CLIENT ALERT

SEC Adopts Rule Modernizing ETF Regulation

October 29, 2019

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On September 26, 2019, the Securities and Exchange Commission (the "SEC") announced that it had unanimously adopted Rule 6c-11 (the "ETF Rule") under the Investment Company Act of 1940 (the "1940 Act")[1] to permit qualifying open-end management investment companies to operate as exchange-traded funds ("ETFs")[2] without first obtaining an exemptive order from the SEC. The exemptive relief previously granted to existing index and transparent actively managed ETFs that qualify for reliance on the ETF Rule will be rescinded, requiring them to operate under the ETF Rule by December 23, 2020. There is a one-year transition period for compliance with new form amendments.

According to the ETF Release, the ETF Rule is designed to create a "consistent, transparent, and efficient regulatory framework for ETFs and facilitat[e] greater competition and innovation among ETFs."[3] The ETF Rule seeks to standardize the operation of most 1940 Act-registered index and transparent actively managed ETFs by replacing the variations resulting from individualized exemptive orders with a single set of requirements applicable to all eligible ETFs.

1 *Exchange-Traded Funds*, Investment Company Act Release No. 33,646 (Sept. 25, 2019) (the "ETF Release"), available here.

2 ETFs are a hybrid product containing elements of both mutual funds and closed-end funds. An ETF engages in a continuous public offering of its shares, and its shares may be redeemed each business day. Unlike a mutual fund, however, an ETF issues and redeems its shares only in transactions with "authorized participants," who purchase and redeem shares directly from the ETF in large blocks called "creation units." Also, unlike shares issued by a mutual fund, but similar to those issued by most closed-end funds, shares of an ETF are listed for trading on a national securities exchange and can be bought or sold throughout the day on an exchange or in the secondary market by investors at a market-determined price. Since the 1940 Act does not contemplate this type of hybrid fund, ETFs have been required to seek exemptions from certain provisions of the 1940 Act, which initially varied in their limitations on certain fund operations but have become relatively standardized in recent years.

3 ETF Release at 5. The SEC's press release announcing the ETF Rule noted that, in light of the growth in size and importance of ETFs, particularly to Main Street investors, it was "important to have a consistent, transparent, and efficient regulatory framework that eliminates regulatory hurdles while maintaining appropriate investor protections."

The ETF Rule is also intended to level the playing field by permitting the use of "custom" creation and redemption baskets by all ETFs that rely on the ETF Rule.

Significant aspects of the ETF Rule and the related form amendments, which we discuss in further detail below, include:

- **Available for Index and Transparent Active ETFs** — The ETF Rule is available for index ETFs that use a third-party or affiliated index provider, as well as for transparent actively managed ETFs (other than excluded ETFs as described below).

- **Full Transparency** — An ETF relying on the ETF Rule must prominently disclose on its website the ETF's portfolio holdings that will form the basis of the next calculation of the ETF's net asset value ("NAV") per share, plus any cash balancing amount, and certain other historical information (e.g., the ETF's NAV, market price, premium or discount, each as of the end of the prior business day, specified disclosures for premiums or discounts greater than 2% over specified time periods, and median bid-ask spreads over the prior 30 calendar days).

- **Custom Baskets** — An ETF may use "custom baskets" (i.e., creation and redemption baskets that do not reflect a pro rata representation of the ETF's portfolio or that differ from the initial basket used in transactions on the same business day) if the ETF adopts written policies and procedures "set[ting] forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the [ETF] and its shareholders."[4]

- **Amendments to Form N-1A** — Several disclosure amendments were adopted to provide investors who purchase ETF shares in secondary market transactions with additional information regarding ETFs, including information about the trading costs associated with an investment in ETFs.[5]

- **Rescission of Existing Exemptive Relief** — The ETF Rule will rescind, on December 23, 2020, the portions of prior exemptive orders that grant relief related to the formation and operation of an ETF for ETFs that qualify to rely on the ETF Rule. The SEC is not, however, rescinding the exemptive relief related to fund-of-funds arrangements that it has granted to ETFs permitting other registered investment companies to invest beyond certain regulatory limits in the ETFs.

[4] *See* Rule 6c-11(c)(3)(i).

[5] The SEC also amended parts of Form N-8B-2, the registration form applicable to ETFs organized as unit investment trusts ("UITs"). UITs, however, are not eligible to rely on the ETF Rule and must obtain exemptive relief in order to operate as ETFs.

- **ETFs Excluded from the ETF Rule** — The ETF Rule is not available to (i) ETFs organized as UITs; (ii) leveraged[6] or inverse ETFs;[7] (iii) ETFs structured as a share class of a multi-class fund;[8] and (iv) non-transparent ETFs. ETFs currently operating in these types of structures would be permitted to continue to rely on their existing exemptive relief. New ETFs seeking to operate in these structures would continue to require individualized relief.

- **ETF Shares as "Redeemable Securities"** — The ETF Rule eliminates uncertainty as to the status of ETF shares as "redeemable securities," within the meaning of Section 2(a)(32) of the 1940 Act, with the result that ETF shares will qualify as excepted securities, exempt from the restrictions of Regulation M, Rules 101 and 102, and Rule 10b-17(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and ETFs will be eligible to rely on the relief from Section 11(d)(1) of the Exchange Act provided to registered open-end funds by Rule 11d1-2, without separate exemptive or no-action relief, but subject to the conditions set out in Rule 11d1-2.[9]

In a companion release, the SEC also provided conditional exemptions from certain provisions of the Exchange Act and the rules thereunder that affect the financing of ETF shares by broker-dealers, creations and redemptions of ETF shares by and through broker-dealers, and secondary market transactions in ETF shares through broker-dealers.[10] These exemptions were formerly codified in a patchwork of exemptive, no-action and interpretive relief in individualized and class relief letters.

The ETF Rule, related form amendments, and the Exchange Act Exemptive Order will become effective on December 23, 2019. To allow ETFs currently in operation to transition to the requirements of the ETF Rule, the ETF Rule permits, but does not require, ETFs to continue to rely on their individualized exemptions during the one-year transition period.[11]

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[6] Leveraged ETFs seek to provide returns that correspond to the performance of a market index by a specified multiple over a predetermined period of time.

[7] Inverse ETFs seek to provide returns that have an inverse relationship to the performance of a market index over a predetermined period of time.

[8] Share class ETFs refer to ETFs that are structured as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio. Currently, only one family of ETFs has the necessary exemptive relief to operate share class ETFs. *See* ETF Release at 122.

[9] The SEC clarified in the ETF Release that it views all ETFs operating as registered open-end management companies or UITs, not just those that will rely on the ETF Rule, as eligible for these redeemable securities exemptions. *See id.* at 36.

[10] *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 (Sept. 25, 2019) (the "Exchange Act Exemptive Order"), available here.

[11] An ETF may elect, for example, to conform its operations to the ETF Rule prior to the end of the one-year transition period in order to gain the benefits of using custom baskets. Certain exemptive orders automatically expire on the effective date of any ETF rule adopted by the SEC, and the SEC has amended those orders to delay the expiration until December 23, 2020.

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I. Availability and Scope of the ETF Rule

The ETF Rule is available to an ETF organized as a 1940 Act-registered open-end management investment company that:

(i) issues (and redeems) creation units to (and from) authorized participants[12] 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.[13]

The ETF Rule defines the term “basket” to mean “the securities, assets or other positions in exchange for which an ETF issues (or in return for which it redeems) creation units.”[14] The scope of this “basket” definition permits ETFs to transact on an in-kind basis, a cash basis, or both. Importantly, the definition is broad enough to encompass both securities (as defined in the 1940 Act) and other assets or positions (e.g., futures or swaps).

The shares of an ETF that meet the conditions of paragraph (c) of the ETF Rule are considered “redeemable securities” within the meaning of Section 2(a)(32) of the 1940 Act. This confirmation of the status of ETF Shares under the 1940 Act has consequences for the application of other provisions of the federal securities laws that reference redeemable securities.[15]

The ETF Rule is available to ETFs that seek returns that correspond to the returns of an index (i.e., index ETFs) and to transparent actively managed ETFs, eliminating the distinction that the SEC historically made with respect to these two types of ETFs. Also, the ETF Rule does not impose additional requirements on index ETFs that use an affiliated index provider (i.e., self-indexed ETFs) or differentiate between such ETFs and ETFs that use a third-party index provider.[16]

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[12] The ETF Rule defines an “authorized participant” as “a member or participant of a clearing agency registered with the [SEC] that has a written agreement with the ETF or one of its service providers that allows the authorized participant to place orders for the purchase and redemption of creation units.” Rule 6c-11(a)(1). This definition represents a change from the definition of authorized participant in most exemptive orders, which referenced the participant’s participation in the DTC system. ETFs may wish to consider amending their authorized participant agreements going forward to allow for this broader definition.

[13] The SEC explained in the ETF Release that this is a fundamental requirement to availability of the exemption under the ETF Rule. ETFs failing to maintain their exchange listing may no longer rely on the ETF Rule and must satisfy individual redemption requests within seven days pursuant to Section 22(e) of the 1940 Act or liquidate if not listed on an exchange. *See* ETF Release at 61.

[14] Rule 6c-11(a)(1). The ETF Release notes that the term includes cash and, as a result, the term “exchange-traded fund” includes an ETF that “transact[s] on an in-kind basis, on a cash basis, or both.” *See* ETF Release at 18 n.41.

[15] *See generally infra* Section VI for a discussion of the implications of this position under the Exchange Act.

[16] *See* ETF Release at 24.

II. Portfolio Transparency and Website Disclosure Conditions

Since the issuance of the first ETF exemptive order, the SEC has consistently "relied on the existence of an arbitrage mechanism to keep the market prices of ETF shares at or close to the NAV per share of the ETF."[17] According to the SEC, daily portfolio transparency is an appropriate mechanism to facilitate the arbitrage process, as it "provides authorized participants and other market participants with a tool to facilitate valuing the ETF's portfolio on an intraday basis, which, in turn, enables them to identify arbitrage opportunities and to effectively hedge their positions."[18] The ETF Rule requires portfolio transparency through website disclosure, but the SEC made several modifications from the proposed rule regarding the required timing and presentation of the holdings disclosure.[19]

To rely on the ETF Rule, an ETF must disclose prominently on its website (which must be publicly available, free of charge)[20] the portfolio holdings that will form the basis for the next calculation of the ETF's NAV per share, plus any cash balancing amount.[21] The portfolio holdings that form the basis for the ETF's NAV calculation must be the ETF's portfolio holdings as of the close of business on the prior business day.[22] This disclosure must be made each business day before the opening of regular trading on the primary listing exchange of the ETF's shares.[23] The ETF must also provide its

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[17] *See id.* at 67.

[18] *See id.* at 68.

[19] As proposed, an ETF would have been required to publish the basket applicable to orders to purchase or redeem creation units on its website each business day, but after considering comments, the SEC did not include this requirement as a condition to the ETF Rule. The SEC stated that this information would provide "little additional value to market participants assessing the existence of arbitrage opportunities" since the SEC understood from commenters that market participants currently have access to this type of information through other means (e.g., through the National Securities Clearing Corporation, an intermediary, or the ETF itself). *See id.* at 95–96.

[20] An ETF may not establish restrictive terms of use for its website that make the disclosure difficult to access or difficult to locate, such as requirements for input of user names or passwords. *See id.* at n.225.

[21] Full transparency is a change from certain individualized index ETF exemptive relief, which permitted disclosure of the constituents of the underlying index rather than requiring disclosure of the ETF's portfolio. The SEC has observed that, notwithstanding the ability to not disclose the ETF's portfolio, all ETFs currently provide full transparency as a matter of industry market practice. *See id.* at 70.

[22] Rule 6c-11(c)(2).

[23] Rule 6c-11(c)(1)(ii). The proposed rule would have required that an ETF disclose its portfolio holdings before the ETF started accepting orders for the purchase or redemption of creation units that day. The SEC received several comments on this proposal, with many commenters explaining the negative effect that this proposed requirement would cause for ETFs accepting creation and redemption orders shortly after U.S. markets close ("T-1 orders"). To accommodate T-1 orders, among other concerns, the SEC did not adopt this requirement. *See* ETF Release at 70–73.

current NAV per share, current market price,[24] premium or discount, each as of the end of the prior business day, and its median bid-ask spread calculated using the ETF's NBBO over the most recent 30 calendar days.[25]

To further support portfolio transparency, the ETF Rule requires that an ETF disclose certain standardized information regarding each portfolio holding. The ETF Rule defines "portfolio holdings" to mean "an ETF's securities, assets, or other positions."[26] As a result, an ETF is required to disclose not just its positions in securities and other investment instruments, but also its cash holdings and holdings that are not securities or assets, including short positions in securities and written options. Specifically, an ETF must disclose the following information on a daily basis:[27] (1) ticker symbol; (2) CUSIP or other identifier; (3) description of holding; (4) quantity of each security or other asset held; and (5) percentage weight of the holding in the portfolio.[28] The SEC noted that "[to] indicate the quantity of a security or other asset held, the ETF generally should use the measure typically associated with quantifying that class of security, such as the number of shares for equity securities, par value for debt securities, number of units for securities, such as UITs, that are measured in units, and dollar value for cash."[29] The SEC also clarified that descriptions of derivatives should "provide both the notional value of the derivative and number of contracts, as well as a general description of the investment, which should include the type of derivative (i.e., swap, option, forward)."[30]

Additionally, ETFs relying on the ETF Rule must also include on their websites certain additional information regarding premiums and discounts. The website must include, for the most recently completed calendar year and the most recently completed calendar quarters of the current year: (i) a table showing the number of days the ETF's shares traded at a premium or discount and (ii) a line graph showing the ETF's premiums and discounts. For any ETF whose premium or discount was greater than 2% for more than seven consecutive trading days, the website must include a statement of this

[24] Rule 6c-11(a)(1) defines "market price" to mean: (i) the official closing price of an ETF share; or (ii) if it more accurately reflects the market value of an ETF share at the time as of which the ETF calculates current NAV per share, the price that is the midpoint of the national best bid and national best offer ("NBBO"), calculated as of the time NAV per share is calculated. The SEC noted its continued belief that using the "official closing price" provides a more precise measurement of an ETF's market price than other alternatives, including during disruptive market events. *See* ETF Release at 100.

[25] This requirement was modified from the proposed rule in three ways. The ETF Rule requires that the ETF post the bid-ask spread on its website, rather than both on its website and in the prospectus. The look-back period was significantly shortened from the most recent fiscal year to a 30-day period, and the rule now requires that an ETF use the NBBO in calculating the bid-ask spread. *See* ETF Release at 111–12. An ETF that does not rely on the ETF Rule may choose whether to post this information on its website or in its prospectus. ETFs not relying on the ETF Rule that decide to post bid-ask spread information in a prospectus only must calculate the bid-ask spread from the ETF's most recent fiscal year. *See* Form N-1A Item 6(c)(5).

[26] Rule 6c-11(a)(1).

[27] In response to commenters who were concerned about the burden of presenting this information in a manner prescribed within Article 12 of Regulation S-X, the SEC relaxed this proposed requirement.

[28] Rule 6c-11(c)(1)(i)(A)–(E).

[29] ETF Release at 77–78.

[30] *Id.* at 78.

fact and a discussion of the factors that the ETF believes materially contributed to this effect. This disclosure and discussion must be maintained on the website for at least one year thereafter.[31]

III. More Flexibility in Establishing Creation Unit Baskets

Most ETFs implement creations and redemptions primarily on an "in-kind" basis. As a result, an authorized participant that purchases a creation unit from the ETF will deposit with the ETF a "basket" of securities and other assets, and an authorized participant that redeems a creation unit will receive a basket of securities and other assets from the ETF. The exemptive orders issued by the SEC generally placed restrictions on basket composition, often requiring ETFs to establish baskets that were representative of the holdings of the ETF or that reflected a pro rata slice of the ETF's portfolio. Since 2006, for example, ETF exemptive applications generally were required to represent that an ETF's creation basket would correspond pro rata to the ETF's portfolio holdings, while identifying certain limited circumstances under which the ETF may use a non-pro rata basket. Additionally, creation baskets and redemption baskets generally were required to be identical unless the ETF was rebalancing.[32] Certain earlier applications, however, included few explicit representations regarding restrictions on baskets and thereby granted flexibility to the ETFs relying on those orders to vary the baskets and have baskets represent holdings other than a pro rata slice of the ETF's overall portfolio.[33] As mentioned, the current exemptive orders will be rescinded by the ETF Rule, and all ETFs covered by the ETF Rule will be subject to the same requirements applicable to baskets going forward.

a. Daily Basket Procedures

The basket conditions were adopted as proposed, which require all ETFs relying on the ETF Rule to adopt written policies and procedures governing the construction and acceptance of baskets. This requirement is intended to provide a consistent framework for the operation of ETFs. The SEC indicated that the basket policies and procedures should contain a significant amount of detail, including:

- the methodology that the ETF will use to construct baskets;
- the circumstances under which the basket may omit positions that are not operationally feasible to transfer in kind;

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[31] The SEC indicated that it believes that this information is not only helpful to investors in making investment decisions, but also to the SEC in assessing the efficiency of an ETF's arbitrage mechanism. *See id.* at 104, n.356. The SEC rejected the commenters' suggestions that a discussion of the factors would be too difficult for firms to accurately report, or that the time an ETF is required to maintain the disclosure on its website should be shortened (e.g., to 45 days instead of one year). *See id.* at 106–07.

[32] *See Exchange-Traded Funds*, Investment Company Act Release No. 33,140 (June 28, 2018) at 90 (the "Proposing Release"), available here.

[33] *See id.*

- when the ETF would use representative sampling of its portfolio to create its basket, and how the ETF would sample in those circumstances; and
- how the ETF would replicate changes in the ETF's portfolio holdings as a result of the rebalancing or reconstitution of the ETF's securities market index, if applicable.[34]

b. Custom Basket Procedures

Significantly, the ETF Rule permits all ETFs relying on the ETF Rule to use "custom baskets," which are defined as baskets that: (i) do not reflect a pro rata representation of an ETF's portfolio or (ii) differ from the initial basket used in transactions on the same business day.[35] The SEC acknowledged the benefits to ETFs and their shareholders of custom baskets, which market participants have long asserted help ETFs operate more efficiently by potentially reducing transaction costs, creating tax efficiencies, facilitating narrower bid-ask spreads and permitting the ETF to retain securities and other assets that the ETF wishes to continue to hold.[36] The SEC expressed concern, however, that the use of custom baskets presents a "risk that an authorized participant could take advantage of its relationship with the ETF and pressure the ETF to construct a basket that favors an authorized participant to the detriment of the ETF's shareholders."[37]

In seeking to address this concern, the use of custom baskets under the ETF Rule is subject to specified compliance and recordkeeping requirements. To use a custom basket, an ETF must have basket policies and procedures that set out "detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the [ETF] and its shareholders."[38] The policies must also specify "the titles or roles of the employees . . . who are required to review each custom basket for compliance with [the procedures]."[39] The SEC explained that custom basket procedures should include "the process for any revisions to, or deviations from, those parameters"[40] and should be appropriately tailored to reflect particular compliance risks.[41]

The SEC noted that the "ETF's adviser (and personnel) are familiar with the ETF's portfolio holdings and are able to assess whether the process and methodology used to construct or accept a custom basket is in the best interests of the ETF and its shareholders and whether a particular custom basket complies with the parameters set forth in the custom

[34] *See* ETF Release at 86.

[35] For example, if an ETF substitutes cash in lieu of a portion of basket assets for a single authorized participant, that basket would be a custom basket. *See id.* at 91.

[36] *See id.* at 81–83.

[37] *Id.* at 82. The SEC noted that the use of custom baskets, for example, could give authorized participants more opportunities for cherry-picking, dumping or other abuses, including the potential for manipulative trading in the underlying portfolio securities. *Id.*

[38] Rule 6c-11(c)(3)(i).

[39] Rule 6c-11(c)(3)(ii).

[40] ETF Release at 86.

[41] *Id.* at 91.

basket policies and procedures."[42] The SEC went on to note that an ETF's adviser could determine that its portfolio management employees are the appropriate employees to be responsible for compliance with custom basket procedures. The SEC also clarified that the procedures should be part of an ETF's compliance program adopted pursuant to Rule 38a-1 under the 1940 Act.[43]

c. Records Relating to Baskets

The ETF Rule requires an ETF to maintain various records relating to its baskets, including:

- ticker symbol, CUSIP or other identifier, description of holding, quantity of each holding, and percentage weight of each holding comprising the basket exchanged for creation units;[44]
- if applicable, identification of the basket as a custom basket and a record stating that the custom basket complies with the ETF's policies and procedures;
- the cash balancing amount, if any; and
- the identity of the authorized participant transacting with the ETF.[45]

These records are intended to allow the SEC staff to review an ETF's baskets as part of an examination.[46] The ETF Rule also requires an ETF to maintain all written agreements between an authorized participant and the ETF (or one of the ETF's service providers) that allows the authorized participant to place orders for the purchase or redemption of creation units.[47]

IV. Other Significant Aspects of the ETF Rule

a. Elimination of Intraday Indicative Value

The SEC noted that exchange listing standards include a requirement that an intraday estimate of an ETF's NAV per share ("IIV") be widely disseminated at least every 15 seconds (every 60 seconds for international ETFs) during regular trading hours and that the existing ETF exemptive orders contain a similar requirement. In response to comments,

[42] *Id.* at 90.
[43] *Id.*
[44] This recordkeeping requirement represents an increase in the amount of information that must be recorded and retained relative to the level of detail the original proposal would have required. The proposed rule only required that the records indicate the name and quantities of each position. *See id.* at 120.
[45] Rule 6c-11(d)(2).
[46] *See* ETF Release at 120.
[47] Rule 6c-11(d)(1).

however, the ETF Rule does not require that an IIV be disseminated as a condition for reliance on the ETF Rule. It is unclear whether the securities exchanges will amend their listing rules to remove the requirement that IIVs be disseminated.

b. Suspensions of Creations and Redemptions and 2% Limit on Redemption Fees

ETFs may suspend the issuance of creation units "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 of time."[48] The SEC explained that "a suspension of creations impairs the arbitrage mechanism, [and] could lead to significant deviations between what retail investors pay (or receive) in the secondary market and the ETF's approximate NAV."[49] The SEC cautioned that "[s]uch a result would run counter to the basis for relief from [S]ection 22(d) and [R]ule 22c-1 and therefore would be inconsistent with [the ETF Rule]."[50] ETFs may suspend the redemption of creation units only in accordance with Section 22(e)[51] of the 1940 Act, which the SEC staff has historically interpreted narrowly. ETFs may charge transaction fees on the redemption of creation units only in accordance with Rule 22c-2 under the 1940 Act, which imposes a 2% limit on redemption fees.[52]

c. No Further Relief for Affiliated Authorized Participants

Sections 17(a)(1) and (a)(2) of the 1940 Act generally prohibit principal transactions between an affiliated person of an ETF, or an affiliated person of such person, and the ETF. The ETF Rule provides exemptions from Sections 17(a)(1) and (a)(2) of the 1940 Act to permit the deposit (and receipt) of baskets to (and from) a person who is an affiliated person of an ETF (or who is an affiliated person of such a person) *solely by reason of (i) "holding with the power to vote* 5% or more of the [ETF's] shares"; or (ii) "*holding with the power to vote* 5% or more of any investment company that is an affiliated person of the [ETF]."[53] Some commenters requested that the SEC expand this relief to cover additional types of affiliated relationships that arise other than through share ownership, such as for broker-dealers that are affiliated with the ETF's adviser. The SEC declined to adopt expanded relief, noting that any expansion would represent "novel" relief inappropriate within the context of the current ETF Rule, but the SEC stated that an application to expand such relief may be considered in the SEC's regular exemptive applications process.[54]

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[48] *See* ETF Release at 58–59.

[49] *Id.* at 59.

[50] *Id.*

[51] Section 22(e) of the 1940 Act generally prohibits a registered open-end management investment company from postponing the date of satisfaction of redemption requests for more than seven days after the tender of a security for redemption.

[52] *See id.* at 58.

[53] Rule 6c-11(b)(3) (emphasis added). Compare Section 2(a)(3)(A)'s definition of affiliated person: "[A]ny person directly or indirectly *owning, controlling, or holding with power to vote*, 5 per centum or more of the outstanding voting securities of such other person" (emphasis added).

[54] *See* ETF Release at 46.

d. Relief from Section 22(e) for up to 15 Days

The SEC has historically granted exemptive relief under Section 22(e) of the 1940 Act to allow ETFs that hold foreign investments[55] and redeem creation units on an in-kind basis to delay the satisfaction of redemption proceeds in excess of seven days to accommodate local market holidays and foreign securities settlement cycles. The ETF Rule grants similar relief from Section 22(e) of up to 15 days if a local market holiday, or series of consecutive holidays, or the extended delivery cycles for transferring foreign investments to redeeming authorized participants, prevent the timely delivery of the foreign investment included in the ETF's basket.

As proposed, the ETF Rule would have included a 10-year expiration of relief from Section 22(e). The SEC had stated that "in light of the continued movement toward shorter settlement times in markets around the world,"[56] such relief would not be needed in the future. Commenters, however, questioned this conclusion, and the SEC ultimately agreed that because these developments may be gradual and difficult to predict, Section 22(e) relief may still be needed at that time. Accordingly, there is no "sunset" provision included in this relief.

e. Absence of Certain Common ETF Representations

The ETF Rule does not impose conditions equivalent to certain representations that were often included in ETF exemptive applications. Applications relating to index ETFs, for example, often included a representation that an ETF would invest at least 80% of its assets, exclusive of collateral held from securities lending, in the component securities of its underlying index.[57] The absence of such a requirement should allow more flexibility for index ETFs to obtain exposure to the underlying index consistent with investment strategies used by traditional index mutual funds.[58] Further, ETF exemptive applications often stated that the ETF would establish a minimum creation unit size (i.e., a minimum number of shares that would constitute a creation unit).[59] The ETF Rule does not require a particular minimum or maximum creation unit size or otherwise place requirements on creation unit size, and the SEC stated that ETFs are incentivized to establish creation unit sizes that are appropriate for market demand pursuant to their investment strategies and objectives.[60]

[55] The ETF Rule defines a foreign investment as an investment that is "traded on a trading market outside of the U.S." The SEC eliminated the requirement from the proposed rule that the foreign investment have "no established U.S. public trading market." *See id.* at 51.

[56] *See id.* at 48.

[57] *See* Proposing Release at 27.

[58] Index ETFs will still be subject to applicable requirements of Rule 35d-1 under the 1940 Act and related guidance with respect to the percentage of assets associated with the name of the ETF. *See, e.g.*, Investment Company Names, Investment Company Act Release No. 24,828 (Jan. 17, 2001) ("Index funds, for example, generally would be expected to invest more than 80% of their assets in investments connoted by the applicable index.").

[59] *See* Proposing Release at 64.

[60] *See* ETF Release at 55.

Certain ETF exemptive applications also represented that an order to purchase creation units or an order to redeem creation units must be received by a specified time (i.e., order cut-off time). The ETF Rule does not require a specified order cut-off time.

V. Rescission of Existing Exemptive Relief

As indicated above, one key purpose of the ETF Rule is to create a consistent, transparent and efficient ETF regulatory scheme. To achieve this goal, the SEC will rescind the exemptive relief issued to ETFs permitted to rely on the ETF Rule. The SEC's rescission, however, is limited to the portions of an ETF's exemptive order that relate to the formation and operation of the ETF. With the exception of certain master-feeder relief,[61] the ETF Rule does not rescind the relief from Section 12(d)(1) and Sections 17(a)(1) and (a)(2) of the 1940 Act related to fund-of-funds arrangements involving ETFs[62] and also does not rescind stand-alone exemptive orders, unrelated to ETF operations, granted to permit investments in ETFs beyond the limits in Section 12(d)(1) of the 1940 Act.[63] With respect to master-feeder relief, given the perceived lack of interest in master-feeder arrangements involving ETFs and an expressed concern around a certain type of master-feeder structure,[64] the SEC will rescind the master-feeder relief granted to ETFs that did not rely on the relief as of June 28, 2018. The SEC will grandfather existing master-feeder arrangements involving ETF feeder funds, but preclude the formation of new ones.[65]

The ETF Rule provides for a one-year transition period to allow ETFs to adjust and bring their operations into conformity with the ETF Rule. To ensure a consistent transition period for all ETFs, the SEC has amended the approximately 200 exemptive orders that provide for the automatic expiration of these orders on the effective date of any ETF rule by delaying the expiration until December 23, 2020. As stated above, the SEC will continue allowing ETFs organized as UITs, ETFs organized as a share class of a multi-class fund, leveraged or inverse ETFs, and non-transparent ETFs to operate under their existing exemptive orders.

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[61] The SEC has granted master-feeder exemptive relief to allow a feeder ETF to rely on Section 12(d)(1)(E) of the 1940 Act and also provided the feeder ETF and its master fund with relief from Sections 17(a)(1) and 17(a)(2) of the 1940 Act with regard to the deposit by the feeder ETF with the master fund and the receipt by the feeder ETF from the master fund of basket assets in connection with the issuance or redemption of creation units. *See* Proposing Release at 139–40.

[62] *See* ETF Release at 131. The fund-of-funds exemptive relief permits other registered investment companies to acquire shares of an ETF beyond the limits of Section 12(d)(1)(A). The fund-of-funds exemptive relief also permits an ETF to sell its shares to, and redeem its shares from, a fund-of-funds that owns five percent or more of the ETF's shares.

[63] *Id.*

[64] The SEC stated that if an ETF feeder fund transacts with a master fund on an in-kind basis, but a non-ETF feeder fund transacts with the master fund on a cash basis, all feeder fund shareholders would bear costs associated with cash transactions. *See id.* at 126.

[65] *See id.* at 129.

VI. Relief From Exchange Act Provisions

ETFs in the past have had to request relief from certain provisions of the Exchange Act and its rules in order to be able to operate. Under the ETF Rule, that relief is no longer required because shares of ETFs operating as registered open-end management companies or UITs are expressly considered “redeemable securities” within the meaning of Section 2(a)(32) of the 1940 Act. As a result, these ETF shares are excepted securities as defined in Rule 101(c)(4) and Rule 102(d)(4) of Regulation M and Rule 10b-17(c) under the Exchange Act, and ETFs are eligible to rely on the relief from Section 11(d)(1) of the Exchange Act provided to registered open-end funds by Rule 11d1-2.[66]

In addition, ETFs typically have requested relief from other provisions of the Exchange Act and its underlying rules in order to facilitate financing of ETF shares, creations and redemptions, and secondary market transactions by broker-dealers (i.e., Section 11(d)(1) and Rules 10b-10, 15c1-5, 15c1-6, and 14e-5). When the ETF Rule was proposed, the SEC requested comments on whether it should provide relief from these provisions. Commenters were generally in favor of granting such relief on a broad basis. In response, the SEC issued the Exchange Act Exemptive Order[67] granting conditional exemptive relief from compliance with Section 11(d)(1) of the Exchange Act and Rules 10b-10, 15c1-5, 15c1-6 and 14e-5 under the Exchange Act. Although the characterization of ETFs as “redeemable securities” and the related ability to rely on exemptions contained in Regulation M, Rule 10b-17 and Rule 11d1-2 apply to all ETFs operating under the 1940 Act as open-end management investment companies, the conditional exemptive relief granted under the Exchange Act Exemptive Order is available only with respect to transactions involving securities of an ETF relying on the ETF Rule. The Exchange Act Exemptive Order imposes substantially all of the conditions applicable to ETFs under the prior custom or class relief, including without limitation, with respect to Section 11(d)(1), the requirement that the broker-dealer extending, maintaining or arranging for the extension of credit on ETF shares not have received, directly or indirectly through affiliates, compensation to promote or sell the ETF shares.[68] The relief is available for both index and transparent actively managed ETFs and without regard to the number of ETF shares constituting an ETF creation unit or the value of those creation and redemption baskets.[69] Except with respect to Rule 14e-5, the relief granted in the Exchange Act Exemptive Order is only available to transactions involving an ETF that meets the diversification requirements in Internal Revenue Code Section 851(b)(3)(B).[70]

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[66] *See supra* note 9.

[67] *See supra* note 10. The SEC did not, however, address the exchange listing process under Rule 19b-4 of the Exchange Act.

[68] *See* Exchange Act Exemptive Order at 7.

[69] *See id.* at 9.

[70] Internal Revenue Code Section 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, 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)).”

The SEC declined to provide an exemption from the reporting and other requirements of Section 13(d) and Section 16 of the Exchange Act.[71] The SEC stated that expanding such relief beyond that provided in the Section 13/16 ETF Letters would be inconsistent with the ETF Rule because the exemptions under the ETF Rule are "based on the existence of a close tie between market price and NAV per share."[72] As a result, holders of more than 5% of the outstanding shares of an ETF, executive officers and directors of the ETF, and holders of more than 10% of the outstanding shares of an ETF, must continue to assess reliance on the existing Section 13/16 ETF Letters.

VII. Amendments to SEC Forms

The SEC adopted several amendments to Form N-1A and Form N-8B-2 that are designed to provide investors with additional information regarding ETF trading and associated costs. The SEC adopted the following changes:

- Adding 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*);

- Requiring narrative disclosures identifying specific costs associated with buying and selling ETF shares, including bid-ask spreads,[73] and directing investors to the ETF's website for additional information (*Item 6*);[74]

- Requiring ETFs that do not rely on the ETF Rule to disclose median bid-ask spread information on their website or in their prospectus (*Item 6*);

- Excluding ETFs that provide premium and discount disclosures in accordance with the ETF Rule from the premium and discount disclosure requirements in Form N-1A (*Items 11 and 27*); and

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[71] Certain SEC staff no-action letters stated that the staff would not recommend enforcement action to the SEC if certain insiders and large shareholders of ETFs seeking to track the performance of a benchmark index through a replication strategy did not file reports under Section 13(d) and Section 16(a) based on certain facts and circumstances, including that there is no material deviation between an ETF's secondary market price and NAV. *See* ETF Release at 38 (citing PDR Services Corporation, SEC Staff No-Action Letter (pub. avail. Dec. 14, 1998); Select Sector SPDR Trust, SEC Staff No-Action Letter (pub. avail. May 6, 1999)) (together, the "Section 13/16 ETF Letters"). The SEC refrained from exempting insiders and large shareholders from these reporting requirements beyond the conditions in these no-action letters. *See id.*

[72] *Id. See supra* note 71.

[73] For example, an ETF must disclose that buying and selling ETF shares are subject to trading costs and that these costs affect returns. The proposal would have required disclosure of similar information, but in a Q&A format, rather than, as adopted, a narrative format. *See* ETF Release at 137. Amended Item 6 of Form N-1A requires an ETF to state that an investor may incur costs attributable to the difference between the highest price a buyer is willing to pay to purchase shares of the ETF (bid) and the lowest price a seller is willing to accept for shares of the ETF (ask) when buying ETF shares in the secondary market. *See id.* at 115.

[74] The SEC declined to adopt the bid-ask spread online interactive calculator because of concerns that it would "overemphasize those costs and thereby obscure the effect of other costs of investing in ETFs." *Id.* at 114.

- Eliminating disclosures relating to creation unit size and disclosures applying to ETFs with creation unit sizes of less than 25,000 shares (*Items 3, 6, 11 and 27*).[75]

The SEC sought to apply the same or similar disclosure requirements regarding ETF trading and associated costs to all ETFs, including those not relying on the ETF Rule. Therefore, ETFs that do not rely on the ETF Rule are subject to the requirements in Items 3, 6, 11 and 27 of Form N-1A described above. Specifically, ETFs not relying on the ETF Rule are required to provide the median bid-ask spread information in their prospectus, or they have the option of complying with the bid-ask spread website disclosure requirements in the ETF Rule.[76] Regarding premium and discount disclosures under Items 11 and 27, ETFs not relying on the ETF Rule are required to include premium and discount information in both the prospectus and annual report, unless they provide this information on their respective websites in accordance with the ETF Rule's requirements.[77]

The SEC also amended Form N-8B-2, applicable to UITs, to mirror several changes to the disclosure requirements in Form N-1A so that investors will receive consistent disclosure for all ETFs. Form N-CEN has also been amended to collect information on which ETFs are relying on the ETF Rule, as well as changing the definition of "authorized participant" in Form N-CEN to conform to the definition in the ETF Rule.

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The ETF Rule, together with the Exchange Act Exemptive Relief, reflect the substantial efforts of the SEC and its staff to modernize and simplify the regulatory framework applicable to ETFs. In seeking to create a consistent set of requirements for all ETFs covered by the ETF Rule and the Exchange Act Exemptive Relief, the SEC has acknowledged that after 27 years of operations, the types of ETFs covered by the ETF Rule are a mainstream investment product and no longer require individualized exemptive relief.

[75] *See id.* at 133–34.

[76] Form N-1A Item 6 Instruction 1.

[77] Form N-1A Item 11(g)(2); Item 27(b)(7)(iv).

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