

Banking Law News

INSIGHT: The SEC's Proposed ETF Rule Creates Fintech Opportunities

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Edward Baer of Ropes & Gray discusses the increasingly important role fintech is poised to play in the ETF industry, in light of the SEC's proposed ETF rule.

The ETF industry has waited a long time for an ETF Rule, and now that the Rule seems to be on its way, fintech is poised to play an increasingly important role. Should that make ETF sponsors nervous?

On June 28, 2018, the Securities and Exchange Commission ("SEC") proposed new Rule 6c-11 (the "ETF Rule"), which would permit Exchange Traded Funds ("ETFs") to organize and operate without the expense and delay of obtaining an exemptive order from the SEC. The SEC seeks to "create a consistent, transparent, and efficient regulatory framework for ETFs and to facilitate greater competition and innovation among ETFs."

If adopted, the ETF Rule would significantly ease the regulatory burdens associated with launching ETFs and create a more level playing field for ETFs. The ETF Rule should also bolster the efficient operation of the arbitrage mechanism that helps ETF shares trade at market prices that are close to the ETF's net asset value per share ("NAV").

The ETF Rule:

- Provides a new portfolio management tool for most ETFs by permitting them to use "custom baskets" in connection with creation and redemption orders;
- Improves disclosure for retail investors by requiring additional information about the costs of owning ETF shares; and
- Removes barriers to entry into the ETF business and eliminates the distinction between index and active ETFs.

Each of these areas will present opportunities for financial technology (fintech) companies and applications.

Custom Creation and Redemption Baskets

The ETF Rule would permit ETFs to transact with authorized participants (“APs”) using customized baskets of securities for purchases and redemptions. While some of the early ETF sponsors currently have few restrictions on using custom baskets, most ETFs can only utilize a pro rata or representative sample basket of the ETF’s current portfolio.

As the SEC noted, custom baskets should enable ETFs and APs to benefit ETFs and their shareholders by reducing costs, increasing efficiency and improving trading.

To use custom baskets, ETFs must adopt written policies that govern the use of custom baskets. These policies must detail the parameters for constructing and accepting custom baskets that are in the best interests of the ETF and its shareholders, and must identify specific employees tasked with reviewing each custom basket for compliance with the parameters. Sponsors must maintain detailed records of any custom baskets accepted, and must perform back-testing to ensure compliance with the custom basket policies.

Custom Baskets Present Opportunities for Fintech Applications, Including Blockchain and Artificial Intelligence (“AI”)

As part of their normal operations, ETFs regularly publish lists of the securities in their portfolios and examples of creation and redemption baskets that they expect APs to use when creating or redeeming shares. Detailed information about these holdings and creation and redemption baskets are published daily through the facilities of the National Securities Clearing Corporation (“NSCC”).

Sponsors and/or the NSCC may wish to explore the use of distributed ledger (blockchain) technology to provide basket and holdings information to APs and to verify creation and redemption transactions with APs. Moreover, with the expansion of custom basket usage across the ETF industry, sponsors may look to create private blockchain applications to publish and verify custom basket transactions with each AP. In the future, these baskets may take the form of “smart contracts” that APs can self execute when the embedded conditions have been satisfied.

Most ETFs today, both by number of ETFs and by assets, are index-based. For ETFs that track equity indexes, acquiring the appropriate securities is relatively straightforward. However, for ETFs that track indexes of fixed income securities, it may be difficult to acquire all of the securities in the benchmark. For example, several of the most popular fixed income ETFs seek to track the Bloomberg Barclays U.S. Aggregate Bond Index, which includes over 8,000 bonds, many of which do not trade regularly.

To attempt to acquire the right bonds, ETFs use custom baskets that are negotiated with the APs. When bonds that the ETFs need become available, the ETFs work with APs to agree on an appropriate custom basket. Building these custom baskets often entails finding the right mix of bonds – considering sector, coupon, duration, credit rating and other factors – and agreeing with an AP on a transaction. In the future, sponsors may choose to make use of AI technology to help construct the optimal custom basket (or mix of custom baskets) for every ETF on a given day.

Finally, as noted above, ETFs that use custom baskets will have to adopt policies governing their use. These policies must include parameters for determining that individual custom baskets are in the best interests of the ETFs, and also must provide for back-testing to ensure that the custom baskets accepted came within those parameters.

Some common factors that could be used to verify that a custom basket was in the best interests of the ETF include whether the custom basket:

- improved tracking error;
- reduced transaction costs;
- reduced potential tax liabilities;
- eliminated over- or underweights in the portfolio;
- removed or added securities in connection with an index or portfolio rebalance; or
- helped the ETF maintain the appropriate portfolio characteristics (duration, credit ratings, country or sectors weights, etc.).

Many of these factors are verifiable through mathematical testing. Fintech companies could develop compliance software that would enable ETF sponsors to forecast the impact of a custom basket *prior* to acceptance, as well as to analyze the actual impact *after* the basket has been accepted into the ETF's portfolio. Some existing portfolio compliance software could also be adapted to assist sponsors in complying with their custom basket policies.

Improving Disclosure for Retail Investors

Under the ETF Rule, ETFs will be required to make additional website disclosures designed to help retail investors understand the costs associated with investing in ETFs, including

- The portfolio holdings (daily);
- A creation and redemption basket (including estimated cash) (daily);
- The ETF's NAV, market price, and premium or discount, each as of the end of the prior business day (daily); and
- Historical information regarding the median bid-ask spreads for the ETF's shares over the most recent fiscal year.

The ETF Rule also requires new prospectus disclosure designed to provide investors who purchase ETF shares in the secondary market with additional information regarding ETF costs. The new disclosures include:

- A narrative explanation that investors may be subject to brokerage and other fees when buying or selling ETF shares; and
- A new Q&A section designed to provide information about bid-ask spreads and other trading costs.

Questions include:

- 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?
- Where can I get more trading information for the ETF?

The Q&A also must provide links to the ETF's website, which must feature an interactive calculator for hypothetical cost-related information.

Improved Disclosure for Retail Investors Means ETFs Will Need More Data and Tools

As the price for receiving custom basket authority, lower barriers to entry and a more level regulatory playing field, the SEC will require ETFs to supply additional disclosure of ETF trading and ownership costs to investors. The disclosure requirements mean ETFs will have to obtain additional data regarding bid-ask spreads and other trading information.

Bid-ask spread information is not measured by ETFs. Instead, exchanges and other market participants calculate and disseminate this data. ETFs may need to license the relevant data, establish connectivity and website functionality, apply the data to the existing bid-asked formulas, and verify the resulting data prior to making it available on the fund websites and in prospectuses.

In addition, the SEC is looking to add a new requirement that ETFs provide a prospectus link to the fund website where retail investors can access an interactive cost calculator. The calculator would allow investors to customize two data points – investment amount and number of trades – and the calculator would rely on the same third-party bid-ask spread data noted above.

While some larger ETF complexes may be able to develop their own interactive calculators, it is likely that most ETF sponsors will purchase or license a calculator from a third party. This may lead one or more fintech companies to develop tools for use by ETFs in presenting bid-ask spread information and in calculating potential trading costs using the interactive calculator.

Removing Barriers to Entry and Eliminating the Distinction between Indexed and Active ETFs

Because ETFs developed over several decades, the rules applicable to one ETF might not be the same as those applicable to other ETFs. To remedy this, the SEC finally proposed a set of rules that would cover most existing ETFs. The ETF Rule would subject both old and new ETF sponsors to a consistent set of rules.

For new entrants into the market, obtaining SEC permission to launch ETFs can currently take many months. The ETF Rule is expected to substantially reduce the length of time needed to break into the ETF market. Once a new ETF sponsor is up and running, they too will be subject to the same, consistent set of rules.

Another development of note arising from the ETF Rule is that the Rule largely does not distinguish between indexed and actively-managed ETFs. All ETFs relying on the ETF Rule would have to comply with the same conditions.

The SEC explained that it eliminated the distinction between index and active ETFs because they operate similarly and do not present significantly different concerns under applicable rules. The SEC also noted that the distinction between index and active ETFs has been blurred due to the recent “proliferation of highly customized, often methodologically complicated, indexes.”

For many years, asset managers have struggled with the decision of whether to jump on the ETF bandwagon. Many “active” investment shops have resisted the temptation, often over concerns that the portfolio transparency demanded of active ETFs might require them to give away their “secret sauce”. While it would lower the barriers to entry, the ETF Rule would not solve the transparency challenge these active managers struggle with. The so-called “non-transparent active” ETF applications that have been filed in various forms with the SEC over the past dozen years have not yet been approved, and if the SEC’s focus on the importance of transparency in the ETF Rule proposal provides any indication, non-transparent active ETFs may still be a ways off.

Low Barriers to Entry and Significant Investment Flexibility Might Entice Fintech Firms into the ETF Industry

While traditional asset managers might still hesitate to enter the ETF market, one or more of the Fintech giants may decide to crash the ETF party. Imagine a fintech firm – let’s call it . . . “Amazin” -- deciding that it can use its technology and data to build a better, less costly ETF family.

This firm has behavioral and demographic data on millions of regular customers. It uses data to target advertising and search results, to recommend products and services and to influence customer decision-making. It could choose to couple this valuable data with highly customized ETFs targeted towards cohorts of similarly situated customers.

The ETF Rule could make this scenario quite plausible. The barriers to entry will be low, and if you are willing to be transparent about your holdings, there is no longer a need to distinguish between index and active ETFs. Fintech applications such as AI and predictive analysis can be used to manage assets and create custom baskets, and shares could be replaced by tokens tracked on public blockchains.

These developments allow you to picture the ETF “world of tomorrow.” The Amazin Pacific Northwest Mass Affluent Socially Responsible Small Cap Value Equity ETF has a .4 basis point expense ratio. A series of data mining drones search every scrap of online data every second for investing insights, and a sentient, solar-powered “portfolio managebot” makes investing decisions in real time. APNMA SRSCVE cryptotokens can be traded on the secondary market or created and redeemed in exchange for USTreasuryCoins or Ether. And with “Primo membership,” you get next day settlement and your brokerage commission is free!

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