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Proposed ETF Rule seeks to Level the Playing Field for ETF Sponsors and Simplify the Process of Launching and Operating ETFs

As expected, the proposed ETF rule (the “Rule”) codifies many aspects of the exemptive relief necessary to form and operate an ETF. The Rule also makes substantial progress toward other Staff goals, including leveling the regulatory landscape for ETF sponsors and bolstering the efficient operation of the arbitrage mechanism that supports an ETF’s shares trading at a market price approximating the shares’ net asset value. Below is a summary of certain key aspects of the Rule and some preliminary observations.

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- **Elimination of the distinction between indexed and actively-managed ETFs.** The Rule does not distinguish between indexed and actively-managed ETFs. All ETFs relying on the Rule must comply with the same conditions and post their full portfolio holdings daily on their website each morning before trading begins.
- **Custom baskets.** The Rule permits all ETFs eligible to rely on it to utilize custom purchase and redemption baskets (*i.e.*, baskets composed of a non-representative selection of the ETF’s holdings *OR* any basket that differs from any other basket used by the ETF that day). All ETFs must adopt written policies and procedures that govern the construction of baskets and the process that will be used for the acceptance of baskets. The Rule imposes additional requirements for policies and procedures relating to custom baskets. Those 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 any revisions to, or deviations from, those parameters; and
 - specify the titles or roles of the employees of the ETF’s adviser who are required to review each custom basket for compliance with the established parameters.
 - The custom basket approach seems to be substantially similar to exemptive relief applications Ropes & Gray prepared and filed in October 2017 on behalf of several of our clients.
- For each custom basket used, ETFs must maintain a record identifying the basket as a custom basket and stating that the custom basket complies with the ETF’s custom basket policies and procedures.
- The release states also that the 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 of interests of the ETF and its shareholders.
 - At the open meeting of the SEC, Commissioner Peirce commented on the inclusion of “and its shareholders” in the best interest standard stated above and 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. This would seem a ripe area for comment during the Rule's comment period.

- **Rescission of existing relief.** Except with respect to ETFs ineligible to rely on the Rule and certain 12(d)(1)-related relief (discussed in the bullets below), the Rule proposes to rescind existing exemptive ETF orders one year after the effective date of the final version of the Rule. This rescission seeks to achieve the goal of leveling the regulatory landscape for all ETFs relying on the Rule and eliminating the regulatory arbitrage available to ETFs with multiple exemptive orders.
- **ETFs ineligible to rely on the Rule.** The following ETFs may not rely on the Rule and must continue to rely on their existing orders (which will not be rescinded under the Rule):
 - Leveraged ETFs (*i.e.*, those that seek to provide returns that exceed the performance of a market index by a specified multiple over a fixed period of time);
 - Inverse ETFs (*i.e.*, those that seek to provide returns that have an inverse relationship to the performance of a market index over a fixed period of time);
 - ETFs that are organized as UITs; and
 - ETFs structured as a share class of an existing open-end investment company that issues multiple classes of shares.
- **Fund of funds relief.** Many existing ETFs have exemptive orders that permit other registered investment companies to make investments in them in excess of the Section 12(d)(1)(A) and (B) limits. The 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 17(a)(1) and 17(a)(2). Unless the SEC proposes a companion rule at a later time, 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.
- **Master/feeder relief.** Many existing ETFs have exemptive relief permitting an ETF to operate as a feeder fund in a master/feeder structure. The Rule does not incorporate this relief and the 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.
- **Regulation M, Rule 10b-17, etc.** Unlike existing exemptive orders, the Rule expressly defines an ETF share as a "redeemable security" within the meaning of Section 2(a)(32) notwithstanding that only authorized participants may redeem ETF shares, and then only when shares are aggregated into creation units. This clarification from the Staff would appear to have significant potential implications under Regulation M as Rules 101(c)(4) and 102(d)(4) of Reg. M and Rule 10b-17(c) under the 1934 Act, each of which provide exceptions for "redeemable securities." In addition, the Rule may also have implications under 1934 Act Rule 11d1-2, which contains an exemption for "registered open-end investment companies."
- **Delayed redemptions.** Many ETFs have exemptive relief permitting the ETFs to settle in-kind transactions beyond the seven-day period prescribed by Section 22(e) of the 1940 Act. This aspect of the relief addresses foreign securities that cannot be delivered timely as redemption proceeds due to local holidays or local settlement customs (or a combination of those factors). The Rule would provide this relief for up to 15 days, but would require delivery *as soon as practicable in all cases*.
 - The Rule also includes a sunset provision relating to this relief based on the view that securities markets around the world will continue to shorten their settlement cycles. Ten years after the effective date of the Rule, this aspect of the relief would be removed unless the SEC takes action before then.

- **Required website disclosure.** Each ETF (as a condition of relying on the Rule) must disclose, among other things, the following information on its website:
 - The ETF's portfolio holdings that will form the basis of the next calculation of the ETF's NAV (daily);
 - The contents of a creation and redemption basket that the ETF would be willing to accept from an authorized participant (including the estimated cash balancing amount) (daily);
 - The ETF's NAV, market price, 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; 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.
- **Prospectus disclosure.** The Rule requires several new prospectus disclosures designed to provide investors who purchase ETF shares in the secondary market with additional information, including information regarding costs associated with investments in ETFs. These disclosures apply to all ETFs, including those that are unable to rely upon the Rule.
 - ETFs must also include disclosure that investors may be subject to brokerage and other fees when buying or selling ETF shares.
 - The Rule also includes a new Q&A section in Item 3 that is designed to provide information about bid-ask spreads and other trading costs and uses the following format:
 - What information do I need to know about ETF trades?
 - What costs are associated with trading shares of an ETF?
 - What is the bid-ask spread?
 - How does the bid-ask spread impact my return on investment?
 - But what if I plan to trade ETF shares frequently?
 - Where can I get more trading information for the ETF?
 - The Q&A must provide links to the fund's website, including to the newly-required interactive calculator for cost-related information.
- **Odds and ends.**
 - On page 31 of the proposing release, the Staff references the "potential staff recommendation of a re-proposal on funds' use of derivatives . . ."
 - The Rule will not require ETFs to make available an intraday indicative value (IIV), although other aspects of ETF relief on which some ETFs rely may continue to require it (such as exchange listing rules, 19b-4 filings and certain types of 1934 Act class relief).
 - 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 and that there is a role for the Board to play in the oversight of the policies and procedures.

- The release confirms that the Staff intends to rescind existing relief from Section 24(d) held by some ETFs. That relief provides an exemption to broker-dealers selling ETF shares from the obligation to deliver prospectuses in most secondary market transactions. The Staff notes its understanding in the release that broker-dealers do not currently rely on that relief.