Form N-CEN

The proposal also includes amendments to Form N-CEN, the structured form that requires registered funds to provide census-type information to the Commission 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. The amendments would add a requirement that ETFs report if they are relying on the Rule. While Form N-CEN already requires funds to report if they are an ETF, the Commission proposes to collect specific information on which funds are relying on the Rule in order to better monitor reliance on the Rule and to support its accounting, auditing, and oversight functions. The proposal would also change the definition of "authorized participant" in Form N-CEN to exclude the specific reference to an Authorized Participant's participation in Depository Trust Company in order to eliminate the need for future amendments if additional clearing agencies become registered with the Commission.[31]

VI. Next Steps

Based on their statements at the open meeting, the Commissioners seemed enthusiastic about the Rule, and the Commission unanimously approved the proposal. The Proposing Release was published in the Federal Register on July 31, 2018, and comments on the Rule are due on or before October 1, 2018.

Please let our ETF team know if you have any questions about the Rule or this Fund Alert.

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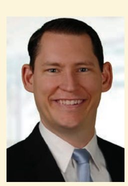
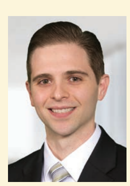
[29] See Instruction 5(c) to Item 3. Note that the proposal provides an exception for ETFs with a limited trading history (i.e., less than a full fiscal year), noting that the disclosure may not be as useful to investors.
[30] See, e.g., proposed amendments to Items 6 and 11 of Form N-1A.
[31] See proposed amendment to Instruction to Item E.2 of Form N-CEN.

If you would like more information, contact:

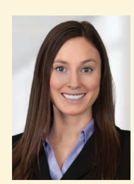

Michael W. Mundt
mmundt@stradley.com
202.419.8403


J. Stephen Feinour Jr.
jfeinourjr@stradley.com
215.564.8521


Mark R. Greer
mgreer@stradley.com
312.964.3505


Joel D. Corriero
jcorriero@stradley.com
215.564.8528


Jamie M. Gershkow
jgershkow@stradley.com
215.564.8543


Miranda Sturgis
msturgis@stradley.com
215.564.8131