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Flash Analysis: The Final ETF Rule

On September 26, 2019, the Securities and Exchange Commission (the “Commission”) announced that it had unanimously adopted Rule 6c-11 (the “ETF Rule”).¹ The ETF Rule was adopted largely in the form proposed on June 28, 2018,² but with several important changes in response to comments, including the elimination of the requirements (i) to publish the ETF’s portfolio holdings prior to the acceptance of a creation or redemption order for that day, (ii) to include historical bid-ask spread information in an ETF’s registration statement, and (iii) to make an interactive bid-ask spread calculator available on the ETF’s website. At the same time, the Commission issued an exemptive order providing relief from certain rules under the Securities Exchange Act of 1934 (“Exchange Act”).³ The Exchange Act Order may reduce regulatory complexity and eliminate inconsistencies applicable to most newly launched ETFs by removing the need for those ETFs to comply with the conditions of certain “class relief” letters. (See the section entitled “Exchange Act Order” below the table.)

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The following table identifies the key provisions of the proposed rule and comments on whether those provisions were adopted as proposed or revised in the final ETF Rule. Ropes & Gray LLP anticipates publishing a more detailed summary and analysis of the ETF Rule in the coming days. In the interim, please contact [Ed Baer](#), [Brian McCabe](#), [Jeremy Smith](#) or your regular Ropes & Gray contact if you have any questions.

Proposed Rule	Final Rule
Scope of the Proposed Rule	
ETF Definition. The Proposed Rule defined 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 basket 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.	No changes from the Proposal.
ETFs Covered by the Proposed Rule. 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: leveraged ETFs (that seek to provide returns at a specified multiple of an index), inverse ETFs (that seek to provide returns that have an inverse relationship to the performance of an index), and ETFs structured as a share class of a multi-class fund. The Proposed Rule would also not apply to ETFs organized as unit investment trusts (“UITs”).	No changes from the Proposal. ETFs not covered by the Proposed Rule must rely on their existing exemptive relief. In addition, the ETF Rule contains a condition preventing leveraged and inverse ETFs from relying upon the Rule. Finally, the ETF Rule does not apply to so-called “non-transparent active” ETFs such as those approved in the recent Precidian exemptive order. ⁴

¹ Exchange-Traded Funds, Release Nos. 33-10695; IC-33646 (September 25, 2019) (“Adopting Release”).
² Exchange-Traded Funds, Release Nos. 33-10515, IC-33140 (June 28, 2018) (“Proposing Release” or the “Proposal”).
³ Order Granting a Conditional Exemption From Exchange Act Section 11(d)(1) and Exchange Act Rules 10b-10, 15c1-5, 15c1-6, and 14e-5 for Certain Exchange Traded Funds, Release No. 34-87110 (September 25, 2019) (the “Exchange Act Order”).
⁴ See Precidian ETFs Trust, et al., Investment Company Act Release Nos. 33440 (Apr. 8, 2019) (notice) and 33477 (May 20, 2019) (order).

<p><u>ETF Shares as Redeemable Securities.</u> Expressly defines as a “redeemable security” within the meaning of Section 2(a)(32) of the 1940 Act shares of any fund that is an “exchange-traded fund” under the Proposed Rule.</p>	<p>No changes from the Proposal. The Adopting Release clarifies that even shares of ETFs ineligible to rely on the ETF Rule will qualify as “redeemable securities” for purposes of the following rules: Rules 101(c)(4) and 102(d)(4) of Regulation M and Rule 10b-17(c) and Rule 11d1-2 under the Exchange Act.</p>
<p>Traditional ETF Relief</p>	
<p><u>Affiliated Transactions.</u> First- and second-tier affiliates 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 own, control or hold with the power to vote 5% or more of the shares of the ETF or any of the ETF’s investment company affiliates. Consistent with prior exemptive orders, such transactions would be exempt from Sections 17(a)(1) and (2) under the Proposed Rule.</p>	<p>No changes from the Proposal. In response to comments, the Adopting Release confirmed that there was no intention to change the scope of the Section 17(a) relief in the ETF Rule from the scope of Section 17 relief in the Commission’s historical ETF orders and, consequently, that the Section 17 relief will apply to shareholders who own, control, or hold with the power to vote, more than 25% of an ETF’s shares.</p> <p>Despite comments requesting that the Section 17 relief be expanded to cover entities affiliated with the Funds for reasons other than owning, controlling or holding with the power to vote 5% or more of a Fund’s shares (e.g., to permit such affiliates to act as authorized participants or to provide in-kind seed capital), the Commission declined to extend the relief in that manner.⁵</p>
<p><u>Additional Time for Delivering Redemption Proceeds.</u> The Proposed Rule would provide exemptive relief permitting in-kind transactions to settle beyond the seven-day period prescribed by Section 22(e) of the 1940 Act. The Proposed Rule would provide this relief for up to 15 days, but would require delivery of redemption proceeds <i>as soon as practicable in all cases</i>.</p>	<p>Adopted as proposed except as noted below.</p> <p>The ETF Rule does not include the ten-year sunset provision for the Section 22(e) relief that was a part of the Proposal. In addition, commenters sought clarification that the Section 22(e) relief extends to a foreign investment even if the foreign investment has a U.S.-traded equivalent security. In response, the ETF Rule defines “foreign investment” as an investment that “is traded on a trading market outside of the U.S.” and the Adopting Release confirms that the Section 22(e) relief applies even if a foreign investment has a U.S.-traded equivalent security.</p>
<p><u>Trading of ETF Shares at Market-Determined Prices.</u> 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 under the Proposed Rule.</p>	<p>No changes from the Proposal.</p>

⁵ See footnote 137 of the Adopting Release and accompanying text.

Other Key Impacts of the Proposed Rule	
<u>Eliminates Distinction between Index-Based and Actively Managed ETFs.</u> The Proposed Rule would eliminate the regulatory distinction between index-based ETFs and actively managed ETFs.	No changes from the Proposal. The ETF Rule contains no specific provisions governing self-indexed ETFs.
<u>Rescinds Existing Exemptive Orders.</u> The Proposed Rule would rescind exemptive orders previously granted to ETFs eligible to rely on the Proposed Rule (except with respect to ETF fund of funds relief). The Proposed Rule would also rescind exemptive relief permitting ETFs to operate in a master-feeder structure for all ETFs that did not rely on the relief as of the date of the Proposing Release.	No changes from the Proposal. Exemptive orders for leveraged and inverse ETFs, ETFs organized as UITs or share class ETFs have not been rescinded.
Creation and Redemption Baskets, including Custom Baskets	
<i>Permits Custom Creation and Redemption Baskets</i>	
<u>Custom Baskets.</u> ETFs relying on the Proposed Rule would be permitted to use non-pro rata baskets and/or baskets that differ from other baskets used in other transactions that day. 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.	No changes from the Proposal. Commenters did not support a requirement that an ETF disclose publicly every basket it accepts from or presents to an authorized participant after the close of trading on each business day, and the ETF Rule does not include any such requirement.
<u>Types of Custom Baskets.</u> Custom baskets contemplated by the Proposed Rule would include: (1) baskets that consist of a non-representative selection of the ETF’s portfolio holdings, such as 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, and (2) different baskets used on the same business day such as: (i) different representative sampling baskets applicable to the same or different authorized participants on a single day, or (ii) baskets including cash in lieu of a portion of the basket assets for a particular authorized participant.	No changes from the Proposal. Despite industry comments to the contrary, partial cash baskets and/or “cash in lieu” baskets will be treated as custom baskets under the ETF Rule.
Basket Policies and Procedures	
<u>Basket Construction Policies and Procedures.</u> ETFs must adopt and implement written policies and procedures that govern the methodology used by the ETF to construct creation and redemption baskets and the process that will be used for the acceptance of baskets.	No changes from the Proposal.
<u>Custom Basket Policies and Procedures.</u> The ETF’s basket construction policies and 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.	No changes from the Proposal. The Adopting Release confirmed that the best interest standard relates to “shareholders” generally rather than individually.

<p><u>Role of Employees in Custom Basket Process.</u> The custom basket policies and procedures must 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.</p>	<p>Adopted as proposed despite industry concerns regarding the requirement to identify the title or roles of the employees required to review each custom basket.</p>
<p><i>Creation and Redemption Basket Recordkeeping</i></p>	
<p><u>Required Information.</u> ETFs are required to maintain a record identifying the names and quantities of positions comprising each creation and redemption basket, the cash balancing amount, if any, and the identity of the authorized participant transacting with the ETF.</p>	<p>No changes from the Proposal.</p>
<p><u>Identifying Custom Baskets.</u> ETFs are also required to identify custom baskets and state that the custom baskets comply with the ETF’s custom basket policies and procedures.</p>	<p>No changes from the Proposal.</p>
<p><i>Implement New Disclosure Requirements</i></p>	
<p><i>Website Disclosure – Each ETF that relies on the ETF Rule must post on its website:</i></p>	
<p><u>Full Portfolio Transparency.</u> Details regarding the portfolio holdings 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).</p>	<p>Adopted as proposed except that the ETF Rule does not require that portfolio holdings include the details and format prescribed by Article 12 of Regulation S-X. Commenters had expressed concerns regarding the practicality and necessity of the details and format of information that would have been required. Under the ETF Rule, ETFs must instead supply a limited set of specified information for each holding on a daily basis: ticker symbol, CUSIP or other identifier, description of holding, quantity of holding and percentage weight of holding.⁶</p>
<p><u>T-1 Order Prohibition.</u> 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.</p>	<p>The ETF Rule does <u>not</u> include this requirement. Commenters had expressed concern that the requirement to post portfolio holdings and basket information before accepting creation and redemption orders would pose significant operational challenges, particularly for ETFs that invest in non-U.S. securities.</p>
<p><u>Published Basket.</u> Information regarding a published basket acceptable to the ETF at the beginning of each business day, as well as the estimated cash balancing amount.</p>	<p>The ETF Rule does <u>not</u> include this requirement. Commenters expressed concern about the utility of this requirement, about whether ETFs would be required to honor the published basket throughout the day, and whether the publication of a non-custom basket would prevent the ETF from also accepting custom baskets that day.</p>
<p><u>Daily Disclosures.</u> The ETF’s NAV, market price, and premium or discount, each as of the end of the prior business day.</p>	<p>No changes from the Proposal.</p>

⁶ See footnote 260 of the Adopting Release and accompanying text.

<p><u>Bid-Ask Spread Disclosure.</u> Historical information regarding the median bid-ask spreads for the ETF's shares over the most recent fiscal year.</p>	<p>The ETF Rule requires website disclosure of median bid-ask spread for most recent 30 days, rather than the most recent fiscal year.</p> <p>Commenters expressed concern that bid-ask spread disclosure may vary from firm to firm and may be susceptible to manipulation and/or misuse due to differences in data sourcing. The ETF Rule provides a formula for calculating the median bid-ask spread information by reference to the ETF's NBBO. That formula entails dividing the difference between each such bid and offer by the midpoint of the NBBO (as of the end of each 10-second interval during each trading day in the last 30 calendar days) and identifying the median of those values.⁷</p>
<p><u>Premium/Discount Disclosure.</u> 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.</p>	<p>No changes from the Proposal.</p>
<p><u>Persistent Premium/Discount Narrative.</u> If an 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.</p>	<p>No changes from the Proposal.</p>
<p><i>Registration Statement Disclosure⁸</i></p>	
<p><u>Revised Item 3: Q&A and Fee and Expense Disclosures.</u> The Proposed Rule incorporates 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 such investments. The Proposed Rule would require additional fee and expense disclosure under a revised Item 3 of Form N-1A, formatted as a series of Q&As designed to provide information about bid-ask spreads and other trading costs.</p>	<p>The Adopting Release significantly streamlined these requirements. ETFs need not use the Q&A format and they may post certain cost information on their websites in lieu of including it in their registration statement. Certain trading cost disclosure requirements were also moved from Item 3 to Item 6 to avoid overemphasizing the disclosure.</p>
<p><u>Historical Bid-Ask Spread.</u> 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.</p>	<p>Disclosure requirement changed to a website-only requirement for ETFs relying on the ETF Rule and further revised as described above. An ETF not relying on the ETF Rule can disclose the median bid-ask spread for the most recent fiscal year in its prospectus or comply with the ETF Rule's website disclosure requirement. Commenters had expressed concern with the utility and potential liability of including historical bid-ask spread disclosures in ETF prospectuses.</p>

⁷ See footnote 369 of the Adopting Release and accompanying text.

⁸ Made applicable to all ETFs (not just those relying on the ETF Rule) by amendments to Form N-1A and Form N-8B-2.

<p><u>Bid-Ask Spread Costs</u>. Under the Proposed Rule, ETFs would also be required to disclose mid-range and high-end spread costs.</p>	<p>Adopting Release eliminated these disclosure elements.</p>
<p><u>Website Link and Interactive Bid-Ask Spread Calculator</u>. Under the Proposed Rule, each 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.</p>	<p>The ETF Rule does <u>not</u> include the interactive calculator requirement. Commenters expressed concern that the interactive bid-ask spread calculator would be of limited utility to retail investors.</p>
<p>Other Issues</p>	
<p><u>Intraday Indicative Value (IIV)</u>. The Proposed Rule would not require ETFs to make an intraday indicative value available (although provisions of other Exchange Act rules or relief may continue to require it).</p>	<p>No changes from the Proposal.</p>
<p><u>Minimum Creation Unit Size</u>. There is no minimum creation unit size required under the Proposed Rule (although provisions of other Exchange Act rules or relief may continue to require an ETF to establish a minimum creation unit size).</p>	<p>No changes from the Proposal. There is also no requirement to disclose the creation unit size in the fund’s prospectus.</p>
<p><u>Fund of Funds Relief</u>. Many existing ETFs have exemptive orders that permit other unrelated registered investment companies to make investments in such ETFs 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). The SEC has proposed Rule 12d1-4 to govern fund of funds relationships, including those covered by traditional ETF relief.</p>	<p>No changes from the Proposal except that the Staff will permit ETFs relying on the ETF Rule that do not currently hold Fund of Funds Relief to operate pursuant to, and subject to the conditions of, Fund of Funds relief recently issued to others.⁹</p>
<p><u>Master-Feeder Relief</u>. Many existing ETFs have exemptive relief permitting them to operate as feeder funds in a master/feeder structure. The Proposed Rule would rescind this relief from exemptive orders except where an existing ETF held the relief and relied on it as of June 28, 2018 (in those cases, the relevant order would be amended to prevent the formation of new master/feeder structures).</p>	<p>No changes from the Proposal.</p>

Exchange Act Order

In the Adopting Release, the Commission confirmed that all ETF shares, including shares of ETFs that are unable to rely on the ETF Rule, are eligible for the exceptions applicable to redeemable securities in Rules 101(c)(4) and 102(d)(4) of Regulation M and Rule 10b-17(c) under the Exchange Act in connection with secondary market transactions and the ETF creation/redemption process, and the exemption in Rule 11d1-2 under the Exchange Act for securities issued by a registered open-end investment company or UIT. This ensures that ETFs will face reduced regulatory and offering burdens under the Exchange Act.

⁹ See footnote 460 of the Adopting Release and accompanying text.

In the Exchange Act Order, the Commission took steps to further reduce regulatory complexity and eliminate inconsistencies applicable to ETFs. The Commission issued an exemptive order that harmonizes certain relief under the Exchange Act applicable to ETFs and broker/dealers. In particular, the Order provides exemptive relief to broker-dealers and other persons from the requirements of Section 11(d)(1) and Rules 10b-10, 15c1-5, 15c1-6, and 14e-5¹⁰ under the Exchange Act, but only with respect to ETFs that rely on the ETF Rule.¹¹ ETFs that fall outside the scope of the ETF Rule will have to continue to rely on the existing Exchange Act class relief letters relating to Section 11(d)(1) and Rules 10b-10, 15c1-5, 15c1-6, and 14e-5.

¹⁰ Significantly, the exemption provided by the Exchange Act Order is available without regard to the size or value of an ETF's creation units or whether the ETF is index-based or actively managed. This means that ETFs that can rely on the ETF Rule will not have to comply with the minimum creation unit size and diversification requirements of the existing ETF "class relief" letters.

¹¹ The Commission stated its belief that the portfolio and other transparency requirements in the ETF Rule, when combined with the conditions in the Exchange Act Order, address the policy concerns underlying the various Exchange Act provisions and rules.