ROPES & GRAY

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Recent ETF-Related Developments

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ETF-related product development continues apace and the ETF regulatory landscape continues to evolve notwithstanding recent market volatility and the work-from-home environment. This Ropes & Gray alert summarizes recent important developments, including the launch of the first non-transparent and semi-transparent ETFs, an upcoming reorganization of a traditional mutual fund into an ETF, and the streamlining of certain exchange listing requirements.

- Non-Transparent and Semi-Transparent Active ETFs Perform Well in Volatile Environment. These new ETFs have commenced operations during an almost unprecedented period of market volatility. Asset management firms navigating these ETFs through the most sudden and deepest bear market in 10 years include ClearBridge, American Century and Fidelity. Despite the markets' recent rollercoaster ride, the ETFs appear to be behaving within expectations with bid/ask spreads ranging between 18 and 45 basis points, and premium/discount daily calculations suggesting a range between 4 and 28 basis points. Investors have not yet widely flocked to these investment vehicles, but that is not surprising given ongoing concerns about the economy and the markets.

- Rule 6c-11's Compliance Date Is Less than Six Months Out. By December 23, 2020, ETFs that fall within the ETF Rule will have to update their website to include new bid-ask spread information and other disclosures, and must adopt policies and procedures governing, among other things, basket construction practices. *See* Ropes & Gray's related alert **here**. For sponsors to utilize custom baskets, their basket policies must also include specific parameters that designated employees will rely on in approving individual custom baskets as in the best interest of the ETF and its shareholders. In those procedures, sponsors must address the specific parameters and controls that will apply to custom basket composition and negotiation, the process for designated employees to approve deviations from approved parameters, and the review, documentation and reporting of such deviations.

- Exchanges Join the Effort to Streamline the Listing and Trading Rules for Most ETFs. The SEC recently approved revised listing rules for the **NASDAQ**, **CBOE BZX** and **NYSE Arca** exchanges. For ETFs relying on the ETF rule, the new listing rules eliminate the continuous listing standards and most of the former quantitative listing standards, including issuer diversification, minimum market capitalization and various other requirements, and also dispense with the requirement that ETFs publish an intraday indicative value (IIV). The elimination of these quantitative requirements will greatly reduce the number of ETFs subject to the Rule 19b-4 process. However, two specific requirements remain. First, following the initial 12-month period after trading commences on an exchange, the ETF must not fall below 50 beneficial holders for 30 or more consecutive trading days. In addition, certain ETFs must implement information barriers designed to prevent insider trading.

  Separately, when the SEC adopted the ETF Rule, it issued an order standardizing conditions for necessary relief 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 (**Exchange Act Order**). Many ETFs that fall outside the scope of the ETF Rule cannot rely on the Exchange Act Order and must rely on existing Exchange Act class relief or other no-action letters. However, while non-transparent and semi-transparent active ETFs may not rely on the Exchange Act Order, they may be able to rely on new Exchange Act no-action relief obtained by Fidelity. The Fidelity letter is available **here**. In the Fidelity letter, the Staff indicated that it will not recommend enforcement action if a broker-dealer treats shares of an ETF operating in a substantially identical manner to that of Fidelity's active, semi-transparent ETF as shares of an ETF relying on the ETF Rule for purposes of the relief from Section 11(d)(1) and Rules 10b-10, 15c1-5, and 15c1-6 provided in the Exchange Act Order.

- A Reorganization of a Mutual Fund to an ETF Is Underway. On May 22, 2020, Guinness Atkinson announced that the Board of two of its conventional mutual funds had approved the funds' reorganizations into ETFs. The announcement lacked additional detail, but stated that a prospectus/information statement would be forthcoming. As of the date of this alert, that prospectus/information statement has not been filed. But we are not surprised that fund sponsors are pursuing conversions and reorganizations of traditional mutual funds into ETFs. We wrote about the potential for such conversions and reorganizations and the regulatory and other issues that they present **here**. We also discussed those issues with the Staff of the SEC. We believe that any obstacles to reorganizations and conversions are not insurmountable and that there will be more such reorganizations and conversions in the near term, especially for funds with a mostly retail investor base or those used by registered investment advisers for asset allocation.

- There's a Movement Afoot to Regulate the Classification of ETPs. A group of leading ETF sponsors has asked the major exchanges to implement a solution that will bring more discipline to the terms and categorizations used for different exchange-traded products. When the SEC adopted the ETF Rule (Rule 6c-11), the SEC did not include any provisions that regulated which exchange traded products could be marketed and promoted as exchange-traded funds (or ETFs), but encouraged industry participants to take up the effort. Exchange-traded products include (i) exchange-traded funds that follow traditional investment strategies and invest directly in stocks and bonds, (ii) pooled investment vehicles that utilize derivatives and leverage to seek returns that approximate some multiple of the daily return of an index (or the inverse thereof), (iii) exchange-traded notes that may represent unsecured debt obligations of an issuer, and (iv) pooled vehicles that invest in hard assets, such as precious metals or other natural resources. Under the framework proposed, these vehicles would be referred to, respectively, as (i) Exchange-Traded Funds (ETFs); (ii) Exchange-Traded Instruments (ETIs), (iii) Exchange-Traded Notes (ETNs), and (iv) Exchange-Traded Commodities (ETCs). The effort, if successful, would have substantial implications for product development and the promotion and marketing of exchange traded products. The proposed classification scheme is below.

Recommended ETP classifications		
Acronym	**Name**	**Description**
ETF	**Exchange-Traded Fund**	A registered open-end management investment company under the Investment Company Act (operating under Rule 6c-11 or an applicable SEC ETF exemptive order) that (i) in the normal course issues (and redeems) creation units to (and from) authorized participants in exchange for a basket 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; Includes funds that transact on an in-kind basis, on a cash basis, or both; and Excludes ETNs, ETCs and ETIs (as defined below).
ETN	**Exchange-Traded Note**	A debt security issued by a corporate issuer (i.e., not issued by a pooled investment vehicle) that is linked to the performance of a market index and trades on a securities exchange; May or may not be collateralized, but in either case, depends on the issuer's solvency to deliver fully to expectations; and Excludes products that seek to provide a leveraged or inverse return, a return with caps on upside or downside performance or "knock-out" features.

ETC	**Exchange-Traded Commodity**	A pooled investment vehicle with shares that trade on a securities exchange that invests primarily in assets other than securities and financial futures; The primary investment objective of an ETC is exposure to traditional commodities and non-financial commodity futures contracts; and May hold physical commodities (e.g., precious metals) or invest in non-financial commodity futures or commodity-based total return swaps.
ETI	**Exchange-Traded Instrument**	Any pooled investment vehicle, debt security issued by a corporate issuer, or similar financial instrument that trades on a securities exchange that has embedded structural features designed to deliver a return other than the full unlevered positive return of the underlying index or exposure (for example, products that seek to provide a leveraged or inverse return, a return with caps on upside or downside performance or “knock-out” features); or All products not captured by the ETF, ETN or ETC classification fall under ETI.