

2019 FINAL ETF RULE



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ABOUT ROPES & GRAY'S ETF PRACTICE

- Ropes & Gray advises ETF sponsors that represent over half of all of the assets under management in the ETF industry on matters relating to the sponsorship and operation of ETFs, product design, operational matters, capital markets issues, tax issues related to custom baskets, index licensing matters, business issues, and exchange listing and trading relief issues.
- Ropes & Gray works with ETFs of all kinds, including actively managed ETFs, non-transparent ETFs, leveraged and inverse ETFs, as well as other exchange traded products, including non-1940 Act ETFs investing in physical metals and futures-based commodities.
- Ropes & Gray's ETF practice group includes the former in-house chief legal officer to the largest ETF complex in the world, who has over 12 years of experience working closely on all matters related to ETF sponsorship.
- Ropes & Gray's recent ETF-related engagements have included advising on non-transparent ETF products, custom basket compliance policies and procedures, order-taking procedures, authorized participant oversight, ETF market-making activities, arbitrage activities, and market structure and trading regulations.
- Ropes & Gray has partnered with ETF sponsors on ETF product development since 2007.

Client Alert: 2019 Final ETF Rule

On September 26, 2019, the Securities and Exchange Commission (“SEC”) announced that it had unanimously adopted Rule 6c-11 (the “Rule”)¹ under the Investment Company Act of 1940, as amended (“1940 Act”), which permits exchange-traded funds (“ETFs”) that satisfy certain conditions to organize and operate without the expense and delay of obtaining an exemptive order from the SEC. The Rule significantly eases the regulatory burdens associated with bringing an ETF to market and creates a more level playing field for new and existing ETF sponsors.

The Rule was adopted largely in the form proposed on June 28, 2018,² but with several important changes in response to industry comments. At the same time, the SEC issued an exemptive order (the “Exchange

Act Order”) providing conditional relief from certain provisions under the Securities Exchange Act of 1934 (“Exchange Act”) and certain rules under the Exchange Act for ETFs relying on the Rule.³ In addition to several key takeaways from the Rule’s adopting release (the “Adopting Release”), we describe the Rule and Exchange Act Order in detail below and offer insights into how each may affect ETFs and their sponsors.

The Rule goes into effect 60 days after its publication in the Federal Register (the “Effective Date”). The related N-1A and N-8B-2 disclosure amendments go into effect 365 days after the Effective Date. Both new and existing ETF sponsors should be sure that they will be able to comply with all conditions of the Rule by the time that they operate pursuant to the Rule.

KEY TAKEAWAYS

- **Existing Exemptive Orders.** To help establish a consistent ETF regulatory approach and replace the existing “patchwork” of exemptive orders, those portions of exemptive orders granted to ETFs eligible to rely on the Rule that grant relief related to the operation of an ETF will be rescinded. ETF fund of funds relief, as described below, has not been rescinded and has been extended to ETFs relying on the Rule, provided that they satisfy the terms and conditions set forth in recent orders. Certain types of ETFs,⁴ including ETFs organized as unit investment trusts (“UITs”), share class ETFs,⁵ leveraged and inverse ETFs,⁶ and non-transparent active ETFs,⁷ will not be able to rely on the Rule, and their exemptive orders will not be rescinded.
- **Custom Creation and Redemption Baskets.** The Rule permits an ETF relying on the Rule to use non-pro rata baskets and/or baskets that differ from other baskets used in transactions on the same business day (“custom baskets”).
- **No Distinction Between Index-Based vs. Actively Managed ETFs.** All ETFs relying on the Rule, whether index-based or actively managed, must comply with the same conditions.
- **New Disclosure Requirements.** The Rule and related amendments to Form N-1A (for open-end ETFs) and Form N-8B-2 (for UITs) require ETFs to disclose certain information on their websites

and/or in their prospectuses, including historical information regarding the ETF’s premiums and discounts and bid-ask spreads.

- **Changes From the Proposed Rule.** The Proposed Rule included a number of conditions and related disclosure requirements that drew industry comments, and the Rule reflects a number of helpful changes from what was proposed. Key changes from the Proposed Rule include the elimination of the requirements to (i) publish the ETF’s portfolio holdings prior to the acceptance of a creation or redemption order for that day, (ii) include historical bid-ask spread information in an ETF’s registration statement and (iii) make an interactive bid-ask spread calculator available on the ETF’s website. In addition, the SEC eliminated the requirement to publish a creation/redemption basket that the ETF would accept, streamlined the format of the required disclosure of portfolio holdings information, limited required bid-ask spread information to the most recent 30 days and eliminated the 10-year sunset of the Section 22(e) relief. Finally, the Adopting Release clarifies that even shares of ETFs ineligible to rely on the Rule will qualify as “redeemable securities” for purposes of certain Exchange Act rules.

PRINCIPAL CONDITIONS

The Rule provides certain exemptions from the 1940 Act, including most of those currently

included in ETF exemptive orders, and also imposes many similar conditions.⁸ The key conditions in the Rule include the following:

- **Transparency.** Each ETF must post its portfolio holdings daily on its website.
- **Custom Basket Policies and Procedures.** Each ETF may use custom baskets if the ETF adopts written policies and procedures that (i) set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders and (ii) specify the titles or roles of the employees of the ETF’s investment adviser who are required to review each custom basket for compliance with those parameters.
- **Website Disclosure.** ETFs must disclose certain information on their websites to increase transparency, including historical information regarding premiums and discounts and bid-ask spreads.

The SEC expects that permitting ETFs to utilize custom baskets will reduce transaction costs, promote efficient portfolio management and lead to a more efficient and effective arbitrage process. In addition, the disclosure requirements, including full portfolio transparency, should enable the SEC, investors and other market participants to evaluate the functioning of an ETF’s arbitrage mechanism.

SUMMARY OF THE ADOPTING RELEASE AND EXCHANGE ACT ORDER

The Rule makes substantial progress toward leveling the regulatory landscape for ETF sponsors and promoting the efficient operation of the arbitrage mechanism that supports an ETF's shares trading at a market price approximating the then-current value of the ETF's net assets. In particular, the Rule:

- Codifies much of the relief granted on a case-by-case basis to ETF sponsors under the current exemptive order regime, permitting most ETFs organized as open-end funds to operate without obtaining individual exemptive relief from the SEC.⁹
- Rescinds exemptive relief previously granted to those ETFs able to rely on the Rule.¹⁰ In addition, the Adopting Release rescinds exemptive relief permitting ETFs to operate in a master-feeder structure for all ETFs that did not rely on relief as of June 28, 2018.¹¹
- Permits an ETF relying on the Rule to use custom creation and redemption baskets that do not reflect a pro rata representation of the ETF's portfolio and/or that differ from other baskets used in creation or redemption transactions on the same business day.
- Requires ETFs relying on the Rule to disclose certain information on their websites, including (i) portfolio holdings that will form the basis of the ETF's next net asset value ("NAV") calculation and (ii) historical information regarding the ETF's NAV, premiums and discounts, and bid-ask spreads.

The Adopting Release amends Form N-1A and Form N-8B-2 to require disclosure by all ETFs (not just ETFs eligible to rely on the Rule) of information relevant to investors who purchase and sell ETF shares in the secondary markets. These new disclosure requirements seek to ensure that all ETFs provide more useful, ETF-specific information to investors who purchase ETF shares in the secondary market.

With the Exchange Act Order, the SEC took further steps to reduce regulatory complexities that might otherwise arise in the ETF creation and redemption process. In particular, the Exchange Act Order harmonizes certain conditional relief under the Exchange Act applicable to ETFs and broker-dealers.¹² (See "Additional Relief from Certain Requirements of the Exchange Act" below.)

SCOPE OF THE ETF RULE'S RELIEF

ETFs that may rely on the Rule will operate under conditions and in a manner similar to how most ETFs currently operate because the Rule codifies much of the standard 1940 Act exemptive relief. Current ETF exemptive orders provide relief from Sections 2(a)(32) and 5(a)(1) (treatment of ETF shares as redeemable securities), Section 22(d) (trading of ETF shares at market-determined prices), Section 22(e) (additional time for delivering redemption proceeds), Sections 17(a)(1) and (2) (affiliated transactions) and Section 12(d)(1) (permitting certain fund of funds arrangements). Except for the Section 12(d)(1) relief, which is not rescinded in the Adopting Release, the Rule addresses all of these areas of exemptive relief.

Treatment of ETF Shares as "Redeemable Securities". Unlike existing exemptive orders, the Rule expressly defines an ETF share as a "redeemable security" within the meaning of Section 2(a)(32) of the 1940 Act, notwithstanding that only authorized participants may redeem ETF shares, and then only when shares are aggregated into creation units.¹³ As discussed below, this clarifies that transactions in ETF shares are eligible for certain exceptions and exemptions under the Exchange Act.

Trading of ETF Shares at Market-Determined Prices. 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. This treatment is also consistent with the new definition of ETF, which requires that ETFs issue shares that are listed on a national securities exchange and trade at market-determined prices.

Additional Time for Delivering Redemption Proceeds. Many ETFs have exemptive relief permitting in-kind transactions to settle beyond the seven-day period prescribed by Section 22(e) of the 1940 Act. This aspect of the relief addresses foreign investments¹⁴ that cannot be delivered timely to authorized participants as redemption proceeds due to local holidays or local settlement customs (or a combination of those factors).¹⁵ The Rule provides this relief for up to 15 days, but requires delivery of redemption proceeds as soon as practicable in all cases. The condition that such investments be delivered

as soon as practicable in all cases represents a new condition not typically found in the historical relief provided to ETFs.¹⁶

Affiliated Transactions. First- and second-tier affiliates¹⁷ 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 hold with the power to vote 5% or more of the shares of the ETF or any of the ETF's investment company affiliates.¹⁸ Consistent with prior exemptive orders, such transactions will be exempt from Sections 17(a)(1) and (2). Despite industry requests to extend the relief to certain other affiliations (e.g., a broker-dealer that is affiliated with the ETF's adviser or in-kind seeding by affiliates), the SEC noted that it is not prepared to extend the Section 17(a) relief to creation and redemption transactions involving parties that are affiliated persons of the ETF for reasons other than the 5% or more interest stated above.¹⁹

Intraday Indicative Value ("IIV"). The Rule will not require ETFs to make available an IIV, although other requirements necessary to operate an ETF may continue to require it, such as exchange listing rules or 19b-4 filings.

Which ETFs Fall Within the Definition of "ETF"? The Rule defines 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 basket²⁰ 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. Some categories of ETFs that would otherwise fall within the Rule's definition of ETF may not, however, rely on the Rule's exemptive provisions, though they remain subject to certain prospectus and website disclosure requirements promulgated in connection with the Rule. Those categories of ETFs include leveraged ETFs, inverse ETFs, ETFs organized as UITs and ETFs structured as a share class of a multi-class fund.²¹ In addition, non-transparent active ETFs may not rely on the Rule's exemptive provisions.²² Further, the definition of ETF excludes all exchange-traded products that are not registered open-end investment companies, such as exchange-traded notes ("ETNs") and exchange-traded commodity pools and physical metals trusts.²³

Considerations for New Sponsors. The Rule will lower the barriers to entry into the ETF market by eliminating the delay and costs associated with obtaining 1940 Act exemptive relief. Not having to obtain exemptive relief should allow new entrants to direct resources towards product development efforts and capital markets relationship building instead of the exemptive application process. Even would-be sponsors of ETFs that are unable to rely on the Rule, such as non-transparent ETFs, are likely to benefit from the Staff's ability to focus its exemptive resources on applications that present novel issues, which should accelerate the process and allow innovative products to come to market more quickly. Breaking into the ETF business will still present challenges for new entrants, including the need for competent and experienced employees, business advisors, legal counsel and service providers to address the legal and operational issues associated with launching ETFs. However, the Rule is likely to promote innovation and competition in the ETF marketplace, which will benefit new entrants and investors alike.



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Elimination of the Distinction Between Index-Based and Actively Managed ETFs. The Rule does not distinguish between index-based and actively managed ETFs, and does not incorporate the special requirements or conditions applicable to self-indexed ETFs under some existing exemptive orders. All ETFs relying on the Rule, whether index-based or actively managed, must comply with the same conditions.

IMMEDIATE CONSIDERATIONS FOR ETF SPONSORS

For ETF sponsors who do not currently have flexibility to utilize custom creation and redemption baskets, the Rule provides an opportunity to reduce trading costs and enhance efficiency. However, the Rule does come at a cost, with both technology and compliance costs likely to increase, at least in the short-term, due to the addition of disclosure obligations and the requirement to adopt and operate pursuant to basket construction policies and procedures. Nevertheless, the Rule provides significant potential benefits to ETF sponsors and investors. We believe the immediate considerations and steps ETF sponsors should take should include the following:

- **Current Landscape.** Identify internally actions currently taken and disclosures currently provided to comply with exemptive relief that will be rescinded by the Rule, as compared to actions and disclosures required to be taken or provided for other reasons that are still applicable (e.g., compliance with exchange continued listing standards);
- **Service Provider Arrangements.** Review and, where necessary, update existing service provider agreements (such as administration, custody and data license agreements), as well as authorized participant agreements and related authorized participant guidelines. In light of the additional responsibilities that may be placed on advisers or sub-advisers in connection with the basket construction and custom basket policies and procedures, advisers should evaluate the responsibilities and standards of care in their existing agreements with ETFs;

- **Compliance Policies and Procedures.** Draft and seek Board approval of basket construction and custom basket policies and procedures, and evaluate compliance policies and procedures to understand how the Rule will impact your overall compliance program. For example, determine whether existing portfolio holdings disclosure policies need to be revised in light of the Rule's portfolio transparency requirements; consider adopting a Rule 38a-1 policy (or amending your existing ETF compliance policy) to cover compliance with all of the Rule's conditions, including the Rule's website disclosure requirements around holdings, premiums/discounts, and bid-ask spreads;²⁴ and assess how the requirements of the Rule, especially the basket construction and custom basket policies and procedures, may interact with other fund policies, such as the liquidity program requirements of Rule 22e-4;
- **Technology and Website Enhancements.** Given the Rule's enhanced disclosure requirements, sponsors should assess their data and technology arrangements, including the functioning and utility of their ETFs' websites. The Rule requires ETFs to post several categories of new information on their websites daily. Sponsors will need

to arrange for the necessary data feeds and website development to ensure that these disclosure obligations can be met. In addition, to the extent ETFs must post information derived from third-party data, they should ensure that any necessary data use licenses have been obtained. Sponsors should prepare to capture the required records (in particular the custom basket records) before relying on the Rule;

- **Continued Reliance on Existing Relief.** Sponsors should evaluate their existing exemptive orders to identify any changes to their existing practices that will be necessary to rely on the Rule after the rescission of their existing exemptive relief. Sponsors of ETFs that are excluded from the scope of the Rule may want to engage proactively with the Staff in order to understand the status of their exemptive relief, as well as what hurdles, if any, they may face in developing and offering new products. The same applies to new sponsors who may need novel relief to develop and offer new ETFs; and
- **Disclosure.** Consider whether to sticker the prospectus/SAI to correct or modify any disclosure that may not accurately describe the new basket process and disclose any related conflicts of interest.



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SEC'S RESPONSE TO INDUSTRY CONCERNS

The SEC was responsive to industry concerns in finalizing the terms of the Rule. While the ETF industry was largely pleased with the Proposed Rule, there were a number of areas that generated significant industry comments. Key industry comments and the SEC's responses are summarized below.

Industry Objections to the Proposed Rule	Treatment in the Rule
To provide 12-month historical bid-ask spread information in the prospectus.	Changed to require 30-day historical bid-ask spread on the ETF's website rather than in the prospectus.
To provide an interactive bid-ask spread calculator.	Requirement eliminated.
To provide Q&As in the summary prospectus that included a heavy emphasis on historical bid-ask spread disclosures.	Permits presentation of streamlined set of information in a format of the ETF's choosing.
To publish portfolio holdings and a basket that the ETF would accept or deliver in connection with a creation or redemption, both prior to accepting a creation or redemption order (which would have had the effect of eliminating T-1 orders or requiring substantial operational changes for most ETF sponsors).	T-1 orders permitted; requirement to publish holdings prior to the acceptance of creation/redemption orders and requirement to publish a basket on the ETF's website eliminated.
To publish the portfolio holdings information in a complex format established under Regulation S-X.	Streamlined set of information (ticker symbol, CUSIP or other identifier, description of holding, quantity of holding, and percentage weight of holding) must be published.

EFFECT OF THE ETF RULE ON EXISTING EXEMPTIVE ORDERS

Rescission of Existing Exemptive Orders Held by ETFs That Can Rely on the Rule. All ETFs registered under the 1940 Act currently rely on exemptive orders issued to them at some point over the last few decades. The terms of those exemptive orders sometimes differ in important respects, with more recent orders typically having tighter restrictions on key ETF operations, such as the creation and redemption basket process. The SEC seeks to remedy that uneven regulatory landscape for ETF sponsors through the uniform terms of the Rule and by rescinding existing exemptive relief held by any ETF that can rely on the Rule. This rescission is limited to the portions of the exemptive relief pertaining to the formation and operation of an ETF, and does not cover the

Section 12(d)(1) fund of funds provisions. (For a discussion of those ETFs that cannot rely on the Rule, see "Scope of the Rule's Relief" above.) The rescission will be effective one year after the Effective Date.

Fund of Funds Relief. Many existing ETFs have exemptive orders that permit other unrelated registered investment companies to make investments in them in excess of the Section 12(d)(1)(A) and (B) limits. The Rule does not amend or rescind this aspect of existing exemptive relief, and ETFs that have an exemptive order containing that relief may continue to rely on that aspect of the relief, until the SEC adopts a fund of funds rule.²⁵

Extension of Fund of Funds Relief. To level the playing field for new ETF entrants relying on the Rule and for other ETFs not presently holding fund of funds exemptive relief, the

Adopting Release extends to them the ability to rely on fund of funds exemptive relief recently issued to other ETFs, provided they comply with the conditions in the orders.²⁶ ETFs seeking to rely on this extension of relief should take care to comply closely with the conditions of the precedent relief and to consider whether any factual differences between their circumstances and those of the applicants in the precedent order might conflict with the bases on which the SEC granted the precedent relief.

Master-Feeder Relief. Many existing ETFs have exemptive relief permitting an ETF to operate as a feeder fund in a master/feeder structure. As proposed, the Rule does not incorporate this aspect of existing relief and, instead, rescinds the outstanding exemptive relief for all holders of such relief other than those ETFs relying on it as of June 28, 2018, the date of the Proposing Release.²⁷

Conditions of the Rule

PORTFOLIO TRANSPARENCY

ETFs relying on the ETF rule must provide full portfolio transparency. Each ETF must disclose prominently on its publicly available website the ETF's portfolio holdings²⁸ 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).²⁹ ETFs must provide such portfolio holdings disclosure each business day before the opening of regular trading on the primary listing exchange of the ETF's shares.³⁰

Changes to timing of disclosure of portfolio holdings. Unlike the Proposed Rule, the Rule does not require that an ETF's portfolio holdings be posted on the ETF's website before the ETF starts accepting creation and redemption orders. This represents an important change for ETFs that invest in markets in time zones that are open for trading after U.S. markets close for a day because those ETFs may continue to accept orders from authorized participants the evening before the ETF's holdings information must be posted (T-1 orders). Compliance with the Proposed Rule would have required that those ETFs either stop taking T-1 orders or undertake substantial operational changes to have the information posted soon after 4 pm E.T. each day.

Changes to form of presentation of portfolio holdings. Under the Proposed Rule, ETFs would have been required to post their portfolio holdings in the form and with the information required by Article 12 of Regulation S-X. In light of strong industry comments against that proposed requirement, the SEC acknowledged that that level of formality and information was neither necessary nor practical for a daily disclosure requirement. Instead, the Rule merely requires the following information be posted for each portfolio holding: (1) ticker symbol; (2) CUSIP or other identifier; (3) a brief description of the holding; (4) the quantity of each security or other asset held; and (5) the percentage weight of the holding in the portfolio.³¹ ETFs relying on the Rule are also required to post daily the estimated cash balancing amount, if any (i.e., the amount of cash to account for any difference between the value of a creation or redemption basket and the net asset value of a creation unit).³²

CREATION AND REDEMPTION BASKETS, INCLUDING CUSTOM BASKETS

Basket Construction Policies and Procedures. The Rule requires ETFs relying on the Rule to adopt and implement written policies and procedures that govern the methodology used by the ETF in the construction of creation and redemption baskets and the process that will be used for the acceptance of baskets.

Custom Baskets. The Rule permits ETFs relying on it to utilize custom creation and redemption baskets. There are two types of custom baskets contemplated by the Rule. The first includes baskets that consist of a non-representative selection of the ETF's portfolio holdings, which would include 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.*

The second type of custom basket encompasses each basket after the initial basket used when different baskets are used

in transactions on the same business day. This would include:

(i) a representative sampling basket with either the same or another authorized participant that differs from the initial basket, or

(ii) baskets including cash in lieu of a portion of the basket assets for a single authorized participant.

Custom Basket Policies and Procedures. The Rule requires all ETFs that use custom baskets in reliance on the Rule to adopt written policies and procedures relating to the use of custom baskets. The custom basket 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; and
- 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.

Under the Rule, an ETF is 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. The SEC indicated in the Adopting Release that an ETF's custom basket policies and procedures should include details regarding the circumstances in which cash, securities or other positions would be substituted for basket assets. The SEC also stated that the policies and procedures should include details on the circumstances under which positions that are not operationally feasible to transfer in kind may be omitted from the basket, how and when the ETF may use representative sampling, and how the ETF will replicate changes in the ETF's portfolio in connection with portfolio or index rebalances and index reconstitutions.³³

ETFs may tailor their custom basket policies and procedures to address different risks and requirements for different types of custom baskets. For example, the ETF could develop tailored policies and procedures with requirements applicable when it uses cash substitutions that differ from the procedures it uses when substituting securities and other positions. The ETF's custom basket policies and procedures could also,

for example, address the differing considerations for custom baskets depending on the direction of the trade (whether the custom basket is being used for a creation or a redemption).

The Adopting Release also states that the custom basket policies and procedures should include provisions for testing compliance with such 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 interests of the ETF and its shareholders. As an example, the compliance policies and procedures could require

Preparing Custom Basket Policies and Procedures

The custom basket approach incorporated in the Rule is substantially similar to the approach outlined in several exemptive relief applications Ropes & Gray LLP prepared and filed in October 2017 on behalf of several of its clients.³⁴ Ropes & Gray attorneys have significant experience assisting clients in preparing basket construction and custom basket compliance policies and procedures. In fact, Ropes & Gray has developed an outline that may be useful in preparing basket construction policies and procedures, as well as related custom basket policies and procedures. If you would like to receive a copy of this outline, please email custombaskets@ropesgray.com.



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the ETF's compliance professionals to conduct periodic post hoc reviews of a sample of custom baskets used by the ETF. In addition, the custom basket policies and procedures must also provide a process governing revisions to, or deviations from, the parameters within the policies and procedures.

Recordkeeping. For each basket exchanged with an authorized participant, an ETF will be required to maintain a record setting forth the following information with respect to each basket position: ticker symbol, CUSIP or other identifier, description of holding, quantity of each holding, and

KEY ADDITIONAL CONSIDERATIONS ABOUT CUSTOM BASKETS

■ *The Importance of Custom Basket*

Flexibility. For many existing ETF sponsors, obtaining flexibility to utilize custom creation and redemption baskets is the most critical element of the Rule and the single item that does the most to level the ETF playing field. Custom baskets should benefit ETFs and their shareholders by reducing costs, increasing efficiency and improving trading. By permitting custom baskets, the Rule also provides newer sponsors the flexibility to compete with some of the more established ETF sponsors for securities, authorized participant transaction interest, creation activity and assets.

■ *Role of the Adviser/Sub-Adviser in Custom*

Basket Construction. The custom basket construction process raises many of the same issues present in traditional portfolio management services (e.g., whether to accept (buy) a specific security in a creation basket or whether to include (sell) a specific security in a redemption basket), as well as whether to include cash in lieu of securities or other assets, or whether to substitute one or more securities for another security or group of securities. Accordingly, the parameters of those policies and procedures may have significant portfolio management and performance implications. Compliance, risk and operational personnel should work closely with portfolio

management and capital markets personnel to determine the contours of the custom basket parameters, as well as to determine the roles and responsibilities of those involved in constructing and administering custom baskets in the best interests of the ETF and its shareholders. The result may be that different parameters may apply to different types of ETFs, or even to different portfolio management teams. The considerations for index and active ETFs, for equity and fixed income ETFs, and for U.S. and foreign ETFs may be different, and the Rule permits investment advisers (and sub-advisers) flexibility to determine the parameters for the construction and acceptance of custom baskets that are in the best interests of each ETF and its shareholders. Even with this flexibility, sponsors should be careful to ensure that custom basket policies and procedures are not so complex that they become difficult and unwieldy to administer and enforce.

■ **Actively Managed ETFs.** Custom baskets will enable actively managed ETFs to man-

age their portfolios in a more efficient and cost-effective way by giving them the ability to optimize creation and redemption baskets. Further, the Rule provides actively managed ETFs with a modicum of non-transparency; with no requirement to publish a basket on the ETF's website, actively managed ETFs will gain one day of non-transparency, which may reduce the ETF's susceptibility to front-running since information about that day's transactions, whether through custom baskets or standard baskets, will not be as readily available to market participants. Moreover, with custom basket transactions, actively managed ETFs will be able to further shield their portfolio transactions if they engage in different custom basket transactions during the day with different authorized participants on the same day. The fact that ETFs now have the ability to set their own smaller creation unit sizes should make creation and redemption transactions more frequent, which will benefit all ETFs, especially actively managed ETFs and fixed income ETFs.



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Ed has significant experience with ETF basket construction issues, both in his former role as chief legal officer for the world's largest ETF sponsor and while at Ropes & Gray, having prepared basket construction and custom basket policies and procedures on behalf of a number of Ropes & Gray clients. Ed also has experience advising clients on all aspects of ETF capital markets, product design and operations.

percentage weight of each holding composing the basket exchanged for creation units, plus the cash balancing amount, if any, and the identity of the authorized participant transacting with the ETF. For each custom basket used, such record will also be required to identify the basket as a custom basket and include a statement that the custom basket complies with the ETF's custom basket policies and procedures. ETF sponsors can expect that the Staff will focus on these records during examinations, and ETF sponsors should give careful consideration to the supporting materials and rationale that should be created and maintained to evidence the basis for any determination to accept a specific custom basket under the custom basket policies and procedures.³⁵ The SEC explained that the recordkeeping requirements will enable the examination staff to evaluate "compliance with the rule and other applicable provisions of the federal securities laws."³⁶

Disclosure Requirements

ETFs that rely on the Rule will be required to disclose certain information on their websites. In addition, amendments to Form N-1A and Form N-8B-2 require disclosures to be made by all ETFs, including those unable to rely on the Rule.

Website Disclosure. Each ETF that relies on the Rule must disclose, among other things, the following information on its website:

- The ETF's portfolio holdings³⁷ that will form the basis of the next calculation of the ETF's NAV (daily);
- The ETF's NAV, market price,³⁸ 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 30 days (daily);³⁹
- 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; 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. Also, this information must be posted on the website on the day immediately after the disclosure requirement is triggered (i.e., the eighth trading day) and must re-

Potential Tax Implications of the Rule. ETFs have the potential to operate in a more tax-efficient manner than traditional mutual funds that redeem in cash. This tax efficiency derives principally from the in-kind creation and redemption mechanism utilized by many ETFs, and custom baskets may be used to facilitate transactions designed to optimize tax efficiencies. ETF sponsors will have to consider whether an ETF's written policies and procedures must identify the tax considerations, if any, that are taken into account in the construction and negotiation of a custom basket. An in-kind redemption made at the demand of a shareholder generally results in no taxable gain or loss to the ETF. Taking into account tax considerations when selecting securities to satisfy in-kind redemptions generally should not affect that result. Some types of tax-motivated redemptions, however, potentially present additional tax issues that may require careful consideration under the ETF's custom basket policies and procedures and under the Rule.



JIM BROWN, Partner, Tax

Jim focuses his practice on the tax aspects of investment funds, including ETFs. He regularly advises sponsors of investment funds on tax structuring and operational issues relating to these funds, including the taxation of registered and unregistered investment funds (e.g., private equity funds, debt funds, hedge funds, commodities funds, and regulated investment companies or mutual funds).

main on the ETF's website for one year after its initial posting.

One of the purposes of these disclosures is to provide investors with a daily "snapshot" into the difference between an ETF's NAV and market price.

Registration Statement Disclosure. The Adopting Release includes amendments to prospectus disclosure requirements designed to provide investors who purchase ETF shares on the secondary market with additional information, including information regarding costs associated with investments in ETFs. For example, ETFs will be required to include registration statement disclosures stating that investors may be subject to brokerage and other fees when buying or selling

ETF shares. These registration statement disclosures apply to all ETFs, including those that fall outside of the Rule.

Revised Item 3 of Form N-1A requires a narrative statement in the introduction to the Fee Table that an investor "may pay other fees, such as brokerage commissions and other fees to financial intermediaries, which are not reflected in the tables and examples below," and adds the term "selling" to current narrative disclosure requirements to clarify that the fees and expenses reflected in the expense table may be higher for investors if they buy, hold and sell shares of the fund. In addition, revised Item 6 of Form N-1A requires disclosure about secondary market trading in ETF shares, including how to access recent information on the ETF's website. Finally, ETFs that do not meet the website

BOARD PERSPECTIVES: THE EFFECT OF THE ETF RULE ON ETF BOARDS

The Rule does not directly impose new obligations on ETF boards. Indeed, the Adopting Release mentions the role of an ETF board only a handful of times, principally to state the SEC's belief that an ETF board's oversight of the ETF's compliance policies and procedures, as well as its general oversight of the ETF, provides an additional layer of protection for an ETF's use of custom baskets.⁴⁰ Given the possibility for overreach and the dilution of shareholder interests through that process, the SEC's expectation that the board provide a level of oversight over that process should not come as a surprise.

Appropriately, nothing in the Rule or the Adopting Release suggests boards should be involved in an ETF's day-to-day operations. As with other oversight functions a

board performs, an ETF board's oversight of the basket construction process will likely be through the review and establishment of policies and procedures required by the Rule and the review of periodic reporting thereunder. The evaluation of whether the policies and procedures continue to result in custom baskets in the best interest of an ETF will require careful consideration of how a basket affects the economic characteristics of the ETF's portfolio, including, potentially, whether it reduces expected tracking error from the ETF's index or target portfolio and/or whether it reduces transaction

costs that authorized participants would otherwise incur, which is important to an efficient arbitrage mechanism. It seems likely that investment and risk professionals at an ETF's investment adviser (or sub-adviser), as well as fund compliance personnel, would be well positioned to provide ETF boards with periodic summary reports evidencing their findings regarding whether the ETF's custom basket policies and procedures remain properly designed to result in baskets that are in the best interest of the ETF and its shareholders.



PAULITA PIKE, *Partner, Asset Management*

Paulita represents investment advisers as well as registered funds, their boards, and service providers throughout the country. Her work on ETFs includes counseling clients on novel investment structures, compliance and regulatory issues, and distribution matters.

disclosure requirements of the Rule must include the median bid-ask spread for the ETF's most recent fiscal year.

In order to ensure consistent disclosure by ETFs that are organized as UITs (which are not otherwise covered under the Rule), Form N-8B-2 was also amended to require ETFs that are organized as UITs to provide the same information as is required by the revised Form N-1A.

Additional Relief From Certain Requirements of the Exchange Act

The Rule seeks to formalize and standardize the relief from the 1940 Act that registered investment companies require to operate as ETFs. However, ETFs and broker-dealers who serve as their authorized participants also require relief from the Exchange Act and regulations promulgated thereunder to operate and interact with each other as they do. ETFs and their authorized participants have historically relied on an extensive and complicated patchwork of no-action letters for that necessary relief. In a pleasant surprise, the Adopting Release and the Exchange Act Order provide some helpful guidance and standardized relief on those matters.

Availability of Exceptions/Exemptions in Rules 101 and 102, Rule 10b-17, and Rule 11d1-2. In the Adopting Release, the SEC confirmed that all ETF shares, including shares of ETFs ineligible to rely on the 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 from Section 11(d)(1) in Rule 11d1-2 under the Exchange Act for securities issued by a registered open-end investment company or UIT. This guidance removes the need for ETFs to ensure their design and operations comport with the conditions of past no-action relief related to these provisions or obtain their own relief tailored to their facts.

In the Exchange Act Order, the SEC took steps to reduce further the regulatory complexity applicable to ETFs by adopting standardized conditions for other necessary exemptions

from Section 11(d)(1) of the Exchange Act, Rules 10b-10, 15c1-5 and 15c1-6 under the Exchange Act, and Rule 14e-5 under Regulation 14E. The Exchange Act Order only applies, however, with respect to ETFs that rely on the Rule and when other specified conditions are satisfied. ETFs that fall outside the scope of the Rule will have to continue to rely on the existing Exchange Act class relief or other no-action letters relating to Section 11(d)(1) and Rules 10b-10, 15c1-5, 15c1-6 and 14e-5.

Significantly, the Exchange Act Order applies 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 Rule will not have to comply with the minimum creation unit size and diversification requirements of the existing ETF “class relief” letters unless those requirements continue to apply to them on some other basis, such as through the standards imposed by the ETF's listing exchange. In granting the Exchange Act Order, the SEC stated its belief that the portfolio and other transparency requirements of the Rule, when combined with the conditions in the Exchange Act Order, address the policy concerns underlying the various Exchange Act provisions and rules. The following summarizes the relevant conditions to the relief granted in the Exchange Act Order (other than those already incorporated into the Rule):⁴¹

- **Section 11(d)(1):**⁴² Non-authorized participant broker-dealers⁴³ who extend, maintain or arrange for the extension of credit to or for a customer in connection with secondary market transactions must not (and their associated persons who are natural persons must not), directly or indirectly (including through any affiliate), receive from the Fund Complex⁴⁴ of the ETF any payment, compensation or other economic incentive to promote or sell the shares of the ETF to persons outside the Fund Complex, other than non-cash compensation permitted under FINRA Rule 2341(I)(5)(A), (B) or (C).

Broker-dealers acting as an authorized participant to the ETF must comply with the compensation condition described above, and must also not extend, maintain or arrange for the extension of credit to or for a custom-

er on shares of the ETF before 30 days have passed from the date that the ETF's shares initially commence trading (except as such activity is otherwise permitted pursuant to Rule 11d1-1).

- **Rule 10b-10:**⁴⁵ Confirmation statements issued in respect of the issuance and redemption transactions in ETF shares will contain all of the information specified in Rule 10b-10 other than the identity, price and number of shares of units (or principal amount) of each component security tendered or received by the customer (the “Omitted Information”); the confirmation statement will contain a statement that the Omitted Information will be provided upon request; and all requests for the Omitted Information will be fulfilled in a timely manner in accordance with Rule 10b-10(c).

- **Rules 15c1-5 and 15c1-6:**⁴⁶ Broker-dealers must provide any information to which a customer is entitled under the Rule upon request and fulfill such requests in a timely manner.

- **Rule 14e-5:**⁴⁷ No purchase of securities subject to a tender offer made by a broker-dealer acting as a dealer-manager of a tender offer is effected for the purpose of facilitating a tender offer; if the basket transactions do not qualify for the Rule 14e-5(b)(5) exception (e.g., it has fewer than 20 securities or the security subject to the tender offer makes up more than 5% of the value of the basket), then any purchases of an ETF component security by that dealer-manager will be effected for the purpose of adjusting a basket of securities in the ordinary course of its business and not for the pur-

PRACTITIONER'S CORNER

With the adoption of the Rule and the issuance of the Exchange Act Order, the need for ETFs to rely on Exchange Act ETF “Class Relief” Letters for no-action relief is as follows:

	Rule 10b-17	Reg M Rules 101 and 102	Rule 11d1-2	Section 11(d)(1)	Rule 10b-10	Rules 15c1-5 and 15c1-6	Rule 14e-5
ETFs that are able to rely on the ETF Rule	No longer applicable	No longer applicable	No longer applicable	No longer applicable (subject to conditions in the Exchange Act Order)	No longer applicable (subject to conditions in the Exchange Act Order)	No longer applicable (subject to conditions in the Exchange Act Order)	No longer applicable (subject to conditions in the Exchange Act Order)
ETFs that are not able to rely on the ETF Rule	No longer applicable	No longer applicable	No longer applicable	Must comply with the SIA Letter ⁴⁹ or other relevant relief	Must comply with the SIA Letter or other relevant relief	Must comply with the SIA Letter or other relevant relief	Must comply with the Equity Index Letter ⁵⁰ or other relevant relief

pose of facilitating a tender offer; and the broker-dealer acting as a dealing manager of a tender offer otherwise complies with Rule 14e-5.

In addition, with respect to each of the above other than Rule 14e-5, the ETF must meet the diversification requirements applicable to regulated investment companies in Internal Revenue Code Section 851(b)(3)(B).⁴⁸

OTHER ITEMS OF NOTE FROM THE RULE AND THE EXCHANGE ACT ORDER

There are a number of other noteworthy provisions of the Rule, the Adopting Release and the Exchange Act Order:

- Redemptions may be suspended only in accordance with Section 22(e) of the 1940 Act. Per the Adopting Release, creations may be suspended only for a limited time and only due to extraordinary circumstances, such as when the markets on which the ETF's portfolio holdings are traded are closed for a limited period.
- Transaction fees charged by ETFs in connection with creation unit redemptions must be in compliance with 1940 Act Rule 22c-2 (i.e., no greater than 2%).
- The Rule permits an ETF to make individual share redemptions in connection with transactions such as mergers, reorganizations, conversions and liquidations. However, by its terms, the Rule does not allow ETFs to buy shares from investors at market-determined prices.
- ETFs cannot make selective disclosure of intraday changes to portfolio holdings, and disclosures of portfolio holdings information must be made consistent with the ETF's disclosure policies. As noted above, sponsors may need to review their portfolio holdings disclosure policies and related disclosures in light of the Rule and the potential for the custom basket construction process to require disclosure of otherwise non-public portfolio holdings information.
- The Adopting Release clarified that ETFs subject to trading halts or trading suspensions by their listing exchange, or that receive temporary non-compliance notices from their listing exchange, will not be considered "delisted" for purposes of the Rule.
- The Rule does not address the ETF exchange listing (Exchange Act Rule 19b-4) process, which can add complexity and potentially lengthy delays to the ETF launch and listing process that should be addressed by future SEC action.
- While the Rule does not directly address the establishment of standard classifications for various types of ETPs, the Adopting Release made it clear that UITs and other ETFs not covered by the Rule can call themselves ETFs.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2019 Ropes & Gray LLP

ENDNOTES

¹ Exchange-Traded Funds, Release Nos. 33-10695; IC-33646 (September 25, 2019), available at <https://www.sec.gov/rules/final/2019/33-10695.pdf> (the “Adopting Release”).

² Exchange-Traded Funds, Release Nos. 33-10515; IC-33140 (June 28, 2018) (“Proposing Release”).

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).

⁴ See Adopting Release at footnote 460. See also Salt Financial (Salt Financial, LLC, et al., Investment Company Act Release Nos. 32974 (Jan. 23, 2018) (notice) and 33007 (Feb. 21, 2018) (order) (“Salt Financial”).

⁵ A “share class ETF” is an ETF structured as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio.

⁶ Leveraged and inverse ETFs seek to exceed the performance of a market index by a specified multiple or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time, respectively.

⁷ Non-transparent active ETFs refers to ETFs that are actively managed and operate without being subject to the daily portfolio transparency condition included in other actively managed ETF orders. See, e.g., Precidian ETFs Trust, et al., 1940 Act Rel. Nos. 33440 (April 8, 2019) and 33477 (May 20, 2019) (order) (“Precidian”).

⁸ The prescribed conditions of the Rule are set forth [here](#).

⁹ ETFs organized as UITs, ETFs structured as a share class of a multi-class fund, non-transparent ETFs, and leveraged or inverse ETFs are unable to rely on the Rule. The Adopting Release states that the SEC believes that the SEC should first complete its broader consideration of the use of derivatives by registered funds before considering allowing leveraged or inverse ETFs to rely on the Rule.

¹⁰ The Adopting Release does not rescind exemptive relief from Section 12(d)(1) and the related relief from Sections 17(a)(1) and (a)(2) of the 1940 Act that permits certain ETF fund of funds arrangements and in fact extends such relief to ETFs relying on the Rule.

¹¹ The Adopting Release grandfathers existing master-feeder arrangements that were in use as of June 28, 2018, but prevents the formation of new master-feeder arrangements by amending existing exemptive orders.

¹² The Exchange Act Order provides conditional 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-5 under the Exchange Act, but only with respect to ETFs that are able to rely on the Rule.

¹³ “Creation unit” means “a specified number of ETF shares that the ETF will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount (if any).” See Adopting Release at footnote 96.

¹⁴ The definition of “foreign investment” is any security, asset or other position of the ETF issued by a foreign issuer (as defined by Rule 3b-4 under the Exchange Act) and that is traded on a trading market outside of the U.S. This formulation represents a change from the Proposed Rule, which would have applied to foreign investments for which there is “no established U.S. public trading market.”

¹⁵ The SEC will no longer require registration statement disclosure of foreign holidays during which an ETF may delay the payment of redemption proceeds and the maximum expected redemption delays.

¹⁶ Under the Proposed Rule, this exemption from Section 22(e) would have expired 10 years from the Effective Date unless the SEC took action before then. However, this “sunset” provision was eliminated in the Adopting Release.

¹⁷ Persons affiliated with the ETF based on their ownership of 5% or more of the ETF’s outstanding securities are “first-tier affiliates,” and affiliated persons of the first-tier affiliates or persons who own 5% or more of the outstanding securities of one or more funds advised by the ETF’s investment adviser are “second-tier affiliates.”

¹⁸ This formulation differs from the SEC’s 2008 ETF rule proposal, where the following formulation was proposed: “solely by reason of holding with the power to vote 5 percent or more, or more than 25 percent, of securities issued by the exchange-traded fund (or who is an affiliated person of such a person), or issued by an investment company under common control with the exchange-traded fund, is exempt from sections 17(a)(1) and 17(a)(2)...” Existing exemptive orders may include yet different formulations. The SEC confirmed that the change in language was not intended to result in a change in the relief from Section 17(a) historically granted to ETFs. See Adopting Release at footnote 128 and accompanying text.

¹⁹ The SEC confirmed that the Rule’s exemptive relief applies to transactions with 5% affiliates who hold more than 25% of the ETF’s shares, and also indicated that they would be willing to entertain exemption requests regarding other affiliation issues.

²⁰ “Basket” is defined in the Rule as “the securities, assets or other positions in exchange for which an ETF issues (or in return from which it redeems) creation units.” See Adopting Release at footnote 41. Therefore, the term “exchange-traded fund” includes ETFs that transact in-kind, in cash or both.

²¹ The Proposing Release cited exemptive orders issued to Vanguard Index Funds as an example of ETFs holding this form of multi-class fund relief. See Proposing Release at footnote 332.

²² See Precidian; see also, T. Rowe Price Associates, Inc. et al. (File No. 812-14214) (Sept. 23, 2013, as amended on Mar. 14, 2014, Feb. 23, 2018, June 18, 2018, Apr. 30, 2019, June 12, 2019, and July 26, 2019); Fidelity Beach Street Trust et al. (File No. 812-14364) (Sept. 26, 2014, as amended on Jan. 26, 2018, May 18, 2018, and Aug. 8, 2018, Apr. 30, 2019, June 7, 2019, and July 16, 2019); Blue Tractor ETF Trust et al. (File No. 812-14625) (Mar. 14, 2016, as amended on Sept. 28, 2016, Feb. 1, 2017, July 31, 2017, Jan. 17, 2018, Apr. 11, 2018, May 23, 2018, May 8, 2019, and June 20, 2019); Natixis Advisors, L.P., et al. (File No. 812-14870) (Jan. 22, 2018, as amended on June 15, 2018, Nov. 9, 2018, May 1, 2019, July 3, 2019, July 26, 2019, and Aug. 26, 2019); Eaton Vance Exchange-Traded Fund Trust et al. (File No. 812-15003) (Feb. 20, 2019); American Century ETF Trust, et al., (File No. 812-15035), 1940 Act. Rel. No. 33590 (Aug. 14, 2019) (notice) and 33620 (Sept. 10, 2019) (order); see also, Application of Invesco Capital Management LLC, et al., filed Sept. 25, 2019.

²³ The SEC staff believes that each of these types of ETFs presents special issues, and will continue to require sponsors seeking to launch these types of ETFs to seek specific exemptive relief and to abide by the tailored conditions that such relief would entail. Sponsors granted relief to launch and operate these products currently are able to launch new products as long as they can operate within the confines of their existing exemptive relief.

²⁴The 30-day bid-spread disclosure and portfolio holdings disclosure are Rule requirements. Accordingly, ETFs will need to ensure data feeds and calculations (for the bid-ask spread disclosure) and data fields (for the portfolio holdings disclosure) are set up appropriately before relying on the Rule.

²⁵In December 2018, the SEC proposed Rule 12d1-4 to streamline and enhance the regulatory framework applicable to fund of funds arrangements for registered investment companies, including ETFs. See Fund of Funds Arrangements, Release Nos. 33-10590; IC-33329 (December 19, 2018).

²⁶See Adopting Release Footnote 460 and accompanying text. See also, Salt Financial, *supra* note 4.

²⁷In the Adopting Release, the SEC expressed concern that an ETF feeder will transact in-kind with its master fund while other feeder funds will transact in cash with the same master fund. In this scenario, all investors in the master fund, including the ETF feeder that transacted in-kind, would bear the costs of the cash transactions within the master fund.

²⁸Portfolio holdings include securities, assets or “other positions.” Other positions include cash, as well as other holdings that are not securities or assets, including short positions or written options.

²⁹“Business day” means any day the ETF is open for business, including any day when it satisfies redemption requests.

³⁰The Rule does not require ETFs to publish a creation/redemption basket that the ETF would accept. We expect, however, that ETFs will continue to publish acceptable baskets (and related cash balancing amounts) to authorized participants and market makers through the NSCC or their non-public authorized participant websites.

³¹These requirements are derived from the generic listing standards applicable to actively managed ETFs. Adopting Release at 75-76 and note 256. See, e.g., NYSE Arca Rule 8.600-E(c)(2); Nasdaq Rule 5735(c)(2); Cboe BZX Rule 14.11(i)(3)(B).

³²The purpose of the requirement to publish a “cash balancing amount” (if any) each day when the ETF publishes the portfolio holdings that will form the basis for each calculation of NAV per share is not clear, as the cash balancing amount can only be determined relative to a specific basket.

³³Adopting Release at 86-87.

³⁴See, for example, <https://www.sec.gov/Archives/edgar/data/919361/000119312517300773/d416276d40app.htm>.

³⁵The Rule also requires that ETFs preserve and maintain copies of all written authorized participant agreements.

³⁶Adopting Release at 120-121.

³⁷ETFs relying on the Rule must disclose for each holding: the ticker symbol, CUSIP or other identifier, description, quantity and percentage weight of each holding. In addition, ETFs must disclose a cash balancing amount, if any, but as noted above, such amount can only be determined relative to a specific basket.

³⁸Market price means (i) the official closing price of the ETF share, or (ii) if it more accurately reflects the market value of the ETF at the time the ETF calculates its NAV, the midpoint between the national best bid-offer (“NBBO”) at the NAV calculation time.

³⁹The 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. See footnote 369 of the Adopting Release and accompanying text.

⁴⁰See Adopting Release, footnote 306 and accompanying text.

⁴¹The conditions of the Exchange Act Order are largely similar to existing class relief letter conditions, but there are a number of differences with respect to Rule 14e-5.

⁴²Section 11(d)(1) generally prohibits a person that is both a broker and a dealer from extending or maintaining credit, or arranging for the extension or maintenance of credit, to or for a customer on any security which was part of a distribution of a new issue of securities in which the broker-dealer participated.

⁴³The release for the Exchange Act Order expresses doubt as to whether Section 11(d)(1) would apply to broker-dealers not acting as an authorized participant to an ETF, but provides the relief nonetheless “to remove any ambiguity about the circumstances when non-AP [b]roker-[d]ealers may offer margin on ETF securities...” See Exchange Act Order at 17.

⁴⁴Fund Complex is defined to mean “the issuer of the ETF shares, any other issuer of ETF shares that holds itself out to investors as a related company for purposes of investment or investor services; any investment adviser, distributor, sponsor, or depositor of any such issuer; or any ‘affiliated person’ [(as defined in the 1940 Act)] of any such issuer or any such investment adviser, distributor, sponsor, or depositor.”

⁴⁵Rule 10b-10 imposes a confirmation statement delivery obligation on a broker or dealer and specifies the information required to be included therein.

⁴⁶Rule 15c1-5 requires a broker-dealer effecting a transaction to disclose any control relationship with an issuer of a security that it purchases for or sells to a customer. Rule 15c1-6 requires a broker-dealer to disclose its participation or interest in a primary or secondary distribution of a security that it purchases for or sells to a customer.

⁴⁷Rule 14e-5 prohibits “covered persons” from directly or indirectly purchasing or arranging to purchase any securities that are the subject to a tender offer (or exchangeable or convertible into such securities) except as part of such tender offer.

⁴⁸Section 851(b)(3)(B) provides that a “regulated investment company” must have: not more than 25 percent of the value of its total assets invested in—(i) the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, (ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary [of the Treasury], to be engaged in the same or similar trades or businesses or related trades or businesses, or (iii) the securities of one or more qualified publicly traded partnerships (as defined in subsection (h)).

⁴⁹See, e.g., letter from Catherine McGuire, Division of Trading and Markets, Securities and Exchange Commission, to Securities Industry Association (Nov. 21, 2005), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/sia112105.htm> (“SIA Letter”).

⁵⁰See, e.g., letter from James A. Brigagliano, Division of Trading and Markets, Securities and Exchange Commission, to Stuart M. Strauss, Clifford Chance US LLP, re: Class Relief for Exchange Traded Index Funds (Oct. 24, 2006), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/etifclassrelief102406-msr.pdf> (“Equity Index Letter”).

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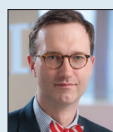
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