

SEC Issues Notice of Intention to Deny Application for Non-Transparent Actively Managed Exchange-Traded Funds

On October 21, 2014, the SEC issued a [notice](#) of intention to deny an application for exemptive relief (the “Application”) under the Investment Company Act, as amended (the “1940 Act”), filed on behalf of Precidian ETFs Trust (the “Trust”), Precidian Funds LLC (the “Adviser”) and Foreside Fund Services, LLC (the “Distributor,” and, together with the Trust and the Adviser, the “Applicants”). If granted, the Application would permit the operation of actively managed exchange-traded funds (“ETFs”) that would not be required to disclose their portfolio holdings on a daily basis.¹

The SEC notice highlights material differences between [the Application](#) and the relief granted to existing actively managed ETFs. These differences include:

- No requirement for the ETF to disclose portfolio holdings daily. Instead, the Applicants propose to provide the standard portfolio disclosures required for traditional mutual funds (on a quarterly basis).
- Trading in shares of the ETF would be based on an intraday indicative value (“IIV”) provided by a calculation agent every 15 seconds during the trading day based on the last available market quotation or sale price of the constituent holdings of the ETF, which would be made available to the calculation agent, as of the close of the previous business day. The IIV is not a real-time net asset value (“NAV”) for the ETF, as the IIV would not reflect the fair value of securities for which current market quotations are not readily available and may not include extraordinary expenses or liabilities that would be included in an NAV calculation.
- Any authorized participant (who can buy and redeem large blocks of shares called “creation units”) would purchase or redeem a creation unit by transacting in cash with a “blind trust” that in turn transacts in-kind with the ETF without disclosing the portfolio securities it sells to and buys from the ETF.²
- Retail investors could redeem individual shares (in less than creation unit aggregations) in cash directly from the ETFs in the event of a significant deviation of closing market price from NAV, subject to certain fees.

In discussing its intention to deny the Application, the SEC stated that the proposed mechanisms “fall far short” of the mechanisms in place for typical actively managed ETF orders to keep ETF shares trading at or close to the ETF’s NAV, which include daily portfolio holdings disclosures. The notice emphasizes that the tie between the price at which an ETF’s shares trade on the exchange and its NAV is critical to ensuring that all ETF shareholders are treated equitably in buying and selling shares, as required by Section 22(d) and Rule 22c-1 under the 1940 Act.

The SEC stated that use of the IIV as a primary pricing signal is “questionable” and likely “would not result in an effective arbitrage mechanism” as it (1) represents stale data; (2) can be calculated inconsistently and/or arbitrarily; (3) would lead to inaccurate valuations for certain securities and asset classes (particularly illiquid

¹ We have previously reported on proposed rules for NYSE Arca Equities to permit ETF shares such as those envisioned by the Application to trade on its exchange. See [Ropes & Gray Alert](#), NYSE Files Proposed Rules for Listing of “Managed Portfolio Shares.”

² This differs from typical actively traded ETFs, which generally allow authorized participants to buy or sell creation units directly from an ETF in exchange for a basket of securities and other assets that is generally representative of the ETF’s portfolio and equal in value to the aggregate NAV of ETF shares in the creation unit.

securities); (4) would include errors that can decrease the efficiency of hedging portfolios by market makers, leading to larger bid-ask spreads for such ETFs; and (5) may lead to greater valuation inaccuracies during periods of market volatility.

Additionally, the SEC stated that the quarterly release of portfolio holdings would “quickly lose ... relevance for purposes of valuing or hedging the proposed ETFs” as ETF holdings could change on a daily basis. The proposed back-up mechanism allowing retail investors to redeem shares was rejected as ineffective, as the fees and costs associated with direct redemptions could dissuade retail investors from redeeming. The SEC stated that even if its concerns regarding retail redemptions were addressed, direct retail redeemability would not address the SEC’s greater concerns about the proposal.

The notice states that interested persons may request a hearing regarding the Application by writing to the SEC’s Secretary and serving the Applicants with a copy of the request. Any request must be received by the SEC by November 17, 2014. Absent a request for a hearing granted by the SEC, the SEC stated that it intends to issue an order denying the application.

We note that SEC notices of intention to deny exemptive applications are relatively rare, as exemptive applications that are not granted are typically withdrawn or abandoned by applicants. The SEC’s decision to issue the notice may reflect a desire to explain to industry participants its rationale for its intention to deny the Application.

For further information concerning this development, please contact your usual Ropes & Gray attorney or any member of the Ropes & Gray [investment management group](#).