

SEC Adopts ETF Rule



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On September 25, the SEC unanimously adopted Rule 6c-11 under the 1940 Act to modernize the regulation of exchange-traded funds by establishing a clear and consistent framework for the vast majority of ETFs operating today. The SEC stated that the Rule also will allow ETFs to come to market more quickly, and without the time or expense of applying for individual exemptive relief. In addition, the SEC voted to issue an exemptive order that further harmonizes related relief for broker-dealers.

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ETFs relying on the Rule and related exemptive order will have to comply with certain conditions designed to protect investors, including conditions regarding transparency and disclosure. The Rule becomes effective 60 days after its publication in the *Federal Register*. One year after the Rule's effective date, the SEC will rescind exemptive relief previously granted to ETFs that fall within the Rule's scope. The SEC will also rescind the master-feeder relief granted to ETFs that do not rely on the relief as of the date of the proposal (June 28, 2018); this is to prevent the formation of new master-feeder arrangements.

The SEC will not rescind the relief from section 12(d)(1) and sections 17(a)(1) and (a)(2) under the 1940 Act relating to fund of funds arrangements involving ETFs. ETFs relying on the Rule that do not already have fund of funds relief may enter into fund of funds arrangements, provided that they satisfy the terms and conditions for fund of funds relief in recent ETF exemptive orders.

ETFs have become enormously popular in the investment company industry. Since 1992, the SEC has issued more than 300 exemptive orders allowing for the launch of more than 2,000 ETFs. The SEC had originally proposed a rule codifying its exemptive order conditions in 2008. That version of a rule was never adopted. This Rule was initially proposed in June 2018; the SEC adopted the Rule largely as proposed in 2018, with certain important changes. Key aspects of the Rule as adopted are discussed below.

Scope of Rule

The Rule defines an ETF as a registered, open-end management investment company that (1) issues (and redeems) creation units to (and from) authorized participants in exchange for a basket and a cash balancing amount (if any) and (2) issues shares that are listed on a national securities exchange and traded at market-determined prices.

The Rule will only be available to ETFs organized as open-end funds. ETFs organized as unit investment trusts (UITs), ETFs structured as a share class of a multiclass fund or a master-feeder arrangement, leveraged and inverse ETFs, and nontransparent ETFs are not able to rely on the Rule and instead must continue to operate under their existing exemptive orders or obtain new exemptive relief.

Index-Based ETFs and Actively Managed ETFs. Consistent with the proposal, the Rule will provide exemptions for both index-based ETFs and fully transparent, actively managed ETFs, but will not, by its terms, establish different requirements based on whether an ETF's investment objective is to seek returns that correspond to the returns of an index. The historical distinction between index-based ETFs and actively managed ETFs is largely a product of ETFs' historical evolution and individual exemptive relief process. The Rule thus levels the playing field between index-based and actively managed ETFs.

Leveraged/Inverse ETFs. As adopted, the Rule will exclude ETFs that seek to provide leveraged or inverse investment returns over a predetermined period of time. Further, the adopting release makes it clear that the Rule also excludes ETFs that track indices with embedded leverage. These ETFs will instead continue to operate pursuant to their existing exemptive orders. The SEC stated that leveraged/inverse ETFs present unique issues and concerns that are more appropriately addressed outside the context of the Rule.

Exemptive Relief Under ETF Rule

In general, the Rule codifies the relief provided by exemptive orders from various provisions of the 1940 Act (e.g., section 22(d), Rule 22c-1, section 17(a) and section 22(e)). Key areas of relief are discussed below.

Treatment of ETF Shares as Redeemable Securities. The Rule makes it clear that an ETF is an open-end company that issues redeemable securities. Importantly, the adopting release clarifies that even shares of ETFs ineligible to rely on the Rule will qualify as "redeemable securities" for purposes of 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 in ETF shares and the creation and redemption of creation units. ETFs relying on the Rule similarly will qualify for the "registered open-end investment company" exemption in Rule 11d1-2 under the Exchange Act.

Trading of ETF Shares at Market-Determined Prices. The Rule will provide exemptions from section 22(d) and Rule 22c-1 of the 1940 Act to permit secondary market trading of ETF shares at market-determined prices, as opposed to net asset value. These exemptions are customary in exemptive relief currently obtained by ETFs.

Affiliated Transactions. The Rule will provide exemptions from sections 17(a)(1) and (a) (2) of the 1940 Act with regard to the deposit and receipt of baskets by a person who is an affiliated person of an ETF (or who is an affiliated person of such a person) solely by reason of (1) holding with the power to vote 5 percent or more of an ETF's shares or (2) holding with the power to vote 5 percent or more of any investment company that is an affiliated person of the ETF.

A number of commenters also recommended expanding the relief to cover additional types of affiliated relationships, such as exempting broker-dealers that are affiliated with the ETF's investment adviser or permitting an ETF's investment adviser or its affiliates to transact with the ETF to provide in-kind seed capital to the ETF. The SEC declined to do so, explaining that the Rule was intended to codify existing relief for ETFs, and expanding the scope of affiliated persons covered by the exemption would constitute novel section 17(a) relief.

Additional Time for Delivering Redemption Proceeds. The Rule includes an exemption from section 22(e) of the 1940 Act, which will permit an ETF to delay satisfaction of a redemption request in the case of certain foreign investments for which a local market holiday or the extended delivery cycles of another jurisdiction make timely delivery unfeasible for up to 15 days. Unlike the proposal, this exemption has no sunset provision.

Conditions for Reliance on the Rule

The Rule requires ETFs to comply with certain conditions in order to operate within the scope of the 1940 Act. These conditions are generally consistent with those required by the exemptive relief previously granted by the SEC.

Listing on a National Securities Exchange. The Rule defines an "exchange-traded fund," in part, to mean a fund that issues shares that are listed on a national securities exchange and traded at market-determined prices. This is a fundamental characteristic of ETFs. An ETF that has its shares delisted would therefore fall outside the scope of the Rule. However, circumstances such as a trading suspension, a trading halt or a temporary noncompliance notice from the exchange would not constitute a "delisting" for purposes of the Rule. An ETF also may request temporary relief from the SEC to permit the ETF to suspend redemptions for a limited period of time where necessary to protect ETF shareholders.

Portfolio Holding Disclosure. The Rule requires daily transparency of portfolio holdings in a standardized manner before the opening of regular trading on the ETF's primary listing exchange. This requirement is different than what was originally proposed. The proposal would have required an ETF to disclose its basket and portfolio holdings before it accepted creation unit orders. This requirement was not adopted, and the Rule therefore accommodates T-1 orders, even when basket and portfolio holding information is unavailable.

Custom Baskets. The Rule will require an ETF to adopt and implement written policies and procedures governing the construction of baskets and the process that the ETF will use for the acceptance of baskets. The Rule will also permit the use of custom baskets if the ETF has adopted written policies and procedures that (1) 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 any revisions to, or deviations from, those parameters, and (2) specify the titles or roles of employees of the ETF's investment adviser who are required to review each custom basket for compliance with those parameters.

Website Disclosure. The following information must be disclosed publicly and prominently on the ETF's website:

- NAV per share, market price, and premium or discount, each as of the end of the prior business day
- a table and chart showing the number of days the ETF's shares traded at a premium or discount during the most recently completed calendar year and calendar quarters of the current year
- for ETFs whose premium or discount was greater than 2 percent for more than seven consecutive trading days, disclosure that the premium or discount was greater than 2 percent, along with a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount
- median bid-ask spread over the most recent 30 calendar days.

Amendments to Form N-1A

The SEC adopted several changes to Form N-1A that are designed to provide ETF investors with additional information regarding ETF trading and associated costs:

- added 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 (Item 3)
- streamlined narrative disclosures relating to ETF trading costs, including bid-ask spreads (Item 6)
- required ETFs that do not rely on Rule 6c-11 to disclose median bid-ask spread information on their websites or in their prospectus (Item 6)
- excluded ETFs that provide premium/discount disclosures in accordance with Rule 6c-11 from the premium and discount disclosure requirements in Form N-1A (Items 11 and 27)
- eliminated disclosures relating to creation unit size and disclosures applying only to ETFs with creation unit sizes of fewer than 25,000 shares (Items 3, 6, 11 and 27).

The Rule represents a major regulatory step in recognizing both the importance and maturation of ETFs as a fixture within the mutual fund industry and could spur a second rush to market by those fund sponsors that have remained on the sidelines thus far. The impact of that rush on the existing fund segment could result in a further transformation of the fund industry that could reverberate for years to come. Pepper Hamilton LLP will continue to closely monitor developments in this space. For specific questions, do not hesitate to contact us.

The SEC’s final rule is available at <https://www.sec.gov/rules/final/2019/33-10695.pdf>.