WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

SEC Proposes New ETF Rule

July 24, 2018

AUTHORS

Margery K. Neale | Barry P. Barbash | Benjamin J. Haskin | Jay Spinola
P. Georgia Bullitt | Anne C. Choe

On June 28, 2018, the Securities and Exchange Commission (the "SEC") voted unanimously to re-propose a rule that would permit open-end management investment companies to operate as exchange-traded funds ("ETFs") under the Investment Company Act of 1940 (the "1940 Act") without first obtaining an exemptive order from the SEC.[1] Proposed Rule 6c-11 ("Rule 6c-11" or the "Proposed Rule"), if adopted, would for the most part eliminate the "eclectic regulatory quilt"[2] of over 300 exemptive orders granted since 1992 to permit the operation of ETFs, and generally replace the variations in the regulatory structure for ETFs with a single set of requirements that would cover the operation of both index-based and transparent actively managed ETFs. According to the SEC, the Proposed Rule, which was highly anticipated by the fund industry, and the related form amendments are "designed to create a consistent, transparent, and efficient regulatory framework for ETFs and to facilitate greater competition and innovation among ETFs."[3]

[1] *Exchange-Traded Funds*, Investment Company Act Release No. 33,140 (June 28, 2018) ("Proposing Release"), available at https://www.sec.gov/rules/proposed/2018/33-10515.pdf. The SEC originally proposed a rule to govern the operation of ETFs in 2008. *Exchange-Traded Funds*, Investment Company Act Release No. 28,193 (Mar. 11, 2008). The new proposal includes significant changes from the prior proposal, including the addition of custom basket policies and procedures and the omission of proposed Rule 12d1-4, which would have provided relief for certain registered investment companies to invest in ETFs subject to the rule beyond the limits of Section 12(d)(1) of the 1940 Act.

[2] SEC Commissioner Kara M. Stein, *Statement at Open Meeting on the Proposed Rule 6c-11 under the Investment Company Act of 1940 Governing Exchange-Traded Funds* (June 28, 2018), available at https://www.sec.gov/news/public-statement/statement-stein-exchange-traded-funds-062818.

[3] *See* Proposing Release at 1.

Underlying the Proposed Rule is the hybrid product design of ETFs,[4] 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 those issued by a mutual fund, but similar to those issued by a closed-end fund, shares of an ETF are listed for trading on a national securities exchange and can be bought or sold throughout the day in the secondary market by investors at a market-determined price. Because the 1940 Act does not contemplate this type of hybrid fund, ETFs have been required to seek exemption from certain provisions of the 1940 Act to operate as designed. The SEC has historically provided this exemptive relief on an individualized basis. The Proposed Rule would change the form of exemptive relief from individualized to a self-executing rule on which eligible ETFs could rely.

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

- **Full Transparency** – All ETFs, including those that seek to track a third-party index and that have not been subject to this requirement, would need to disclose on their websites all of the portfolio holdings that will form the basis of the next calculation of the ETFs' net asset value ("NAV") per share. An ETF would be required to maintain a website that is publicly available, free of charge, and that discloses certain specified information.

- **Custom Basket Policies and Procedures** – An ETF would be permitted to 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 other baskets 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."[5]

- **Amendments to Form N-1A** – Several disclosure amendments are being proposed 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.[6]

---

[4] References to "ETFs" do not include pooled investment vehicles that trade on national securities exchanges but are not registered with the SEC under the 1940 Act.

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

[6] The SEC has also proposed amendments to Form N-8B-2, which is the registration statement form applicable to ETFs organized as unit investment trusts. The Proposed Rule is not otherwise applicable to unit investment trusts.

- **Rescission of Existing Exemptive Relief** – The SEC is proposing to rescind the exemptive relief to operate as an ETF previously granted to an ETF eligible to rely on the Proposed Rule. The SEC is not, however, proposing to rescind the exemptive relief from Section 12(d)(1) of the 1940 Act that it has granted to ETFs permitting other registered investment companies to invest beyond certain regulatory limits in the ETFs. As a result, the Proposed Rule and related amendments do not extend the existing Section 12(d)(1) exemptive relief to permit private funds[7] to invest in ETFs in excess of the applicable Section 12(d)(1) limit.

- **ETFs Included in the Proposed Rule** – The Proposed Rule would be available to index ETFs that use a third-party or affiliated index provider, as well as transparent actively managed ETFs.

- **ETFs Excluded from the Proposed Rule** – Rule 6c-11, as proposed, would not be available to (i) ETFs organized as unit investment trusts; (ii) leveraged[8] or inverse ETFs; and (iii) ETFs structured as a share class of a multi-class fund.[9] 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.

Aspects of the Proposed Rule are accompanied by extensive requests for comment. Comments on the Proposed Rule are due on or before 60 days after publication of the re-proposal in the Federal Register.

I. Availability of the Proposed Rule

Rule 6c-11 would be 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 in exchange for a basket[10] of securities, assets or other positions and a cash balancing amount (if any); and

---

[7] Private funds are companies that rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act for an exclusion from the definition of "investment company" under the 1940 Act.

[8] Leveraged ETFs seek to provide returns that exceed, by a specified multiple, a market index or to provide returns that are inverse to the performance of a market index, over a fixed period of time. The SEC expresses concerns in the Proposing Release about the daily or other periodic reset of a leveraged ETF's portfolio and the effects of compounding returns that occur with leveraged ETFs. *See* Proposing Release at 31.

[9] 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* Proposing Release at 138.

[10] The Proposed 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." The scope of the definition of basket would permit ETFs that transact on an in-kind basis, cash basis, or both.

(ii) issues shares that are listed on a national securities exchange and traded at market-determined prices.[11]

A. *Index-Based ETFs and Actively Managed ETFs*

The Proposed Rule would be available to ETFs that seek returns that correspond to the returns of an index (*i.e.*, index ETFs) and also to actively managed ETFs, eliminating the distinction that the SEC has historically made with respect to these two types of ETFs. The SEC notes in describing the Proposed Rule that based on its observations of how actively managed ETFs operate, it has not identified any operational issues that suggest additional conditions for actively managed ETFs are warranted.[12] Also, the SEC has historically differentiated between index ETFs that use an affiliated index provider (*i.e.*, self-indexed ETFs) and ETFs that use a third-party index provider. The Proposed Rule does not make this distinction, and the SEC requests comment on whether self-indexed ETFs should be required to adopt additional policies and procedures designed to further limit information sharing between portfolio management staff and index management staff.[13]

B. *Other Differences from Current ETF Exemptive Orders*

The Proposed Rule does not contain certain elements that are included in current ETF exemptive orders. Index ETF exemptive orders, for example, often include 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.[14] The Proposed Rule does not require this representation, which should allow more flexibility for index ETFs to provide exposure to the underlying index consistent with investment strategies used by traditional index mutual funds.[15] As another example, ETF exemptive applications often state that the ETF would establish a specific creation unit size (*i.e.*, a minimum number of shares).[16] The Proposed Rule does not require a particular minimum or maximum creation unit size, which appears to reflect the SEC's acknowledgement that creation unit aggregations may differ among ETFs based on an ETF's investment

---

[11] The Proposing Release notes that this requirement "is not designed to establish a minimum level of trading volume for ETFs necessary in order to rely on the rule, but rather to distinguish ETFs from other products that are listed on exchanges, but trade at NAV-based prices (*i.e.*, exchange traded managed funds)." Proposing Release at 70-71.

[12] *See* Proposing Release at 25.

[13] *See* Proposing Release at 28.

[14] *See* Proposing Release at 27.

[15] Index ETFs would still be subject to the "Names Rule" requirements related to the percentage of assets associated with the name of the ETF. *See* 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.").

[16] *See* Proposing Release at 64.

strategy, the type and availability of the assets in the basket and the types of authorized participants.[17] Certain ETF exemptive applications also state 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 Proposed Rule does not require a specified order cut-off time for an ETF.

II. Portfolio Transparency

In describing the Proposing Rule, the SEC notes that since the issuance of the first ETF exemptive order, it 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."[18] The SEC continues to believe that daily portfolio transparency is an appropriate mechanism to facilitate the arbitrage process as it "provides authorized participants and other market participants with an important tool to facilitate valuing the ETF's portfolio on an intraday basis, which, in turn, would enable them to assess whether arbitrage opportunities exist."[19] Reflecting this belief, the Proposed Rule would require portfolio transparency through website disclosure.

To rely on Rule 6c-11, an ETF must disclose prominently on its website (which must be publicly available, free of charge) the portfolio holdings that will form the basis for the next calculation of NAV per share.[20] This disclosure must be made each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting orders for the purchase or redemption of creation units for that day.[21] The Proposed Rule defines "portfolio holdings" to mean "the securities, assets or other positions held by the [ETF]."[22] As a result, an ETF would be 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 options.[23]

---

[17] *Id.*

[18] Proposing Release at 76.

[19] Proposing Release at 76.

[20] Rule 6c-11(c)(1)(i)(A). Full transparency would be a change from certain index-based ETF relief that permitted disclosure of the constituents of the underlying index rather than 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* Proposing Release at 77.

[21] As noted in the Proposing Release, the Proposed Rule would require the portfolio holdings that form the basis for the ETF's NAV calculation to be the ETF's portfolio holdings as of the close of business on the prior business day. As a result, changes in the ETF's holdings would be reflected on a T+1 basis.

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

[23] *See* Section V.A. below for the website disclosure requirements under the Proposed Rule.

III. Creation Unit Baskets

Most ETFs carry out creations and redemptions on a "in-kind" basis. As a result, an authorized participant[24] that purchases a creation unit from the ETF deposits with the ETF a "basket" of securities and other assets, and an authorized participant that redeems a creation unit receives a basket of securities and other assets from the ETF. Historically, the SEC has placed restrictions on this process and has generally required ETFs to establish baskets that are representative of the holdings of the ETF or that reflect a *pro rata* slice of the ETF's portfolio. Since 2006, for example, the SEC has generally expressly required that an ETF's creation basket correspond *pro rata* to the ETF's portfolio holdings, identifying certain limited circumstances under which the ETF may use a non-*pro rata* basket, and for creation baskets and redemption baskets generally to be identical unless the ETF is rebalancing.[25] Certain earlier orders, however, included few explicit restrictions on baskets.[26] As stated above, the current exemptive orders would be rescinded by the Proposed Rule and all ETFs would be subject to the same requirements applicable to baskets.

A. *Basket Procedures*

All ETFs relying on the Proposed Rule would be required 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 has indicated that the basket policies and procedures should contain a significant amount of detail, including:

- the methodology that the ETF would use to construct baskets;
- the circumstances when the basket may omit positions that are not operationally feasible to transfer in kind;
- 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.[27]

---

[24] The Proposed Rule defines an "authorized participant" as "a member or participant of a clearing agency registered with the [SEC], which 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).

[25] *See* Proposing Release at 90.

[26] *See Id.*

[27] *See* Proposing Release at 94-95.

B. *Custom Basket Procedures*

Significantly, the Proposed Rule would permit all ETFs relying on the Proposed Rule to use "custom baskets" (*i.e.*, baskets that do not reflect a *pro rata* representation of an ETF's portfolio or that differ from other baskets used in transactions on the same business day).[28] The SEC acknowledges 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.[29] The SEC expresses concern, however, that "the use of custom baskets presents an increased risk that the ETF may be subject to improper pressure by an authorized participant to create specific baskets that favor that authorized participant."[30] In seeking to address this concern, the SEC is proposing to impose heightened requirements on ETFs to allow the use of custom baskets. Specifically, 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."[31] 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]."[32]

C. *Records Relating to Baskets*

The Proposed Rule would require that an ETF maintain various records relating to its baskets, including:

- the names and quantities of the positions composing the basket exchanged for creation units;
- 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.[33]

---

[28] 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.

[29] *See* Proposing Release at 89-94.

[30] *See* Proposing Release at 96. The SEC notes 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.*

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

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

[33] Rule 6c-11(d)(2).

These records are intended to allow the SEC staff to review an ETF's baskets as part of an examination.[34] The Proposed Rule would also require an ETF to maintain all written agreements between an authorized participant and the ETF or one of its service providers that allows the authorized participant to place orders for the purchase or redemption of creation units.[35]

IV. Other Significant Elements of the Proposed Rule

A. *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 Proposed Rule would provide exemptions from Sections 17(a)(1) and (a)(2) 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]".[36] Under the Proposed Rule, the exemptions from the prohibitions of Sections 17(a)(1) and (a)(2) would not 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, although the SEC asks for comment on this aspect of the Proposed Rule.

B. *Relief from Section 22(e)*

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

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. The SEC has historically granted exemptive relief under Section 22(e) to allow ETFs that hold foreign investments and transact creation units on an in-kind basis to delay the satisfaction of redemption proceeds in excess of seven days to accommodate local market holiday and foreign securities settlement cycles. The Proposed Rule would grant 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.

---

[34] *See* Proposing Release at 222.

[35] Rule 6c-11(d)(1).

[36] 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).

2. *Sunset Provision*

The exemption from Section 22(e) would expire ten years after the Proposed Rule's effective date. Underlying this sunset provision is the SEC's view that technological innovation and changes in market infrastructures and operations will lead to further shortening of settlement cycles.[37]

C. *ETFs as Open-End Funds Under the 1940 Act and Relief from Provisions of the Securities Exchange Act of 1934*

In describing the Proposed Rule, the SEC clarifies that shares of an ETF relying on Rule 6c-11 would be "redeemable securities" within the meaning of Section 2(a)(32) of the 1940 Act. The effect of this clarification is to provide that an ETF operating in compliance with the conditions and requirements of the Proposed Rule would meet the definition of open-end company in the 1940 Act. ETFs operating in reliance on the Proposed Rule would thus be subject to the requirements of the 1940 Act and its rules applicable to open-end funds (except as exempted under the Proposed Rule) and not closed-end funds.[38] In addition, the SEC states that the rules under the Securities Exchange Act of 1934 (the "Exchange Act") that apply to redeemable securities issued by an open-end fund would apply to ETFs relying on the Proposed Rule. ETFs operating under the Proposed Rule therefore would be eligible for the "redeemable securities" exceptions in 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 or redemption of creation units.[39] Similarly, an ETF relying on the Proposed Rule would fall within the "registered open-end investment company" exemption in Rule 11d1-2 under the Exchange Act (relating to the extension of margin credit by broker-dealers).

ETFs typically request relief from certain other rules under the Exchange Act (*i.e.*, Section 11(d) and Rules 10b-10, 14e-5, 15c1-5 and 15c1-6), and the SEC requests comment on whether it should also provide relief from these provisions under the Exchange Act. The SEC did not specifically address the application of Section 13(d) and Section 16 of the Exchange Act to an ETF operating pursuant to the Proposed Rule.

D. *Elimination of Intraday Indicative Value*

The SEC notes 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 ETF exemptive orders contain a similar requirement. The SEC, however, is not proposing that

[37] *See* Proposing Release at 54-59.

[38] *See* Proposing Release at 38.

[39] *See* Proposing Release at 39.

an IIV be disseminated as a condition of the Proposed Rule. The SEC acknowledges that the IIV may not reflect the actual value of an ETF that holds securities that do not trade frequently and its belief that the IIV is no longer used by market participants when conducting arbitrage trading.[40]

E. *Suspensions of Creations*

In describing the Proposed Rule, the SEC includes discussion regarding the extent to which an ETF may directly or indirectly suspend the issuance and redemption of creation units. The SEC notes that suspensions of issuance or redemption of creation units indefinitely could cause a breakdown of the arbitrage mechanism, which could result in harm to the market and to investors. The SEC goes on to say significantly that ETFs may suspend redemption of creation units only in accordance with Section 22(e) of the Act (which the SEC staff has historically interpreted narrowly) and may suspend 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."[41]

V. Conditions to Proposed Rule 6c-11

The Proposed Rule would require an ETF seeking to rely on Rule 6c-11 to satisfy the following conditions.

A. *Website Disclosure Requirements*

The Proposed Rule mandates that the ETF disclose, every business day, prominently on its website:

- the ETF's current NAV per share, market price,[42] and premium or discount, each as of the end of the prior business day;
- before the opening of regular trading on the primary listing exchange of the ETF shares and before the ETF starts accepting orders for the purchase or redemption of creation units:
    - the portfolio holdings that will form the basis of the next calculation of current NAV per share;

[40] *See* Proposing Release at 73.

[41] *Id.* at 67.

[42] The Proposed Rule 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, calculated as of the time NAV per share is calculated. The SEC notes its belief that the official closing price is a better measure of an ETF's market price than the closing market price, particularly in situations where the last trade of the day was not reflective of the actual market price.

  - a basket applicable to orders for the purchase or redemption of creation units to be priced based on the next calculation of current NAV; and
  - the estimated cash balancing amount (if any);

- a table showing the number of days the ETF's shares traded at a premium or discount during the most recently completed calendar year and the most recently completed calendar quarters of the current year;
- a line graph showing the ETF's premiums and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year;
- for any ETF whose premium or discount was greater than 2% for more than seven consecutive trading days, information acknowledging that fact and a discussion of the factors that the ETF believes materially contributed to this effect (which must be maintained on the website for at least one year thereafter); and
- in a manner prescribed within Article 12 of Regulation S-X, the description, amount, value and unrealized gain/loss for each portfolio holding or basket asset required to be disclosed.

B. *Basket Procedures*

Under the Proposed Rule, an ETF must adopt and implement written policies and procedures that govern the construction of baskets and the process that will be used for the acceptance of baskets. An ETF that utilizes a custom basket must adopt enhanced procedures that (i) set out 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 (ii) specify the titles or roles of the employees of the ETF's investment adviser who are required to review each custom basket for compliance with those parameters.

C. *Additional Conditions*

In addition to the conditions described above with respect to website disclosure and basket construction, the Proposed Rule would impose the following conditions on ETFs operating under the Proposed Rule:

- the ETF must reflect changes in its portfolio holdings in the first calculation of NAV per share on the first business day following the trade date; and
- the ETF must not seek, directly or indirectly, to provide returns that exceed the performance of a market index by a specified multiple, or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time (*i.e.*, act as a leveraged ETF).

VI. Amendments to SEC Forms and Potential Alternatives

The SEC proposes to amend Form N-1A and Form N-8B-2 with respect to ETF-specific disclosure. The SEC is additionally seeking comment on whether it should create a completely new registration form that is specifically designed for ETFs.

The proposed amendments to Form N-1A include two changes to the Form's definitions: (i) adding the definition of "exchange-traded fund," as defined in the Proposed Rule; and (ii) removing the definition of "market price" in light of other proposed changes to Form N-1A that would make it unnecessary to include this definition. The proposed amendments to Form N-1A also include certain additional narrative disclosure to the Item 3 fee table, as well as a series of six "Q&As" that would require disclosure of certain ETF trading information and trading costs (*e.g.*, costs associated with trading ETF shares, median bid-ask spread information and how that affects a hypothetical investment of $10,000). An ETF would be required to include an interactive calculator on its website to calculate hypothetical cost-related information. The proposed amendments would also remove and simplify certain current ETF disclosure obligations by: (i) removing the requirement that an ETF disclose the number of shares it issues or redeems in exchange for the deposit or delivery of baskets (this requirement is duplicative of the information required in Form N-CEN); (ii) permitting all ETFs, not just those with creation unit sizes of not less than 25,000 shares, to omit the information required by Items 11(a)(2), (b), and (c) of Form N-1A; and (iii) removing information required by Item 11(g)(2) and Item 27(b)(7)(iv) (*i.e.*, a table of premium/discount information, which would be duplicative of the premium/discount information that would be available on the ETF's website under the Proposed Rule).

The proposed amendments to Form N-8B-2 mirror the proposed changes to the disclosure requirement in Form N-1A, Item 3, so that investors would receive consistent disclosure for all ETFs, including unit investment trusts. The proposed amendments to Form N-CEN include the addition of a requirement that an ETF must indicate whether it is relying on the Proposed Rule.

VII. Rescission of Existing Exemptive Relief

The evolution and growth of the ETF industry has resulted in changes to the SEC's approach to ETF regulation over time. The more than 300 exemptive orders that the SEC has issued represent a range of terms that at times may subject ETFs to different operational requirements. As indicated above, one key purpose behind the Proposed Rule is to create a consistent, transparent and efficient ETF regulatory scheme.

To achieve this goal, the SEC has proposed to amend and rescind the exemptive relief issued to ETFs that would be permitted to rely on the Proposed Rule. The SEC's proposed rescission, however, is limited to the portions of an ETF's

exemptive order that relate to the operation of the ETF. With the exception of certain master-feeder relief,[43] the Proposed Rule would 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[44] and would also not rescind standalone exemptive orders, unrelated to ETF operations, granted to permit investments in ETFs beyond the limits in Section 12(d)(1) of the 1940 Act.[45] 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,[46] the SEC is proposing to rescind the master-feeder relief granted to ETFs that do not rely on the relief as of June 28, 2018. The SEC is also proposing to grandfather existing master-feeder arrangements involving ETF feeder funds but preclude the formation of new ones.

In 2008, the SEC began including provisions in ETF exemptive orders stating that the relief permitting ETF operation would expire on the date, if and when, any rule permitting the operation of ETFs becomes effective. Approximately 200 of the more than 300 exemptive orders contain this clause, and those orders that do not, would be amended to include it. The effect of this action by the SEC would be to provide that all applicable exemptive orders would automatically expire, if the Proposed Rule is adopted, one year after the effective date of the Proposed Rule. The SEC proposes to allow upon the adoption of the Proposed Rule a one-year grace period to allow ETFs to adjust and bring their operations into conformity with the various requirements of the Proposed Rule.

As stated above, the SEC proposes to continue allowing ETFs organized as unit investment trusts, ETFs organized as a share class of a multi-class fund, and leveraged ETFs to operate under their existing exemptive orders.

* * * * *

The Proposed Rule reflects the substantial efforts of the SEC and its staff to modernize and simplify the regulatory framework applicable to ETFs. The Proposed Rule seeks to create a consistent set of requirements for all ETFs covered by the Proposed Rule, and acknowledges that after 26 years of operations, the types of ETFs covered by the Proposed Rule are a mainstream investment product and no longer require individualized exemptive relief.

---

[43] 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) 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.

[44] *See* Proposing Release at 143. 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 5 percent or more of the ETF's shares.

[45] *Id.*

[46] The SEC states 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* Proposing Release at 141.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

Margery K. Neale
212 728 8297
mneale@willkie.com

Barry P. Barbash
202 303 1201
bbarbash@willkie.com

Benjamin J. Haskin
202 303 1124
bhaskin@willkie.com

Jay Spinola
212 728 8970
jspinola@willkie.com

P. Georgia Bullitt
212 728 8250
gbullitt@willkie.com

Anne C. Choe
202 303 1285
achoe@willkie.com