AT THE END OF THE RAINBOW: A CUSTOM BASKET?

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U.S. Exchange-Traded Funds Alert

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For several years now, the Securities and Exchange Commission ("SEC") has placed strict limitations on the composition of exchange-traded fund ("ETF") creation and redemption "baskets." [1] Creation and redemption baskets are, quite simply, the groups (or baskets) of securities that ETFs require to be deposited when selling creation units and that ETFs distribute when redeeming creation units. Creation units are the large aggregations of shares in which ETFs transact with institutional investors (called authorized participants), who then make the shares available in the market.

The limitations imposed by the SEC since approximately 2012 have required an index ETF's baskets (for both creations and redemptions) generally to correspond *pro rata* to the positions in the ETF's portfolio (including cash positions), except: (i) to avoid fractional shares and odd lots; (ii) to exclude positions that cannot be transferred in-kind; (iii) when an ETF's index has rebalanced and the ETF is, accordingly, rebalancing its portfolio; and (iv) when an ETF representatively samples its portfolio to produce a basket. [2] In other words, the ability of index ETFs to customize the composition of the baskets has been materially restricted.

On October 2, 2017, four exemptive application filings signaled that the era of these restrictions may (hopefully) be coming to an end. [3] The Applications, if granted, would permit index ETFs, including what are commonly referred to as "self-indexed" ETFs, substantially more flexibility to customize their baskets. [4] More specifically, the ETFs could sell and redeem creation units using different baskets, neither of which is a *pro rata* slice of the portfolio (generically, "Custom Baskets"); provided that the ETF's board, including a majority of its independent trustees, approves written policies and procedures detailing:

1. the parameters used by the ETF's adviser for the construction of Custom Baskets and the process used for the acceptance of Custom Baskets;
2. the circumstances under which, or the standards for determining when, use of Custom Baskets is in the best interests of the fund; and
3. the titles or roles of the ETF's adviser's employees who may determine on any given business day that utilizing a Custom Basket is in the best interests of the fund (collectively, the "Basket Policies and Procedures").

Although there have not been any publicly reported abuses involving ETF basket composition, the SEC seems to have been concerned about the potential for an imbalance of power between ETFs s and authorized participants due to the importance of authorized participants' trading to the ETF arbitrage mechanism. To eliminate the potential for authorized participants to take advantage of such an imbalance and "dump" undesirable securities into an ETF's portfolio in connection with a creation and/or "cherry pick" an ETF's portfolio in connection with a redemption, the SEC imposed the strict limits described above. The Applications essentially posit the Basket Policies and Procedures as an elegant substitute for such limits and call on the ETF's independent trustees to oversee the potential conflicts of interest, as independent trustees are well-suited to do.

ETFs and their shareholders stand to benefit materially from a wider usage of Custom Baskets. First, ETFs are most likely to use Custom Baskets to deliver out, in kind, in connection with redemptions, securities that may face liquidity or other unique concerns, or more low-cost-basis securities, which will improve their tax efficiency over the long term. Second, Custom Baskets could result in narrower bid/ask spreads and smaller premiums and discounts to net asset value for ETF shares to the extent that ETFs use baskets with fewer CUSIPs and authorized participants can more easily and efficiently hedge, arbitrage and trade the ETF shares. Third, the use of Custom Baskets would provide advisers with greater portfolio management flexibility, which could be especially useful for ETFs that hold a representative sample of, rather than replicate, their underlying indices. Fourth, injecting additional flexibility into the basket formation process across the ETF industry may further increase competition by "leveling the playing field" between now-established ETF sponsors and newer market entrants. Prior to 2012, ETF sponsors were frequently able to obtain exemptive relief that had fewer — and in some cases almost no — restrictions on how baskets must be formed. As a result, long-established ETF sponsors may operate pursuant to significantly less onerous exemptive orders than newer market entrants. Such disparities have arguably put newer market entrants at a competitive disadvantage, which the modernized relief signaled by the Applications may allow them to overcome.

Most importantly, the Applications do not reduce in any way the fiduciary duty owed by an ETF adviser to the ETF. As a fiduciary, the adviser remains under an obligation to form baskets (including Custom Baskets) that are in the best interest of the ETF. This should continue to be the SEC's main assurance that the ETF will not be subject to overreaching by authorized participants (to "dump" undesirable securities into, or "cherry pick" desirable securities from, the ETF's portfolio) at the expense of shareholders.

For many index ETF sponsors and investors alike, the Custom Baskets described in the Applications could be akin to a pot of gold at the end of a rainbow. With any luck, the weather pattern that produced this rainbow might hold out and result in a similar forecast for active ETFs.

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[1] Currently, every ETF needs a proprietary exemptive order from the SEC to operate. As a result, the SEC has an opportunity to impose conditions and limitations on ETF market entrants as part of the exemptive order process.

[2] When using a representative sample, the sample must (i) be designed to generate performance highly correlated to the ETF's portfolio; (ii) consist entirely of instruments that are already included in the ETF's portfolio; and (iii) be the same for all authorized participants on a given business day. Also, ETFs have more flexibility to use all cash for creations and redemptions and to use cash when required securities are unavailable or cannot be transacted by an authorized participant.

[3] Goldman Sachs ETF Trust, et al. (File No. 812-14826); NuShares ETF Trust, et al. (File No. 812-14824); Oppenheimer Revenue Weighted ETF Trust, et al. (File No. 812-14825); and PIMCO ETF Trust, et al (File No.

812-14827) (collectively, the "Applications"). As of the date of this client alert, notices of the Applications have not been issued by the SEC.

[4] A "self-indexed" ETF is an index ETF for which an "affiliated person," as defined in Section 2(a)(3) of the Investment Company Act of 1940, or an affiliated person of an affiliated person serves or will serve as the index provider.

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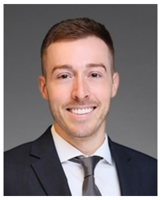

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