

Recent Wave of Actively Managed ETFs Overcomes Lengthy Approval Process

Ten new actively managed exchange-traded funds (“ETFs”) were approved in February for listing on NYSE Arca (“Arca”). Among them is the eagerly awaited PIMCO Total Return Exchange-Traded Fund, an ETF managed by Bill Gross, manager of the prominent PIMCO Total Return Fund. Meanwhile, the first actively managed ETF to be listed on NASDAQ was also approved in February. The number of actively managed ETFs has grown rapidly since the first such ETF was listed in 2008. McKinsey now predicts that actively managed ETFs could exceed \$1 trillion in assets under management before the end of this decade.¹

Advisers looking to join this budding market must be ready to navigate the complex regulatory regime. Launching an actively managed ETF not only requires exemptive relief from the SEC’s Division of Investment Management,² but also requires approval of the SEC’s Division of Trading and Markets. Unlike most index-based ETFs, actively managed ETFs must go through the 19b-4 filing process, introducing additional uncertainty to, and sometimes significantly extending, the product launch cycle.

During the 12 months ended February 29, 2012, managers listing actively managed ETFs on Arca have had to wait an average of 66 days from the date the exchange files a proposed rule change pursuant to Rule 19b-4 to the date their ETFs are approved for listing on the exchange. Because the process can include informal discussions with the SEC before the official filing of Form 19b-4, however, a better measure of the length of the process may be the time from filing an actively managed ETF’s registration statement on Form N-1A until the fund is approved for listing. By this alternative calculation, it actually took an average of eight months for the listings to obtain final approval. And the product approval process may be getting even longer. Considering only funds approved for listing in the first two months of 2012, the average time needed has grown to 9½ months—significantly longer than the typical 75-day period for automatic effectiveness of registration statements for new “traditional” funds.³

Why is the regulatory approval process longer for actively managed ETFs? Section 19(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) requires a self-regulatory organization—including Arca and other exchanges—to get approval from the SEC for “any proposed rule or proposed change in, addition to, or deletion from the rules of such self-regulatory organization.”⁴ This requirement ensnares ETFs because listing or trading a new securities derivative product qualifies as a proposed rule change. However, Rule 19b-4(e) creates an exception for cases where the SEC has approved the “trading rules, procedures and listing standards for the product class that would include the new derivative securities product and the self-regulatory organization has a surveillance program for the product class.”⁵

This Rule 19b-4(e) exception is the source of a key difference between launching index-based and actively managed ETFs. The SEC has already approved rules for many exchanges allowing index-based ETFs that meet the generic listing requirements to be listed without SEC approval.⁶ While exact requirements vary by type of underlying index—e.g., equity or fixed income, U.S. or global—generally the underlying index must

¹ McKinsey & Company, *The Second Act Begins for ETFs*, Aug. 2011, at 19.

² The SEC continues to impose a moratorium on the issuance of exemptive relief to actively managed ETFs that seek to use derivatives as part of their investment strategy.

³ Funds that are series of an existing registrant are eligible for automatic effectiveness in 75 days pursuant to Rule 485(a)(2) under the Securities Act of 1933.

⁴ 15 U.S.C. § 78s(b)(1).

⁵ 17 C.F.R. § 240.19b-4(e)(1).

⁶ See, e.g., NYSE Arca, Rule 5.2(j)(3).

(i) not have any single security exceeding a maximum weighting; and (ii) contain a specified minimum number of securities; and must, in addition, be composed of securities the majority of which (iii) meet a minimum market value threshold; (iv) meet a minimum monthly trading volume threshold; and (v) are listed on an appropriate exchange.⁷

Unfortunately, these rules do not allow actively managed ETFs to take advantage of the exception. While Arca Rule 8.600, which was approved by the SEC in 2008, contains generic listing requirements for actively managed ETFs⁸ (e.g., calculating the net asset value daily and making it available to all market participants at the same time,⁹ disclosing the identity and quantity of underlying securities daily and making the information available to all market participants at the same time,¹⁰ and disseminating the estimated value of a share every 15 seconds through a major market data vendor¹¹), the rule explicitly requires SEC 19b-4 approval before the listing or trading of any new actively managed ETF.¹²

The Division of Trading and Markets will review the proposed rule change for a new actively managed ETF to ensure it complies with Section 6 of the Exchange Act and the rules promulgated thereunder. In particular, the regulatory focus is on whether the proposed rule is “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest” in accordance with Section 6(b)(5)¹³ and is “in the public interest and appropriate for the protection of investors. . .” in accordance with Section 11A(a)(1)(C)(iii).¹⁴ After the recent change made by Dodd-Frank¹⁵ to Section 19(b)(2), the SEC has 45 days from the date of publication of a proposed rule to approve, disapprove, or institute proceedings to make a decision, a period which the Commission can extend up to 45 additional days if it publishes its reasons for doing so.¹⁶

⁷ See NYSE Arca, Rule 5.2(j)(3), Commentary .01(a), .02(a), .03.

⁸ See SEC, Release No. 34-57619, 73 F.R. 19544 (Apr. 10, 2008).

⁹ See NYSE Arca, Rule 8.600(d)(1)(B).

¹⁰ See NYSE Arca, Rule 8.600(d)(2)(B).

¹¹ See NYSE Arca, Rule 8.600(d)(2)(A).

¹² See NYSE Arca, Rule 8.600, Commentary .01.

¹³ 15 U.S.C. § 78f(b)(5).

¹⁴ 15 U.S.C. § 78k-1(a)(1)(C)(iii).

¹⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 916, 124 Stat. 1376, 1833–36 (2010).

¹⁶ See 15 U.S.C. § 78s(b)(2)(A). See also SEC, Release No. 34-63723 (Jan. 24, 2011) (implementing revised Rules of Practice in compliance with the Dodd-Frank changes).

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