

2018 PROPOSED ETF RULEMAKING



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ABOUT ROPES & GRAY’S ETF PRACTICE

- Ropes & Gray advises ETF sponsors that represent over half of all of the assets under management in the ETF industry on matters relating to the sponsorship and operation of ETFs, product design, operational matters, capital markets issues, tax issues related to custom baskets, index licensing matters, business issues, and exchange listing and trading relief issues.
- Ropes & Gray works with ETFs of all kinds, including actively-managed ETFs, non-transparent ETFs, leveraged and inverse ETFs, as well as other exchange traded products, including non-1940 Act ETFs investing in physical metals and futures-based commodities.
- Ropes & Gray’s ETF practice group includes the former in-house Chief Legal Officer to the largest ETF complex in the world who has over 12 years of experience working closely on all matters related to ETF sponsorship.
- Ropes & Gray’s recent ETF-related engagements have included advising on non-transparent ETF products, custom basket compliance policies and procedures, order-taking procedures, authorized participant oversight, ETF market-making activities, arbitrage activities, and market structure and trading regulations.
- Ropes & Gray has partnered with ETF sponsors on ETF product development since 2007.

Client Alert: 2018 Proposed ETF Rulemaking

On June 28, 2018 at an open meeting (the “Open Meeting”), the Securities and Exchange Commission (“SEC”) unanimously voted to propose new Rule 6c-11 (the “Proposed Rule”) under the Investment Company Act of 1940, as amended (“1940 Act”), which, if adopted, would permit exchange-traded funds (“ETFs”) that satisfy certain

conditions to organize and operate without the expense and delay of obtaining an exemptive order from the SEC. In addition to several key takeaways from the SEC release describing the proposals¹ (the “Release”), we describe the Proposed Rule in detail below and offer insights into how the Proposed Rule may affect ETFs and their sponsors.

KEY TAKEAWAYS

The Proposed Rule seeks to “create a consistent, transparent, and efficient regulatory framework for ETFs and to facilitate greater competition and innovation among ETFs.”² If adopted, the Proposed Rule would significantly ease the regulatory burdens associated with bringing an ETF to market and create a more level playing field for new and existing ETF sponsors. To accomplish this, the SEC proposes to take the following steps:

- **Rescind Prior Exemptive Orders.** To help establish a consistent ETF regulatory approach and remove the existing “patchwork” of exemptive orders, the SEC would, except with respect to ETF fund of funds relief described below, rescind exemptive orders previously granted to ETFs eligible to rely on the Proposed Rule. As noted below, certain types of ETFs will not be able to rely on the Proposed Rule and will not have their exemptive orders rescinded under the proposal.
- **Allow Custom Creation and Redemption Baskets.** An ETF relying on the Proposed Rule would be permitted to use non-pro rata baskets and/or baskets that differ from other baskets used in transactions

on the same business day (“custom baskets”).

- **Eliminate the Distinction Between Index-Based and Actively Managed ETFs.** All ETFs relying on the Proposed Rule, whether index-based or actively managed, must comply with the same conditions.
- **Implement New Disclosure Requirements.** The Proposed Rule and related amendments to Form N-1A (for open-end ETFs) and Form N-8B-2 (for UITs) would require ETFs to disclose certain information on their websites and in their prospectuses, including historical information regarding the ETF’s premiums and discounts and bid-ask spreads.

NEW CONDITIONS

The Proposed Rule would provide certain exemptions from the 1940 Act, including most of those currently included in ETF exemptive orders, and also impose many similar conditions. The new conditions in the Proposed Rule include the following:

- **Transparency.** Each ETF relying on the Proposed Rule must post its portfolio holdings daily on its website.
- **Custom Basket Policies and Procedures.**

An ETF relying on the Proposed Rule would be permitted to use custom baskets if the ETF adopts written policies and procedures that set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders and specify the titles or roles of the employees of the ETF’s investment adviser who are required to review each custom basket for compliance with those parameters.

- **Website Disclosure.** The Proposed Rule and related form amendments would require ETFs to disclose certain information on their websites to increase transparency, including historical information regarding premiums and discounts, bid-ask spread information and information regarding a published creation/redemption basket.

The SEC expects that permitting ETFs to utilize custom baskets will reduce transaction costs, promote efficient portfolio management and lead to a more efficient and effective arbitrage process. In addition, the new disclosure requirements, including full portfolio transparency, should enable the SEC, investors and other market participants to evaluate the functioning of an ETF’s arbitrage mechanism.³

SUMMARY OF THE RELEASE

The SEC's proposals aim to level the playing field among existing ETF sponsors, as well as to make it easier for new entrants to break into the ETF business. The SEC hopes the Proposed Rule will "facilitate greater competition and innovation in the ETF marketplace, leading to more choice for investors."⁴ The proposals in the Release would make substantial progress toward leveling the regulatory landscape for ETF sponsors and promoting the efficient operation of the arbitrage mechanism that supports an ETF's shares trading at a market price approximating the ETF's net asset value per share ("NAV"). In particular, the proposals set forth in the Release would:

- Codify much of the relief granted on a case-by-case basis to ETF sponsors under the current exemptive order regime, permitting ETFs organized as open-end funds, with some exceptions, to operate without obtaining individual exemptive relief from the SEC.⁵
- Rescind exemptive relief previously granted to those ETFs able to rely on the Proposed Rule.⁶ In addition, the Release proposes rescinding exemptive relief permitting ETFs to operate in a master-feeder structure for all ETFs that do not currently rely on such relief.⁷
- Permit an ETF relying on the Proposed Rule to use custom creation and redemption baskets that do not reflect a pro rata representation of the ETF's portfolio and/or that differ from other baskets used in creation or redemption transactions on the same business day.
- Require ETFs relying on the Proposed Rule to disclose certain information on their websites, including (i) portfolio holdings that will form the basis of the ETF's next NAV calculation; (ii) historical information regarding the ETF's NAV, premiums and discounts, and bid-ask spreads; and (iii) information regarding a basket of securities that the ETF would accept or provide in connection with a creation or redemption, updated at the beginning of each business day.
- Amend Form N-1A and Form N-8B-2 to require disclosure by *all* ETFs (not just ETFs eligible to rely on the Proposed Rule) of information relevant to investors who purchase and sell ETF shares in the secondary

markets. These new disclosure requirements seek to ensure that ETFs provide more useful, ETF-specific information to investors who purchase ETF shares in the secondary market.

As the SEC noted in the Release, the proposals are based on the SEC's experience in regulating ETFs for more than 25 years, and have been informed by the feedback received in response to the SEC's 2008 Exchange-Traded Funds Rule Proposal⁸ and the SEC's 2015 Request for Comment on Exchange-Traded Products.⁹

SCOPE OF THE PROPOSED RULE'S RELIEF

ETFs relying on the Proposed Rule will be able to operate under conditions and in a manner similar to how they currently operate because the Proposed Rule codifies much of the standard 1940 Act exemptive relief ETFs rely on presently. Currently, ETF exemptive orders commonly provide relief from Sections 2(a)(32) and 5(a)(1) (treatment of ETF shares as redeemable securities), Section 22(d) (trading of ETF shares at market-determined prices), Section 22(e) (additional time for delivering redemption proceeds), Sections 17(a)(1) and (2) (affiliated transactions) and Section 12(d)(1) (permitting certain fund of funds arrangements). The Proposed Rule addresses all of these topics except the exemptive relief from Section 12(d)(1), which relief, as noted below, will not be rescinded under the proposal.

Treatment of ETF Shares as "Redeemable Securities". Unlike existing exemptive orders, the Proposed Rule expressly defines an ETF share as a "redeemable security" within the meaning of Section 2(a)(32) of the 1940 Act, notwithstanding that only authorized participants may redeem ETF shares, and then only when shares are aggregated into creation units.¹⁰ As discussed below, this clarification may benefit ETF shares in relation to certain Securities Exchange Act of 1934 ("Exchange Act") trading rules.

Trading of ETF Shares at Market-Determined Prices. Consistent with existing exemptive orders, a dealer in ETF shares is exempt from Section 22(d) of the 1940 Act and Rule 22c-1(a) with regard to purchases, sales and repurchases of ETF shares at market-determined prices. This treatment is also consistent with the new definition of ETF, which in-

cludes the notion that ETFs issue shares that are listed on a national securities exchange and trade at market-determined prices rather than NAV.

Additional Time for Delivering Redemption Proceeds. Many ETFs have exemptive relief permitting in-kind transactions to settle beyond the seven-day period prescribed by Section 22(e) of the 1940 Act. This aspect of the relief addresses foreign investments¹¹ that cannot be delivered as redemption proceeds timely due to local holidays or local settlement customs (or a combination of those factors).¹² The Proposed Rule would provide this relief for up to 15 days, but would require delivery of redemption proceeds *as soon as practicable in all cases*. The condition that such investments be delivered as soon as practicable in all cases represents a new condition not typically found in the historical relief provided to ETFs. Under the Proposed Rule, this exemption from Section 22(e) would expire ten years from the effective date of the rule unless the SEC takes action before then. This “sunset” provision reflects the view of the SEC that securities markets around the world will continue to adopt shorter settlement cycles.

Affiliated Transactions. First and second tier affiliates¹³ of an ETF may enter into in-kind creation and redemption transactions with the ETF if they are affiliated with the ETF solely because they or their affiliates hold with the power to vote 5% or more of the shares of the ETF or any of the ETF’s investment company affiliates.¹⁴ Consistent with prior exemptive orders, such transactions would be exempt from Sections 17(a)(1) and (2) by the Proposed Rule. Despite industry requests to extend the relief to certain other affiliations (e.g., a broker-dealer that is affiliated with the ETF’s adviser), the SEC noted that it is not prepared “at this time” to extend the Section 17(a) relief to creation and redemption transactions involving parties that are affiliated persons of the ETF for reasons other than the 5% interest stated above.

Intraday Indicative Value (IIV). The Proposed Rule will not require ETFs to make available an intraday indicative value, although other types of relief necessary to operate an ETF may continue to require it, such as exchange listing rules, 19b-4 filings and certain types of Exchange Act class relief.

Which ETFs Fall Within the Definition of “ETF”? The Proposed Rule defines an “exchange-traded fund” as a registered open-end management company that: (i) issues (and redeems) creation units to (and from) authorized participants in exchange for a basket¹⁵ of securities, assets or other positions and a cash balancing amount, if any, and (ii) issues shares that are listed on a national securities exchange and traded at market-determined prices. Importantly, the definition of ETF excludes all exchange-traded products that are not registered open-end investment companies. This means that exchange-traded notes (ETNs) and exchange-traded commodity pools and physical metals trusts may not rely on the Proposed Rule. Unit investment trusts (UITs) that operate as ETFs are also outside the scope of the Proposed Rule.

Further, some categories of ETFs that would otherwise fall within the Proposed Rule’s definition of ETF may not rely on the Proposed Rule’s exemptive provisions, though they remain subject to certain requirements, such as the prospectus and certain website disclosure requirements discussed below. Those categories of ETFs include leveraged ETFs (that seek to provide returns at a multiple of a specific index), inverse ETFs (that seek to provide returns that have an inverse relationship to the performance of a specific index), and ETFs structured as a share class of a multi-class fund.¹⁶ The Staff of the SEC’s Division of Investment Management (the “Staff”) believes that each of these types of ETFs presents special issues, and the Staff will continue to require sponsors seeking to launch these types of ETFs to seek specific exemptive relief and to abide by the tailored conditions that such relief would entail. Sponsors granted relief to launch and operate these products currently would appear to be able to launch new products if they can operate within the confines of their exemptive relief. Additionally, non-transparent ETFs of the type proposed by a number of sponsors would be unable to meet the transparency requirements of the Proposed Rule.¹⁷

Elimination of the Distinction Between Index-Based and Actively Managed ETFs. The Proposed Rule does not distinguish between index-based and actively managed ETFs, and does not incorporate the special requirements applicable to self-indexed ETFs under some current exemptive orders. The Release states that “index-based and actively

managed ETFs that comply with the Proposed Rule's conditions function similarly with respect to operational matters, despite different investment objectives or strategies, and do not present significantly different concerns under the provisions of the [1940] Act from which the proposed rule grants relief."¹⁸ Further, the Release notes that the distinction between index-based ETFs and actively managed ETFs has been blurred due to the "proliferation of highly customized, often methodologically complicated, indexes."¹⁹ Accordingly, the SEC suggests in the Release "that eliminating the regulatory distinction between index-based ETFs and actively managed ETFs would help to provide a more consistent and transparent regulatory framework for ETFs organized as open-end funds"²⁰ and would be consistent with the way other types of open-end funds are regulated. As a result, all ETFs relying on the Proposed Rule, whether index-based or actively managed, must comply with the same conditions. In addition, because the Proposed Rule does not distinguish between index-based and actively managed ETFs in its conditions (or otherwise), transparent actively managed ETFs would be able to take advantage of custom basket flexibility previously available only to a handful of sponsors of index-based ETFs.

EFFECT OF THE PROPOSED RULE ON EXISTING EXEMPTIVE ORDERS

Rescission of Existing Exemptive Orders Held by ETFs That Can Rely on the Proposed Rule. All ETFs registered under the 1940 Act currently rely on exemptive orders issued to them at some point over the last few decades. The terms of those exemptive orders sometimes differ in important respects, with more recent orders typically having tighter restrictions on key ETF operations, such as the creation and redemption basket process. The SEC seeks to remedy that uneven regulatory landscape for ETF sponsors through the uniform terms of the Proposed Rule *and* by rescinding existing exemptive relief held by any ETF that can rely on the Proposed Rule. This rescission is generally limited to the portions of the exemptive relief pertaining to the formation and operation of an ETF, and does not cover the Section 12(d)(1) fund of funds provisions. (For a discussion of those ETFs that cannot rely on the Proposed Rule, see "Scope of

the Proposed Rule's Relief" above.) The rescission of those portions of the exemptive orders to be rescinded will be effective one year after the effective date of Rule 6c-11.

Fund of Funds Relief. Many existing ETFs have exemptive orders that permit other unrelated registered investment companies to make investments in them in excess of the Section 12(d)(1)(A) and (B) limits. The Proposed Rule does not address this aspect of the exemptive relief, and ETFs that have an exemptive order containing that relief may continue to rely on that aspect of the relief, including the related relief from Sections 17(a)(1) and 17(a)(2). Until the SEC adopts a similar fund of funds rule, ETF sponsors that do not have fund of funds relief must file a separate exemptive application to obtain the fund of funds relief that many current ETF sponsors already possess. A proposed fund of funds rule remains on the SEC's rulemaking agenda for potential action by the SEC.²¹

Master-Feeder Relief. Many existing ETFs have exemptive relief permitting an ETF to operate as a feeder fund in a master/feeder structure. The Proposed Rule does not incorporate this relief, and the Proposed Rule would rescind the relief from exemptive orders that include it except in the limited instances where an existing ETF currently relies on the relief (although in those cases, the relevant order would be amended to prevent the formation of new master/feeder structures).²²

Section 24(d) Relief. The Release confirms that the Staff intends to rescind existing relief from Section 24(d) of the 1940 Act held by some ETFs whose orders would be rescinded under the proposal. That relief provides an exemption to broker-dealers selling ETF shares from the obligation to deliver prospectuses in most secondary market transactions. The SEC notes its understanding in the Release that broker-dealers do not currently rely on that relief.

New Conditions Under the Proposed Rule

PORTFOLIO TRANSPARENCY

The Proposed Rule requires all ETFs relying on the rule to provide full portfolio transparency. Each ETF must disclose

prominently on its publicly available website the portfolio holdings²³ that will form the basis for the ETF's next calculation of NAV (*i.e.*, the ETF's portfolio holdings as of the close of business on the prior business day).²⁴ The portfolio holdings disclosure must be provided each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting creation and redemption orders.

CREATION AND REDEMPTION BASKETS, INCLUDING CUSTOM BASKETS

Basket Construction Policies and Procedures. The Proposed Rule would require all ETFs relying on the rule to adopt and implement written policies and procedures that govern the methodology used by the ETF in the construction of creation and redemption baskets and the process that will be used for the acceptance of baskets. The policies and procedures must include details on how and when the ETF may use representative sampling and how the ETF will conduct portfolio or index rebalances and index reconstitutions.

Custom Baskets. The Proposed Rule also permits all ETFs eligible to rely on it to utilize custom creation and redemption baskets. There are two types of custom baskets contemplated by the Proposed Rule. The first includes baskets that consist of a non-representative selection of the ETF's portfolio holdings, which would include baskets that do not reflect:

- (i) a *pro rata* representation of the ETF's portfolio holdings,
- (ii) a representative sampling of the ETF's portfolio holdings, or
- (iii) changes due to rebalancing or reconstitution of the ETF's securities market index, if applicable.

The second type of custom basket encompasses when different baskets are used on the same business day. Thus, any basket that differs from any other basket used by the ETF on a given day would be a custom basket. This would include:

- (i) different representative sampling baskets applicable to different authorized participants on a single day, or
- (ii) baskets including cash in lieu of a portion of the basket assets for a single authorized participant.

Custom Basket Policies and Procedures. As noted above, the Proposed Rule, which Commissioner Piwowar characterized as "principles-based," would require all ETFs relying on the Proposed Rule to use custom baskets to adopt written policies and procedures relating to the use of custom baskets.²⁵ The custom basket procedures must:

- Set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for revising, or deviating from, those parameters; and
- Specify the titles or roles of the employees of the ETF's adviser (or sub-adviser) who are required to review each custom basket for compliance with the established parameters.

Under the Proposed Rule, an ETF would be permitted to construct creation and redemption baskets using cash, securities, or other positions, provided that the ETF has satisfied the appropriate policies and procedures requirement. The SEC indicated in the Release that an ETF's custom basket policies and procedures should include details regarding the circumstances in which cash, securities, or other positions would be substituted for basket assets. The Release also states that the custom basket policies and procedures should include provisions for testing compliance with the custom basket policies and procedures and assessing (including through back testing or other periodic reviews) whether the parameters continue to result in baskets that are in the best interests of the ETF and its shareholders. Custom basket policies and procedures must also provide a process governing revisions to, or deviations from, the parameters within the policies and procedures. In addition, the SEC suggested that ETFs consider utilizing non-portfolio manager employees to review the components of custom baskets before approving a creation or redemption.

Recordkeeping. For each basket exchanged with an authorized participant, an ETF would also be required to maintain a record identifying the names and quantities of positions comprising the basket, the cash balancing amount, if any, and the identity of the authorized participant transacting with the ETF. For each custom basket used, such

record would also be required to identify the basket as a custom basket and state that the custom basket complies with the ETF's custom basket policies and procedures. ETF sponsors can expect that the Staff will focus on these records during examinations and ETF sponsors

should give careful consideration to the supporting materials and rationale that should be created and maintained to evidence the basis for any determination to accept a specific custom basket under the custom basket policies and procedures.²⁶

KEY ADDITIONAL CONSIDERATIONS ABOUT CUSTOM BASKETS

■ *The Importance of Custom Basket*

Flexibility. Obtaining flexibility to utilize custom creation and redemption baskets has been the Holy Grail of the ETF industry for the better part of a decade. Custom baskets should benefit ETFs and their shareholders by reducing costs, increasing efficiency and improving trading. The SEC noted that “ETFs without basket flexibility typically are required to include a greater number of individual securities within their baskets when transacting in-kind, making it more difficult and costly for authorized participants and other market participants to assemble or liquidate baskets. This could result in wider bid-ask spreads and potentially less efficient arbitrage.”²⁷ For fixed income ETFs, the ability to customize baskets is critical because many bonds do not trade frequently and requiring an ETF to include a hard-to-locate bond in a redemption basket simply to maintain the basket's representation of the overall ETF's portfolio would be counterproductive. By permitting custom baskets, the Proposed Rule will provide newer sponsors the flexibility to compete

with some of the more established ETF sponsors for securities, authorized participant transaction interest, creation activity and assets. In addition, custom baskets should enable actively managed ETFs to manage their portfolios in a more efficient and cost-effective way.

■ **Role of the Adviser/Sub-Adviser in Custom Basket Construction.** The custom basket construction process raises many of the same issues present in traditional portfolio management services (*e.g.*, whether to accept (buy) a specific security in a creation basket or whether to include (sell) a specific security in a redemption basket), as well as whether to include cash in lieu of securities or other assets or whether to substitute one or more securities for another security or group of securities. Accordingly, the investment adviser's (or sub-adviser's)

portfolio management team will play an important role in the basket construction process, though they must do so within the strictures of the ETF's custom basket policies and procedures. Accordingly, the parameters of those policies and procedures may have significant portfolio management and performance implications. Investment advisers (or sub-advisers) will also have a significant interest in the standard of care that applies to their activities in respect of the basket construction process. Compliance, risk and operational personnel should work closely with portfolio management and capital markets personnel to determine the contours of the custom basket parameters, as well as to determine the roles and responsibilities of those involved in constructing and administering custom baskets in the best interests of the ETF and its shareholders.



EDWARD BAER *Counsel, Investment Management*

Ed has significant experience with ETF basket construction issues, both in his former role as Chief Legal Officer for a large ETF sponsor and while at Ropes & Gray, having prepared basket construction and custom basket policies and procedures on behalf of a number of Ropes & Gray clients.

DISCLOSURE REQUIREMENTS

The Proposed Rule requires disclosure of certain information on an ETF's websites for all ETFs that rely on the Proposed Rule. In addition, the Release proposes certain disclosure amendments to Form N-1A and Form N-8B-2 that would apply to *all* ETFs, including those unable to rely upon the Proposed Rule.

Website Disclosure. The Proposed Rule expands the website disclosure requirements applicable to ETFs. Each ETF that relies on the Proposed Rule must post on its website information regarding a published basket at the beginning of each business day, as well as the estimated cash balancing amount.²⁸ The ETF must publish a single basket for creations and redemptions representing “a basket that it would accept if presented by any authorized participant in exchange for creation units (or present to an authorized participant redeeming creation units).”²⁹ The published basket need not represent a pro rata selection of the ETF's portfolio holdings.³⁰

Each ETF (as a condition of relying on the Proposed Rule) must also disclose, among other things, the following information on its website:

- The ETF's portfolio holdings³¹ that will form the basis of the next calculation of the ETF's NAV (daily);
- The ETF's NAV, market price³², and premium or discount, each as of the end of the prior business day (daily);
- Historical information regarding the median bid-ask spreads for the ETF's shares over the most recent fiscal year;
- A table and line graph describing the ETF's premiums and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year; and
- If the ETF's share premium or discount is greater than 2% 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. Also, this information must be posted on the website on the day immediately after the disclosure is triggered (*i.e.*, the eighth trading day) and must remain on the ETF's website for one year after its initial posting.

The purposes of these disclosures include to provide investors with a “snapshot” into the difference between an ETF's NAV and market price. The SEC is seeking comment on ways to better inform investors about intraday deviations between NAV and market price.

Potential Tax Implications of the Proposed Rule. ETFs have the potential to operate in a more tax-efficient manner than traditional mutual funds that redeem in cash. This tax efficiency derives principally from the in-kind creation and redemption mechanism utilized by many ETFs, and custom baskets may be used to facilitate transactions designed to optimize tax efficiencies. ETF sponsors will have to consider whether an ETF's written policies and procedures must identify the tax considerations, if any, that are taken into account in the construction and negotiation of a custom basket. An in-kind redemption made at the demand of a shareholder generally results in no taxable gain or loss to the ETF. Taking into account tax considerations when selecting securities to satisfy in-kind redemptions generally should not affect that result. Some types of tax-motivated redemptions, however, potentially present additional tax issues, that may require careful consideration under the ETF's custom basket policies and procedures and under the Proposed Rule.



JIM BROWN, *Partner, Tax*

Jim focuses his practice on the tax aspects of investment funds, including ETFs. He regularly advises sponsors of investment funds on tax structuring and operational issues relating to these funds, including the taxation of registered and unregistered investment funds (e.g., private equity funds, debt funds, hedge funds, commodities funds and regulated investment companies or mutual funds).

Registration Statement Disclosure. The Release details several new prospectus disclosure requirements designed to provide investors who purchase ETF shares on the secondary market with additional information, including information regarding costs associated with investments in ETFs. For example, the disclosure proposals would require ETFs to include registration statement disclosures that investors may be subject to brokerage and other fees when buying or selling ETF shares. These registration statement disclosures would apply to *all* ETFs, including those that fall outside of the Proposed Rule.

The disclosure proposals would also require additional fee and expense disclosure under a revised Item 3 of Form N-1A, which would be formatted as a series of Q&As designed to provide information about bid-ask spreads and other trading costs. Pursuant to revised Item 3, an ETF would be required to disclose its median bid-ask spread over the most recent fiscal year and to describe how the bid-ask spread would affect an investor's return on a hypothetical \$10,000 investment. ETFs would also be required to disclose mid-range and high-end spread costs. An ETF would be required to provide a cross-reference or hyperlink to its website, which would be required to provide an interactive calculator that would allow investors to test the hypothetical impact of such costs on their planned trading behavior. These new disclosure obligations would not apply to ETFs that have been in operation for less than one full fiscal year. The Q&As can be found on page 155 of the Release (<https://www.sec.gov/rules/proposed/2018/33-10515.pdf>).

In order to ensure consistent disclosure by ETFs that are organized as UITs (which are not otherwise covered under the Proposed Rule), the disclosure proposals also would revise Form N-8B-2 to require ETFs that are organized as UITs to provide the same information as is required by the revised Form N-1A.

Other Impacts of the Proposed Rule

EXCHANGE ACT ISSUES

ETFs require exemptive relief beyond that provided by the Proposed Rule to operate. In order to list shares on an exchange, ETFs must meet the requirements of the exchange

listing rules. Most new ETFs meet the generic listing standards of each listing exchange, but some novel or complex ETFs do not. For ETFs that do not meet the generic exchange listing standards, it may be necessary to seek an Exchange Act rule change under Rule 19b-4 to enable the ETF's shares to list on an exchange. This process, which is overseen by the SEC's Division of Trading and Markets ("T&M"), can be lengthy, with complex or novel products taking upwards of nine months before being approved or disapproved for listing.

In addition, ETFs currently require relief from certain Exchange Act trading rules, including Regulation M Rules 101 and 102, Rule 10b-17, Rules 15c1-5 and 15c1-6, Rule 14e-5, Section 11(d) and Rule 11d1-2, Rule 200(g) of Regulation SHO and Rule 10b-10, unless they are eligible to rely upon certain "class relief letters" issued by T&M. While most ETFs come within the parameters of the class relief letters, those that do not have had to seek individual no-action or exemptive relief, which can take several months to obtain.

As noted above, the Proposed Rule seeks to address some of these Exchange Act issues by establishing that ETFs that meet the definition of "exchange-traded fund" under the Proposed Rule issue "redeemable securities" as defined in Section 2(a)(32) of the 1940 Act. As redeemable securities, ETF shares will fall within an exemption in Rules 101(c)(4) and 102(d)(4) of Regulation M and Rule 10b-17(c) under the Exchange Act, each of which provides exceptions for "redeemable securities" issued by open-end investment companies. In addition, the Proposed Rule may also have implications under Rule 11d1-2 under the Exchange Act, which contains an exemption for "registered open-end investment companies." To the extent that ETFs no longer have to seek relief from these provisions, the new ETF launch process should be further streamlined.

The SEC also requested comment on whether it should provide relief from Exchange Act Rules 10b-10, 15c1-5 and 15c1-6. ETFs currently rely on relief from these and other Exchange Act rules, and that relief is subject to a variety of conditions, including minimum creation unit sizes, frequent dissemination of the IIV, restrictions on the payment

of certain cash compensation or economic incentives to broker-dealers, minimum levels of diversification in the ETF's portfolio, and whether the ETF is managed to track an index. If relief from these other Exchange Act provisions were available to ETFs under the Proposed Rule, another significant regulatory workset would be removed, further paving the way for new and existing sponsors to bring products to market more rapidly and at a reduced cost.

POTENTIAL EFFECT OF THE PROPOSED RULE ON INDICES

Since the advent of ETFs, ETFs that seek to track the performance of an index have represented the vast majority of both ETFs and assets under management held in ETFs. This growth in index-based ETFs mirrors the larger investment trend toward lower cost beta strategies, such as index investing. One result of the growth of index-based ETFs was that index providers came to occupy an important commercial space in the ETF industry. The Proposed Rule presents the possibility that more ETFs in the future will be launched without any specific ties to an index. For now though, the Proposed Rule's requirement of daily transparency of an ETF's portfolio holdings, as described above, may remain a significant obstacle to active managers launching and operating ETFs in reliance on the Proposed Rule and may signal broader reluctance by the SEC to embrace less transparent ETF structures.³³

ADDITIONAL POTENTIAL CONSIDERATIONS FOR ETF SPONSORS

The Proposed Rule seeks to level the playing field among ETF sponsors by rescinding most existing ETF exemptive orders and applying consistent regulatory requirements to ETFs. For ETF sponsors who do not currently have flexibility to utilize custom creation and redemption baskets, the Proposed Rule may be a game changer. However, the Proposed Rule does come at a cost, with both technology and compliance costs likely to increase due to the addition of significant disclosure obligations and the requirement to adopt and operate pursuant to basket construction policies and procedures. Nevertheless, the Proposed Rule provides significant potential benefits to ETF sponsors and investors. In evaluating the potential impact of the Proposed Rule, existing and prospective ETF sponsors should consider the following issues.

New Sponsors. The Proposed Rule will lower the barriers to entry into the ETF market by eliminating the time delays and costs associated with obtaining 1940 Act exemptive relief. While the time needed to obtain exemptive relief has declined from a year or more to three to four months for routine exemptive applications, the uncertainty of the exemptive process will be eliminated for most ETFs by the Proposed Rule. In addition, not having to obtain exemptive relief should save new entrants significant legal fees that they can use towards product development efforts and capital markets relationship building.

Breaking into the ETF business will still present challenges for new entrants, including the number of competing sponsors (which will inevitably increase once the Proposed Rule goes into effect) and the potential challenges presented by the current ETF listing process. In addition, new sponsors must address the legal and operational issues described herein, which will involve hiring competent and experienced employees, business advisors, legal counsel and service providers. However, if the Proposed Rule is adopted and the SEC is successful in its efforts to promote innovation and competition in the ETF marketplace, reduced barriers to entry, a more level regulatory playing field, and lower startup costs should benefit new entrants and investors alike.



BRIAN MCCABE

*Partner,
Investment Management*
Brian focuses his practice on representing investment advisers, broker-dealers and mutual

funds and their directors. He regularly advises on the formation, compliance maintenance and operations of open- and closed-end investment companies. Brian has broad-based experience with ETFs, including representing Impact Shares and its independent trustees, representing Pax World Funds in connection with the formation of ESG Shares, and representing advisers to various ETFs.

Advisory/Sub-Advisory Agreements and Other Service Provider Arrangements. As noted previously, in light of the additional responsibilities that may be placed on advisers or sub-advisers in connection with the basket construction and custom basket policies and procedures, advisers should evaluate the responsibilities and standards of care in their existing agreements with ETFs. In addition, the new requirements under the Proposed Rule may necessitate new or modified arrangements with fund service providers such as custodians, administrators, index providers, pricing vendors and data providers. It also may be necessary to review the ETF's authorized participant agreements and any related procedural documents to ensure that the ETF will be able to take advantage of the flexibility custom baskets will offer, when available.

Compliance Policies and Procedures. Sponsors and ETF boards should carefully evaluate their compliance policies and procedures to understand how the Proposed Rule may impact their overall compliance program. For example, the Proposed Rule will require sponsors and boards to adopt or amend basket construction and, if relevant, custom basket policies and procedures. In addition, sponsors and boards should determine whether existing portfolio holdings disclosure policies need to be revised in light of the Proposed Rule's portfolio transparency requirements. Further, sponsors and boards may need to adopt policies and procedures relating to how information is posted to the ETF's website and how they will ensure that the required disclosures will be made timely and accurately. Sponsors should also assess how the requirements of the Proposed Rule, especially the basket construction and custom basket policies and procedures, may interact with other fund policies, such as the liquidity program requirements of Rule 22e-4.

Technology and Website Enhancements. Given the Proposed Rule's enhanced disclosure requirements, sponsors should assess their data and technology arrangements, including the functioning and utility of their ETFs' websites. The Proposed Rule requires ETFs to post several categories of new information on their websites daily, and to provide an interactive calculator to enable investors to assess potential trading costs. Sponsors will need to arrange for the necessary data feeds and website development to ensure that

these disclosure obligations can be met. In addition, to the extent ETFs must post information derived from third-party data, they should ensure that any necessary data use licenses have been obtained.

Continued Reliance on Existing Exemptive Relief or Need for Additional Exemptive Relief. Sponsors, particularly sponsors that currently enjoy significant basket flexibility, should evaluate their existing exemptive orders to determine whether those orders include relief that is beyond the relief provided by the Proposed Rule and which may be essential to the continued efficient operation of their ETFs. Certain sponsors may seek to establish a dialogue with the Staff during the Proposed Rule's comment period regarding potential changes to the Proposed Rule or to procure separate exemptive relief. Under the Proposed Rule and the terms of the Release, an inability to continue an ETF's existing operations as presently conducted would not appear to remove the ETF's exemptive order from the population of orders that will be rescinded *unless* that inability arises out of the ETF's operation as a leveraged ETF, inverse ETF, UIT or class of a multi-class fund. Sponsors of ETFs that are excluded from the scope of the Proposed Rule may want to engage proactively with the Staff in order to understand the status of their exemptive relief, as well as what hurdles, if any, they may face in developing and offering new products. The same suggestion would apply to new sponsors who may need novel relief to develop and offer new ETFs.

BOARD PERSPECTIVES: THE EFFECT OF THE PROPOSED RULE ON ETF BOARDS

The Proposed Rule does not directly impose new obligations on the boards of ETFs. Indeed, the Release mentions the role of an ETF board only a handful of times, principally to state the Staff's expectation that boards have a role to play in the oversight of the custom basket creation and redemption process.³⁴ Given the possibility for overreach and the dilution of shareholder interests through that process, the Staff's expectation that the board provide a level of oversight over that process should not come as a surprise.

Appropriately, nothing in the Proposed Rule or the Release suggests boards should get involved in an ETF's day-to-day operations. As with other oversight functions a board performs, an ETF

board's oversight of the basket construction process will likely be through the review and establishment of policies and procedures required by the Proposed Rule and the review of periodic reporting regarding the operation of those policies and procedures provided by the qualified professionals involved in the ETF's day-to-day operations. The evaluation of whether the policies and procedures continue to result in custom baskets in the best interest of an ETF will require careful consideration of how a basket affects the economic characteristics of the ETF's portfolio, including, potentially, whether it reduces or increases the prospect of tracking error from an

ETF's index or target portfolio or whether it reduces transaction costs that the authorized participants would otherwise incur, which is important to an efficient arbitrage mechanism. It seems likely that investment and risk professionals at an ETF's investment adviser (or sub-adviser), as well as fund compliance personnel, would be best placed to provide ETF boards with periodic summary reports evidencing their findings regarding whether the ETF's custom basket policies and procedures remain properly designed to result in baskets that are in the best interest of the ETF and its shareholders.



JEREMY SMITH, *Partner, Investment Management*

Jeremy's practice focuses on advising mutual funds and ETFs, their independent directors, and investment advisers. Jeremy has advised ETF sponsors regarding product design, registration, licensing, compliance and other operational issues.

OTHER ITEMS OF NOTE

There are a number of other noteworthy provisions of the Proposed Rule and the Release:

- The Release references the "potential staff recommendation of a re-proposal on funds' use of derivatives . . ."³⁵
- There is no minimum creation unit size required under the Proposed Rule, although certain exchange listing rules and Exchange Act class relief provisions require an ETF to establish a minimum creation unit size.³⁶
- As noted above, custom basket transactions may be effected only in accordance with policies and procedures

that detail parameters for the construction and acceptance of custom baskets that are "in the best interests of the ETF *and its shareholders*." (Emphasis added.) At the Open Meeting, Commissioner Peirce commented on the inclusion of "and its shareholders" in the best interest standard stated above, and she noted that the adviser owes a fiduciary duty only to the ETF it manages. Commissioner Peirce also highlighted the difficulty any adviser would have in assessing the individual tax and other circumstances of each shareholder, and noted that even redeeming shareholders fall within the population of shareholders whose interests seemingly

must be considered under that standard. We expect that this issue will generate a number of industry comments during the Proposed Rule's comment period.³⁷

- Redemptions may be suspended only in accordance with Section 22(e) of the 1940 Act. Per the Release, creations may be suspended only for a limited time and only due to extraordinary circumstances, such as when the markets on which the ETF's portfolio holdings are traded are closed for a limited period.
- Redemption fees charged by ETFs in connection with creation unit redemptions must be in compliance with 1940 Act Rule 22c-2; fees charged in respect of the creation process may not be so high as to effectively suspend the issuance of creation units.
- The Proposed Rule permits individual share redemptions for transactions such as mergers, reorganizations, conversions and liquidations.
- ETFs cannot make selective disclosure of intra-day changes to portfolio holdings, and disclosures of portfolio holdings information must be made consistent with the ETF's disclosure policies. Sponsors may need to review their portfolio holdings disclosure policies and related disclosures in light of the Proposed Rule and the potential for the custom basket construction process to require disclosure of otherwise non-public portfolio holdings information.
- ETFs that are delisted or suspended from their listing exchange may no longer rely on the Proposed Rule.
- The new Form N-1A Item 3 narrative disclosure that fees may apply when you sell shares would apply to both ETFs and mutual funds.
- The SEC proposed an amendment to Item C.7. of Form N-CEN to require ETFs to report whether they are relying on the Proposed Rule.
- The SEC requested comment on whether an index-based ETF should be required to disclose information on the ETF's tracking error relative to its benchmark index.

WHAT THE PROPOSED RULE DOES NOT COVER

ETF Exchange Listing Process. The Proposed Rule does not address the ETF exchange listing (Exchange Act Rule 19b-4) process, which is overseen by T&M and is outside the scope of the Proposed Rule. However, as Commissioner Peirce noted in her statement on the Proposed Rule, the exchange listing rules add complexity and potentially lengthy delays to the ETF launch and listing process that should be addressed by future SEC action.

ETP Classifications. As noted by Commissioner Stein at the Open Meeting, the Proposed Rule does not directly address the establishment of standard classifications for various types of ETPs. Often, the term "ETF" is used generically to refer to products that are exchange-traded regardless of the features, exposures and regulatory treatment of the products. Certain non-1940 Act ETPs provide exposure to physical metals, currencies and commodity futures or other derivatives, while ETNs typically represent unsecured debt obligations of the ETN issuer. These products all present risks that differ from those posed by ETFs registered under the 1940 Act, and they are regulated differently, yet some investors and some in the media tend to lump all exchange-traded products together. And while the Proposed Rule clearly defines what constitutes an ETF, it does not attempt to limit the use of the term to those products relying on the Proposed Rule.

Extension of Fund of Funds Provisions to 3(c)(1) and 3(c)(7) Funds. When the 2008 ETF rule proposal was issued, numerous commenters suggested that there is no obvious reason to limit 3(c)(1) and 3(c)(7) funds from investing in unaffiliated ETFs beyond the limits of Section 12(d)(1)(A) and (B) when other investment companies may do so under exemptive relief then commonly provided. It is possible the SEC may consider this issue in separate rulemaking related to Section 12(d)(1) in the near future as a potential rule for fund of funds relief for ETFs remains on the SEC's rulemaking agenda.³⁸

COMMENTS

Comments on the Proposed Rule are due within 60 days of the publication of the proposal in the Federal Register. The Release contains dozens of specific requests for comment on the Proposed Rule and other elements of the proposals. We encourage existing and prospective ETF sponsors, authorized participants and other market participants to comment on specific aspects of the Proposed Rule that may raise challenges or concerns, and to note their support for specific elements that they agree with, as applicable. Many in the industry have waited a long time for an ETF rule, and this may be the industry's best opportunity to obtain a clear, consistent and fair regulatory scheme for ETFs.

Ropes & Gray would be pleased to assist you in analyzing the impact of the Proposed Rule and preparing comments on the proposals. Please contact the authors or your regular Ropes & Gray contact for assistance.

ENDNOTES

¹ Exchange Traded Funds, Investment Company Act Release No. 28193, available at <https://www.sec.gov/rules/proposed/2018/33-10515.pdf>.

² *Id.* at 6.

³ The Release contains an extensive discussion of the purpose and operation of the ETF arbitrage mechanism. See Release at pp. 41-49 (“The arbitrage mechanism is the foundation for why retail and other secondary market investors generally can buy and sell ETF shares at prices that are at or close to the prices at which authorized participants are able to buy and redeem shares directly from the ETF at NAV.”)

⁴ Securities and Exchange Commission. (2018, June 28). *SEC Proposes New Approval Process for Certain Exchange-Traded Funds* [Press release]. Available: <https://www.sec.gov/news/press-release/2018-118>.

⁵ ETFs organized as unit investment trusts (“UITs”), ETFs structured as a share class of a multi-class fund, and leveraged or inverse ETFs would be unable to rely on the Proposed Rule. At the Open Meeting, however, Commissioner Peirce said that she hoped commenters would weigh in on whether and how the Proposed Rule could accommodate leveraged or inverse ETFs.

⁶ Note that, with the exception of rescissions related to master-feeder relief discussed herein, the proposed rescissions would be limited to the portions of an ETF's exemptive order that grant relief related to the formation and operation of an ETF. The Staff does not propose to rescind exemptive relief from Section 12(d)(1) and the related relief from Sections 17(a)(1) and (a) (2) of the 1940 Act that permits certain ETF fund of funds arrangements.

⁷ The proposal would grandfather existing master-feeder arrangements that were in use as of June 28, 2018, but would prevent the formation of new master-feeder arrangements by amending existing exemptive orders.

⁸ Investment Company Act Release 28193 (March 11, 2008).

⁹ Securities Exchange Act Release 75165 (June 12, 2015).

¹⁰ “Creation unit” means “a specified number of ETF shares that the ETF will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount (if any).” See Release at footnote 92.

¹¹ The definition of “foreign investment” means any security, asset or other position of the ETF issued by a foreign issuer (as defined by Rule 3b-4 under the Exchange Act) for which there is no established U.S. public trading market (as that term is used in Regulation S-K under the Securities Act 1933).

¹² The SEC will no longer require registration statement disclosure of foreign holidays during which an ETF may delay the payment of redemption proceeds and the maximum expected redemption delays.

¹³ Persons affiliated with the ETF based on their ownership of 5% or more of the ETF's outstanding securities are “first-tier affiliates” and affiliated persons of the first-tier affiliates or persons who own 5% or more of the outstanding securities of one or more funds advised by the ETF's investment adviser are “second-tier affiliates.”

¹⁴ This formulation differs from the SEC's 2008 ETF rule proposal where the following formulation was proposed: “solely by reason of holding with the power to vote 5 percent or more, or more than 25 percent, of securities issued by the exchange-traded fund (or who is an affiliated person of such a person), or issued by an investment company under common control with the exchange-traded fund, is exempt from sections 17(a)(1) and 17(a) (2)...” Existing exemptive orders may include yet different formulations. Care should be taken to consider whether broader relief from Section 17(a) (1) and 17(a)(2) within the Proposed Rule may be necessary or appropriate in some cases for ETFs to continue to operate in the same manner as they have in the past.

¹⁵ “Basket” is defined in the Proposed Rule as “the securities, assets or other positions in exchange for which an ETF issues (or in return from which it redeems) creation units.” See Release at footnote 33. Therefore, the term “exchange-traded fund” includes ETFs that transact in-kind, in cash or both.

¹⁶ The Release cites to exemptive orders issued to Vanguard Index Funds as an example of ETFs holding this form of multi-class fund relief. See Release at footnote 332.

¹⁷ Precidian ETFs Trust et al. (File No. 812-14405) (Dec. 22, 2014, as amended on Aug. 11, 2015, Sept. 21, 2015, May 3, 2017, October 2, 2017, December 4, 2017 and May 30, 2018); T. Rowe Price Associates, Inc. et al. (File No. 812-14214) (Sept. 23, 2013, as amended on Mar. 14, 2014, February 23, 2018 and June 18, 2018); Fidelity Beach Street Trust et al. (File No. 812-14364) (Sept. 26, 2014, as amended on Jan. 26, 2018 and May 18, 2018); Natixis Advisors, L.P. et al. (File No. 812-14870) (Jan. 22, 2018, as amended on June 15, 2018); and Blue Tractor ETF Trust et al. (File No. 812-14625) (Mar. 14, 2016, as amended on Sept. 28, 2016, Feb. 1, 2017, July 31, 2017, Jan. 17, 2018, April 11, 2018 and May 23, 2018). In addition the Proposed Rule would not apply to exchange-traded mutual funds. See Eaton Vance Management et al., Investment Company Release No. 31361 (Dec. 2, 2014).

¹⁸ See Release at 24.

¹⁹ *Id.* at 26.

²⁰ *Id.*

²¹ U.S. Securities and Exchange Commission, “Agency Rule List – Spring 2018,” available at: https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235.

²² In the Release, the SEC expressed concern that an ETF feeder will transact in-kind with its master fund while other feeder funds will transact in cash with the same master fund. In this scenario, all investors in the master fund, including the ETF feeder that transacted in-kind, will bear the costs of the cash transactions within the master fund.

²³ Portfolio holdings include securities, assets or “other positions.” Other positions include cash, as well as other holdings that are not securities or assets, including short positions or written options.

²⁴ “Business day” means any day the ETF is open for business, including any day when it satisfies redemption requests.

²⁵ The custom basket approach incorporated in the Proposed Rule seems to be substantially similar to exemptive relief applications Ropes & Gray LLP prepared and filed in October 2017 on behalf of several of its clients. See, for example, <https://www.sec.gov/Archives/edgar/data/919361/000119312517300773/d416276d40app.htm>.

²⁶ The Proposed Rule would also require that ETFs preserve and maintain copies of all written authorized participant agreements.

²⁷ See Release at 93.

²⁸ Current exemptive orders do not require index-based ETFs (other than 130/30 funds or long/short funds) to post their portfolio holdings daily.

²⁹ See Release at 104.

³⁰ The SEC also requested comment on whether ETFs should be required to publish, after the close of trading each business day, information regarding every basket used by the ETF that day. Release at page 106.

³¹ To standardize the presentation of portfolio holdings, the Proposed Rule would require that the format of the portfolio holdings disclosure be consistent with the format contained in Article 12 of Regulation S-X. See Release at page 83 and footnote 220. See also 17 C.F.R. Part 210.12.

³² Market price means (i) the official closing price of the ETF share, or (ii) if it more accurately reflects the market value of the ETF at the time the ETF calculates its NAV, the midpoint between the national best bid-offer (NBBO) at the NAV calculation time. The definition of “market price” in the Proposed Rule differs from the existing definition in Form N-1A, but the Proposed Rule would amend Form N-1A to remove the conflicting definition.

³³ See fn. 17, above.

³⁴ The Staff stated its view that an ETF’s basket policies and procedures (including its custom baskets policies) should be covered by the ETF’s compliance program and other requirements under Rule 38a-1.

³⁵ The SEC includes “Use of Derivatives by Registered Investment Companies and Business Development Companies” among the list of proposed rules on its Spring 2018 rulemaking agenda. See U.S. Securities and Exchange Commission, “Agency Rule List – Spring 2018,” available at: https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235.

³⁶ Certain Exchange Act class relief letters require ETFs to adopt a minimum creation unit size of 50,000 shares. Letter from James A. Brigagliano, Division of Trading and Markets, Securities and Exchange Commission, to Stuart M. Strauss, Clifford Chance US LLP, re: Class Relief for Exchange Traded Index Funds (Oct. 24, 2006), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/etifclassrelief102406-msr.pdf>. However, some more recent relief has required only 10,000 share creation units. See John Hancock Exchange-Traded Fund Trust, Release No. 34-82234 (Dec. 7, 2017) available at <https://www.sec.gov/rules/exorders/2017/34-82234.pdf>.

³⁷ We note that the SEC also released proposed guidance in 2008 related to board oversight of trade execution that, had it been adopted, would have required an analysis of whether the payment of certain costs is in the best interest of a fund and its shareholders. See “Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices,” Investment Company Act Release 38345 (July 30, 2008).

³⁸ U.S. Securities and Exchange Commission, “Agency Rule List – Spring 2018,” available at: https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235.

ROPES & GRAY ETF CONTACTS



Ed Baer

Counsel, San Francisco
edward.baer@ropesgray.com
+1 415 3156 6328



Jim Brown

Partner, New York
james.brown@ropesgray.com
+1 212 596 9696



Bryan Chegidden

Partner, New York
bryan.chegidden@ropesgray.com
+1 212 497 9696



Sarah Clinton

Partner, Boston
sarah.clinton@ropesgray.com
+1 617 951 7375



Gregory C. Davis

Partner, San Francisco
gregory.davis@ropesgray.com
+1 415 315 6327



Timothy W. Diggins

Partner, Boston
timothy.diggins@ropesgray.com
+1 617 951 7389



Michael G. Doherty

Partner, New York
michael.doherty@ropesgray.com
+1 212 497 3612



Pamela Glazier

Partner, Boston
pamela.glazier@ropesgray.com
+1 617 951 7420



Thomas R. Hiller

Partner, Boston
thomas.hiller@ropesgray.com
+1 617 951 7439



Susan Johnston

Partner, Boston
susan.johnston@ropesgray.com
+1 617 951 7301



John M. Loder

Partner, Boston
john.loder@ropesgray.com
+1 617 951 7405



Brian D. McCabe

Partner, Boston
brian.mccabe@ropesgray.com
+1 617 951 7801



Mark V. Nuccio

Partner, Boston
mark.nuccio@ropesgray.com
+1 617 951 7368



Paulita A. Pike

Partner, Chicago
paulita.pike@ropesgray.com
+1 312 845 1212



George B. Raine

Partner, Boston
george.raine@ropesgray.com
+1 617 951 7556



Elizabeth J. Reza

Partner, Boston
elizabeth.reza@ropesgray.com
+1 617 951 7919



Adam M. Schlichtmann

Partner, Boston
adam.schlichtmann@ropesgray.com
+1 617 951 7114



Gregory D. Sheehan

Partner, Boston
gregory.sheehan@ropesgray.com
+1 617 951 7621



Jeremy C. Smith

Partner, New York
jeremy.smith@ropesgray.com
+1 212 596 9858



David C. Sullivan

Partner, Boston
david.sullivan@ropesgray.com
+1 617 951 7362



James E. Thomas

Partner, Boston
james.thomas@ropesgray.com
+1 617 951 7367

OUR OFFICES WORLDWIDE

NEW YORK

1211 Avenue of the Americas
New York, NY 10036

T +1 212 596 9000

F +1 212 596 9090

CHICAGO

191 North Wacker Drive
32nd Floor
Chicago, IL 60606

T +1 312 845 1200

F +1 312 845 5500

HONG KONG

One Exchange Square
41st Floor
8 Connaught Place
Central, Hong Kong

T +852 3664 6488

F +852 3664 6588

WASHINGTON, D.C.

2099 Pennsylvania Avenue, NW
Washington, DC 20006

T +1 202 508 4600

F +1 202 508 4650

SAN FRANCISCO

Three Embarcadero Center
San Francisco, CA 94111

T +1 415 315 6300

F +1 415 315 6350

SHANGHAI

36F, Park Place
1601 Nanjing Road West
Shanghai 200040

T +86 21 6157 5200

F +86 21 6157 5299

BOSTON

Prudential Tower
800 Boylston Street
Boston, MA 02199

T +1 617 951 7000

F +1 617 951 7050

SILICON VALLEY

1900 University Avenue
6th Floor
East Palo Alto, CA 94303

T +1 650 617 4000

F +1 650 617 4090

SEOUL

POSCO P&S Tower, 21F
134 Teheran-ro, Gangnam-gu
Seoul 06235

T +82 2 2141 5900

F +82 2 2141 5950

LONDON

60 Ludgate Hill
London EC4M 7AW

T +44 20 3201 1500

F +44 20 3201 1501

TOKYO

JP Tower 30F
2-7-2, Marunouchi
Chiyoda-ku, Tokyo 100-7030

T +81 3 6259 3500

F +81 3 6259 3501

ROPES & GRAY

ropesgray.com

NEW YORK | WASHINGTON, D.C. | BOSTON | LONDON
CHICAGO | SAN FRANCISCO | SILICON VALLEY
HONG KONG | SEOUL | SHANGHAI | TOKYO