SEC ADOPTS LONG AWAITED ETF RULE TO MODERNIZE ETF REGULATION

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Investment Management Alert

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On September 25, 2019, the U.S. Securities and Exchange Commission (the “Commission” or “SEC”) approved Rule 6c-11 under the Investment Company Act of 1940, as amended (“1940 Act”) and related amendments to Form N-1A for exchange-traded funds (“Disclosure Amendments”). Once effective, Rule 6c-11 (the “Final Rule”) will allow most exchange-traded funds (“ETFs”) to operate without obtaining an exemptive order from the Commission, as has historically been required due to the inability of ETFs to comply strictly with the 1940 Act. Although the Final Rule represents a significant achievement for the Commission, it was adopted without an open meeting and pursuant to the Commission's seriatim approval process.[2]

While the SEC largely adopted the Final Rule and Disclosure Amendments as proposed, certain key changes were made. In particular, in response to industry comments, the Disclosure Amendments did not include many of the bid-ask spread disclosures proposed. In addition, also in response to comments, the Final Rule was accompanied by the SEC's separate and simultaneous issuance of an exemptive order from certain provisions of the Securities Exchange Act of 1934 (“Exchange Act”) for secondary market transactions in ETF shares.[3] This exemptive order eliminates the need for most ETFs to obtain relief from the Exchange Act before commencing operations in order to ensure that their shares may trade in the secondary market in substantially the same manner as traditional securities.

THE FINAL RULE ELIMINATES NEED FOR MOST ETFS TO SEEK EXEMPTIVE RELIEF, OPENING THE DOOR FOR FURTHER ETF GROWTH

The adoption of the Final Rule represents a seminal event in the history of ETFs by eliminating the need for the “vast majority” of ETFs to seek exemptive relief to operate, facilitating future ETF market growth.[4] The Final Rule covers the vast majority of ETFs and eliminates the historic distinction between index-based and fully transparent actively-managed ETFs by requiring all ETFs that rely on the Final Rule to comply with the same conditions and provide full portfolio transparency. Non-transparent (or semi-transparent) actively-managed ETFs are not permitted by the Final Rule.

The Final Rule provides an exemption from Section 22(d) of the 1940 Act, which requires open-end fund shares to be purchased and sold only at net asset value (“NAV”), to be purchased and sold at secondary market prices. It also grants an exemption from the affiliated transaction provisions of the 1940 Act to permit persons, who are affiliated with an ETF by virtue of owning more than 5% of the ETF's shares (and their affiliates), to purchase and redeem ETF shares in kind (*i.e.*, in exchange for a basket of securities), which is otherwise prohibited by Section

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17(a).[5] Finally, it grants an exemption from Section 22(e) of the 1940 Act, which generally requires open-end funds to honor redemption requests within seven days, to allow ETFs up to 15 days to deliver foreign investments in connection with in-kind redemptions of ETF shares.[6] In a departure from the proposed rule, the Final Rule no longer sunsets this exemption from Section 22(e) in ten years as was originally proposed.

THE FINAL RULE IS SUBSTANTIALLY THE SAME AS THE PROPOSED RULE

The Final Rule, like the proposed rule before it, deems shares of ETFs that operate in reliance on the Final Rule to be "redeemable securities" (within the meaning of the 1940 Act) of open-end investment companies. This classification of ETF shares is important because the Exchange Act has various exemptions for redeemable securities of open-end investment companies. Thus, this classification makes these exemptions available to ETFs that rely on the Final Rule. In addition, the Adopting Release for the Final Rule extends this classification to the shares of *all* ETFs -- not only those operating in reliance on the rule. As a result, all ETF shares may rely on Exchange Act exemptions previously reserved largely for mutual fund shares.[7]

In addition, similar to the proposed rule, the Final Rule allows ETFs relying on it to create and redeem creation units of their shares in-kind for baskets of securities that are not representative of the ETF's portfolio, *i.e.*, in "custom baskets." Prior exemptive orders granted to different parties over time had varied custom basket allowances such that an uneven competitive landscape had developed. The Final Rule largely levels that playing field by ensuring that the vast majority of ETFs (*i.e.*, those that will operate in reliance on the rule) operate subject to the same custom basket restrictions -- namely compliance controls and Board oversight.

Further, as originally proposed by the SEC, the Final Rule does not require an ETF to publish an intraday indicative value ("IIV") of its portfolio during the trading day. This is a change from the way ETFs currently operate under their exemptive orders, as all such orders require ETFs to have an IIV calculated and published throughout the trading day. The Adopting Release explains that the SEC determined no longer to require IIVs in light of the fact that market participants generally do not use them, as currently published, because there is insufficient assurance that they are accurate and their publication is not timely. Thus, once operating in reliance on the Final Rule, ETFs will be relieved of this obligation and expense.

Finally, the Final Rule largely imposes the same website disclosure requirements on ETFs as were originally proposed. For example, in order to rely on the rule, an ETF must disclose, on a free and publicly available website, each business day before the opening of trading, the following unique ETF data:

- Each portfolio holding (including the ticker symbol, CUSIP or other identifier, description of holding, quantity of each security/asset, and percentage weight of the holding) that will form the basis for the next NAV calculation, and the cash balancing amount for a creation unit;
- As of the close of the prior business day, the ETF's NAV, market price and premium/discount;[8]
- The ETF's median bid-ask spread during the last 30 calendar days (calculated as instructed); and
- A table and a line graph, each of which show the number of days that the ETF's shares traded at a premium or discount during the last calendar year and during the most recently completed calendar quarter(s); and, if the ETF's premium or discount has been greater than 2% for seven consecutive trading days, a discussion of the factors that caused it.

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CHANGES MADE TO THE PROPOSED RULE AND DISCLOSURE AMENDMENTS BY THE SEC LARGELY ADDRESS INDUSTRY COMMENTS

As proposed, the rule would have required information about each portfolio holding (including the ticker symbol, CUSIP or other identifier, description of holding, quantity of each security/asset, and percentage weight of the holding) that will form the basis for the next NAV calculation and cash balancing amount to be published before the ETF accepted creation unit orders. Because ETFs that invest in foreign markets have difficulty complying with this requirement and other, well-accepted market practices (known as “T-1 orders”) have developed, the Commission received significant comment on this proposed provision. Among other things, commenters warned that curtailing T-1 orders could result in wider bid-ask spreads, which would adversely impact retail trades in ETF shares. Based on educational comments such as these, as adopted, the Final Rule is drafted to permit T-1 orders.

In addition, the Final Rule no longer requires that the holdings information comply with the requirements of Article 12 of Regulation S-X, which would have required holdings information to be in the same format as the shareholder report. Many commenters voiced concerns about the burdensomeness of the Regulation S-X standard and questioned the benefits of it. As a result, the Final Rule eliminates the Regulation S-X standard and instead requires a description of each holding that is detailed enough to allow investors to identify the specific security held by the ETF. The Adopting Release recognizes that this description may differ by asset type.

Finally, the Final Rule and Disclosure Amendments pare back the bid-ask spread disclosure from that which was originally proposed. Most importantly, they no longer require an extensive Q&A in ETF registration statements about bid-ask spreads and an interactive website calculator. Instead, ETFs relying on the rule will only need to disclose their median bid-ask spread during the last 30 calendar days on their website.[9] In addition, ETFs in their registration statements on Form N-1A will provide largely standardized bid-ask spread disclosure.

IMPACT ON EXISTING ETF ORDERS, INCLUDING FUND OF FUNDS RELIEF IN SUCH ORDERS

The Adopting Release states that one year following the effective date of the Final Rule, the SEC will rescind the exemptive orders of current ETFs that "would be permitted to operate in reliance” on the Final Rule. The rescission will include any master-feeder relief previously granted to ETFs to operate as feeder funds in master-feeder structures, unless as of June 28, 2018 they were relying on such relief and operating such feeder funds.

The Adopting Release makes it clear that the rescission will not affect the relief ETFs have obtained from Section 12(d)(1) and Sections 17(a)(1) and (a)(2) permitting them to be acquired funds in fund-of-funds arrangements. In addition, the Adopting Release extends such fund-of-funds relief to all ETFs that rely on the Final Rule, provided they satisfy the conditions of recent exemptive orders that grant such relief to ETFs. Under the Adopting Release, this exemptive relief for all (including new) ETFs to be acquired funds in a fund-of-funds structure without obtaining a proprietary exemptive order will last until the SEC adopts a more comprehensive fund-of-funds rule.

Further, the rescission will not impact exemptive orders for ETFs that are structured as unit investment trusts, for ETFs that pursue leveraged and/or inverse index strategies, for ETFs that operate as a share class of a mutual fund, or for ETFs that do not provide full portfolio transparency. The Final Rule does not reach such bespoke structures as it was explicitly proposed, and is designed, to cover only the “vast majority” of ETFs that are currently available in the U.S. market.[10]

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IMPACT ON ETFS NOT RELYING ON THE FINAL RULE

Although not *all* ETFs will be able to rely on the Final Rule for their operation, the Final Rule and Disclosure Amendments will have ramifications for all ETFs -- even those not relying on the rule. This is the case because they will either need to provide the website disclosures required by the Final Rule, or augment their prospectus disclosure to include additional information on the median bid-ask spread and premium/discount in their shares during the past fiscal year.[11] Because many commenters voiced concerns about including bid-ask spread disclosures in ETF registration statements, including due to the potential for staleness, we anticipate most ETFs will choose to satisfy the disclosure requirements by updating their websites to include the information prescribed by the Final Rule.

NEXT STEPS

The Final Rule is a long awaited and welcome development in the modernization of ETF regulation. New ETF industry entrants will no longer need individualized exemptive relief under either the 1940 Act or the Exchange Act to come to market, and all market participants will operate under the same restrictions (*i.e.*, on a level playing field).

The Final Rule and Disclosure Amendments will be effective 60 days after publication in the Federal Register, and there will be a one-year transition period for compliance with the Disclosure Amendments.[12] We welcome all inquiries as we continue to study the Final Rule and the next steps for our clients. For more information about regulation of the ETF industry, please go to the K&L Gates HUB.

Notes:

[1] *See* "Exchange-Traded Funds," SEC Release Nos. 33-10695 & IC-33646 (September 25, 2019) (https://www.sec.gov/rules/final/2019/33-10695.pdf) ("Adopting Release").

[2] The Final Rule was originally scheduled to be adopted at an open meeting of the Commission on September 25, 2019. However, the meeting was canceled on September 24, 2019. The Commission has not issued any statement regarding the rationale for canceling the open meeting or for proceeding seriatim.

[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] The Final Rule did not change the definition of exchange-traded fund from the proposed rule and defines an "exchange-traded fund" as "a registered open-end investment company: (i) that issues (and redeems) creation units to (and from) authorized participants in exchange for a basket and cash balancing amount if any; and (ii) whose shares are listed on a national securities exchange and traded at market determined prices." Key terms included in this definition of "exchange-traded fund," including "creation unit," "authorized participant," "basket" and "cash balancing amount," are defined in the Final Rule.

[5] ETFs generally sell and redeem their shares in aggregations of shares called "creation units."

[6] The Final Rule defines "foreign investments" by reference to Rule 3b-4 under the Exchange Act.

[7] *See* Adopting Release at 36.

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[8] The “market price” can be either the official closing price of the ETF's shares on its listing exchange or, if more reflective of their market value, the midpoint of the national best bid and offer (“NBBO”).

[9] The Final Rule adopts a standardized format for calculating the bid-ask spread that uses the midpoint of the NBBO for the calculation.

[10] The Final Rule is not available to ETFs (1) organized as unit investment trusts (UITs), (2) structured as a share class of a multiclass fund, (3) operating as leveraged or inverse ETFs or (4) non-transparent ETFs. See Adopting Release at 17; see also SEC Proposes New Approval Process for Certain Exchange-Traded Funds, SEC Press Release (June 28, 2018); “Exchange-Traded Funds,” SEC Release Nos. 33-10515 & IC-33140 (June 28, 2018) (https://www.sec.gov/rules/proposed/2018/33-10515.pdf) at 146.

[11] The premium/discount information would also need to be provided in the annual report.

[12] The Disclosure Amendments includes amendments to Form N-1A that apply to both mutual funds and ETFs. They also include technical amendments to Form N-CSR, Form N-1A, Form N-8B-2, Form N-PORT, and Regulation S-X.

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