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SEC Proposes Exchange-Traded Fund Rule

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The Securities and Exchange Commission (SEC) recently issued Proposed Rule 6c-11 under the Investment Company Act of 1940 (the “1940 Act”) and certain disclosure requirements (“Proposed ETF Rule”) that would codify the process for launching and operating many index-based and actively managed exchange-traded funds (ETFs). The Proposed ETF Rule applies to ETFs that are organized as open-end investment companies and would remove the requirement to obtain individual SEC exemptions. It would also establish uniform conditions for operating certain types of ETFs, including permitting custom creation and redemption baskets, as discussed below, and adding certain disclosure requirements. Other types of ETFs, like those formed as unit investment trusts or share classes of multiple-class funds and leveraged ETFs, would not be able to rely on the Proposed ETF Rule and would still need individual exemptive orders from the SEC before operating.

Compliance Period

The Proposed ETF Rule would amend and rescind prior ETF exemptive relief for ETFs that would be eligible to rely on the final rule. The Proposed ETF Rule release (“SEC Release”) notes that approximately two-thirds of existing ETF exemptive orders would expire immediately if the SEC adopts a final version of the rule. To provide ETFs relying on such relief with more time to transition to the new regulation, the SEC would allow eligible ETFs to rely on their existing ETF exemptive relief until one year after a final rule becomes effective. At that time, the SEC would revoke ETF exemptive relief for all funds eligible to rely on the Proposed ETF Rule—regardless of whether that relief contains an expiration provision.

Proposed ETF Rule

Overview of the Proposed ETF Rule

Many aspects of the Proposed ETF Rule are consistent with existing ETF exemptive relief. For example, open-end ETFs would still issue and redeem creation units exclusively with authorized participants (“APs”) and list their shares for sale on a national securities exchange. Current fund-of-fund exemptive relief issued to ETFs to allow other investment companies to invest in those ETFs in excess of the limits under the 1940 Act would also remain in place. However, the Proposed ETF Rule would differ in some important ways, which we summarize in the following table.

	Current ETF Exemptive Relief	Proposed ETF Rule
Creation and Redemption Basket Policies and Procedures/Custom Baskets	Require representations regarding construction of creation and redemption baskets. Only a minority of ETFs with older exemptive relief may exchange custom baskets with APs	All ETFs would need to adopt and implement written policies and procedures governing their basket construction and process for accepting baskets, and all ETFs would be permitted to exchange custom baskets if they adopt and implement certain written policies and procedures
Basket Composition Disclosure	No general requirement	All ETFs would disclose a single hypothetical creation/redemption basket each day, which may be a custom basket
Portfolio Transparency	No requirement for disclosure of ETF-specific trading information and trading costs	All ETFs would be required to disclose their portfolio holdings on a daily basis
Prospectus and Website Disclosure	No requirement for disclosure of ETF-specific trading information and trading costs	A new section in Item 3 of Form N-1A would require disclosure of certain ETF-specific trading information and costs in a required question and answer format
Master-Feeder Relief	ETFs with certain exemptive relief may operate in a master-feeder structure	With limited exceptions, ETFs would not be permitted to operate in a master-feeder structure

Below, we discuss some of these aspects of the Proposed ETF Rule in greater detail:

Creation and Redemption Basket Policies and Procedures/Custom Baskets

Since 2012, the SEC has generally required that the basket of securities that an ETF exchanges with an AP correspond *pro rata* to the ETF's portfolio holdings. Because some early ETF exemptive orders did not contain this *pro rata* basket requirement, some ETFs are able to exchange non-*pro rata* baskets of securities or different baskets on the same day ("custom baskets"), while others are not. One of the most significant features of the Proposed ETF Rule is that it would permit all ETFs relying on the Rule to use custom baskets, thereby levelling the playing field for all ETF sponsors.

The Proposed ETF Rule would require an ETF to adopt and implement written policies and procedures setting forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders as part of the ETF's compliance program, subjecting these procedures to oversight by an ETF's board and its chief compliance officer (CCO).

Uniform Treatment of Open-End ETFs

Under existing ETF exemptive relief, actively managed ETFs are subject to certain different regulatory requirements than indexed-based ETFs, and index-based ETFs with affiliated index providers are subject to certain different regulatory requirements than those with unaffiliated indexes. Under the Proposed ETF Rule, all open-end ETFs would be subject to the same operational and disclosure requirements.

For example, all ETFs under the Proposed ETF Rule would be required to publish the portfolio holdings that formed the basis of their net asset value calculation as of the close of the previous business day and the composition of a single hypothetical creation/redemption basket for that day, i.e., the basket of securities or other assets that the ETF would be willing to accept (which may be a custom basket). The portfolio holdings information would need to be presented in the manner currently required by ETF financial statements. Presently, index-based ETFs are not required to post daily portfolio information, although many do. ETFs do not currently post information regarding their creation/redemption basket on their website, nor is there any standardized format to that information.

Master-Feeder Relief

The Proposed ETF Rule would rescind existing master-feeder exemptive relief, which allows ETFs to operate in a master-feeder structure. The SEC's concern regarding these structures relates to the additional costs that might be borne by an ETF feeder fund if there are other non-ETF feeder funds. The SEC Release points out that, as of June 28, 2018, only one fund complex had established master-feeder structures involving ETFs. Under the Proposed ETF Rule, that complex would be permitted to continue relying on its master-feeder exemptive relief but barred from forming additional master-feeder ETFs and additional feeder funds.

Comment Period

The SEC has requested comment on or before October 1, 2018, on various aspects of the Proposed ETF Rule and ETF operations. Among others, the SEC has posed the following questions to commenters about the scope and conditions of the Proposed ETF Rule:

- Should the Proposed ETF Rule provide exemptive relief for ETFs organized as unit investment trusts?
- Does the structure and operation of leveraged ETFs warrant excluding them from a rule of general applicability related to the structure and operations of ETFs?
- Should the SEC establish requirements for creation unit sizes and/or dollar amounts?
- Are there operational differences between index-based and actively managed ETFs that should be addressed in Proposed ETF Rule?
- Should the Proposed ETF Rule include requirements relating to index-based ETFs with an affiliated index provider?
- Should the Proposed ETF Rule include other transparency options?
- To what extent would the proposed website disclosure requirements increase ETFs' costs or result in operational challenges?
- Is the proposed requirement that all ETFs adopt written policies and procedures governing basket construction appropriate? Are there alternatives the SEC should consider?
- Should the SEC allow ETFs to utilize baskets that deviate from a *pro rata* representation of the ETF's portfolio holdings but require ETFs to utilize the same basket for all transactions on a particular business day?
- Should the SEC provide additional guidance or include additional requirements in the rule regarding the elements of effective custom basket policies and procedures?
- Should the Proposed ETF Rule require the ETF's investment adviser to review the basket policies and procedures (including the custom basket policies and procedures) on an annual basis or with such frequency as the ETF's adviser deems reasonable and appropriate?
- Should the Proposed ETF Rule include board reporting requirements relating to custom basket policies and procedures?
- Should the SEC revoke some or all of the existing ETF exemptive relief? Would allowing existing exemptive relief to continue create an unequal playing field for ETF market participants?

Practice Points

The elimination of the need for most ETF sponsors to obtain individual SEC exemptive relief would reduce initial start-up costs. Further, the Proposed ETF Rule would standardize the conditions that all eligible ETFs would need to comply with. In particular, the custom basket relief provided by the Proposed ETF Rule would provide more flexibility for all eligible ETFs to operate. The custom basket relief would require additional policies and procedures surrounding the basket process and oversight at the Board and CCO levels. The SEC has been concerned for many years that APs could attempt to include inappropriate securities in custom creation and redemption baskets. Accordingly, these policies and procedures will need to be thoughtfully drafted and supervised to mitigate potential conflicts of interest involving investment advisers and APs that participate in the creation and redemption processes.

Investment Management Team

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