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SEC Proposes New Rule to Permit Certain ETFs to Operate without an Exemptive Order

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I. Executive Summary

Overview

The Securities and Exchange Commission (the "Commission") proposed Rule 6c-11 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"),[1] if adopted, would permit exchange-traded funds ("ETFs"), subject to certain conditions, to operate in reliance on a rule rather than individual exemptive orders. The Proposed Rule, issued on June 28, 2018, is a significant, albeit anticipated,[2] development for the ETF industry. The Proposed Rule, along with proposed form and disclosure amendments, is intended to modernize the regulatory framework for most ETFs. According to the Proposing Release, the Proposed Rule and amendments are "designed to create a consistent, transparent, and efficient regulatory framework for ETFs and to facilitate greater competition and innovation among ETFs." As part of this effort, the Commission is proposing to rescind the individual exemptive orders issued to all ETFs other than certain limited types of ETFs that would not be permitted to rely on the Proposed Rule, with a one-year transition period. To date, the Commission has granted more than 300 such orders, many with inconsistent terms and conditions.

The Commission seeks comment on all aspects of the Proposed Rule and the form and disclosure amendments.

Highlights

Highlights of the Proposed Rule are as follows:

- ***Conditions****.* The Proposed Rule's conditions are, in large measure, drawn from the existing exemptive relief for ETFs, but reflect certain modifications based on the Commission's experience regulating ETFs, as well as current market practices, such as with respect to portfolio transparency (discussed further below).
- ***Custom baskets permitted****.* Notably, the Proposed Rule would provide flexibility with respect to the use of "custom baskets"—i.e., baskets that are composed of a non-representative selection of the ETF's portfolio holdings (*e.g.*, baskets that do not reflect a *pro rata* representation or representative sampling of the ETF's portfolio holdings), or different baskets used in transactions on the same business day.

- ***No distinction between index-based and actively managed ETFs.*** As part of the effort to simplify the regulatory framework governing ETFs, ETFs that are able to rely on the Proposed Rule would be subject to the same conditions, regardless of whether the ETF is index-based[3] or actively managed.[4]
- ***No distinction between self-indexed and unaffiliated index funds.*** In a departure from historical exemptive relief, the Proposed Rule does not impose additional conditions on self-indexed ETFs and, thus, these ETFs are treated the same as ETFs with an unaffiliated index provider.
- ***Full portfolio transparency required.*** To support the arbitrage mechanism, the Proposed Rule would require an ETF to disclose prominently on its website the portfolio holdings that will form the basis for the next calculation of its net asset value per share. 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.
- ***Additional disclosure requirements and changes.*** The Proposed Rule reflects several disclosure changes, including new website disclosure requirements.

II. Background and Prior Commission Releases

As "hybrid" investment companies, ETFs do not fall squarely within the regulatory regime contemplated for either open-end funds or closed-end funds under the 1940 Act. Consequently, ETFs must obtain exemptive relief from several provisions of the 1940 Act to operate.[5] The terms of the exemptive relief granted to ETFs have evolved over time and have resulted in an uneven playing field among ETF complexes and sponsors, subjecting ETFs that pursue the same or similar investment strategies to different operational requirements and limitations. The Commission first proposed, but did not adopt, an exemptive rule for ETFs on March 11, 2008 (the "2008 Proposal"),[6] which was designed to codify the exemptive relief that had been issued to ETFs up to that time. The Commission had previously issued a concept release on actively managed ETFs on November 8, 2001, which asked questions about the then-perceived structural and operational differences between actively managed ETFs and index-based ETFs.[7] More recently, the Commission published a request for comment on exchange-traded products ("ETPs")—which include ETFs—on June 12, 2015, focusing on arbitrage mechanisms and market pricing for ETPs, and regulatory matters related to the trading of ETPs, as well as securities exchange listing standards for ETPs.[8] The Proposing Release notes that responses to these Commission actions, as well as industry developments, have "informed the parameters of [the Proposed Rule] and the related disclosure amendments."

III. Scope of Proposed Rule 6c-11; Summary of Exemptive Relief

A. *Scope of the Proposed Rule—What's Included*

1. *Open-End Funds*

The Proposed Rule would define an ETF as a registered open-end management investment company (i.e., an open-end fund) that: (i) issues (and redeems) creation units to (and from) authorized participants 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.

2. *Index-Based and Actively Managed ETFs*

The Proposing Release attributes the distinction between the treatment of index-based ETFs and actively managed ETFs in exemptive orders largely to "ETFs' historical evolution," adding that, despite differences in investment objectives or strategies, these ETFs operate in a similar manner. Thus, the Proposed Rule does not establish different requirements based on whether an ETF's investment objective is to seek returns that correspond to the returns of an index. As a result, all ETFs relying on the Proposed Rule, whether index-based or actively managed, must provide full portfolio transparency.[9] The Commission believes that permitting index-based and actively managed ETFs to operate under the same conditions would provide a level playing field among market participants. Moreover, as the Commission observed, "[t]he proliferation of highly customized, often methodologically complicated, indexes has blurred the distinction between [index-based and actively managed ETFs]."

B. *Excluded from the Proposed Rule*

Each of the following types of ETFs would <u>not</u> be able to rely on the Proposed Rule and, instead, would continue to operate pursuant to the terms of their existing exemptive orders or would need to seek individual exemptive relief:

1. *UIT ETFs*

Consistent with the 2008 Proposal, the Proposed Rule would not be available to UIT ETFs. In excluding UIT ETFs from the Proposed Rule, the Commission cites the limited sponsor interest in developing ETFs organized as UITs, as well as the different conditions that would be required for UIT ETFs under an exemptive rule because of their unmanaged structure.

2. *Leveraged and Inverse ETFs*

The structure and operation of leveraged and inverse ETFs[10] present "unique considerations" that, in the Commission's view, warrant excluding them from the Proposed Rule (collectively, "leveraged ETFs"). Specifically, the Proposing Release cites leveraged ETFs' use of derivatives to achieve their targeted returns and the daily or periodic portfolio rebalancing required to maintain a constant leverage ratio. The Commission is concerned that the daily or other periodic "reset" of a leveraged ETF combined with the effects of compounding can result in performance that diverges widely from a leveraged ETF's benchmark and, in that respect, "[differ] significantly from some investors' expectations of how index investing generally works." The Proposing Release notes that leveraged ETFs' use of derivatives also may raise issues under Section 18 of the 1940 Act that the Commission "is evaluating as part of our broader consideration of the use of derivatives by registered funds and business development companies." Accordingly, the Proposed Rule includes a condition that would prevent leveraged ETFs from relying on the Proposed Rule.[11]

3. *Share Class ETFs*

An ETF structured as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio—i.e., a "share class ETF"—would not be permitted to rely on the Proposed Rule due to the additional policy considerations raised under Section 18.[12] In this regard, the Proposed Rule would not provide any relief from Sections 18(f)(1) or 18(i) of the 1940 Act.

C. *Treatment of Other Types of ETFs*

1. *Master-Feeder ETFs*

Many recent ETF orders include exemptive relief from Sections 12(d)(1)(E), 17(a)(1) and 17(a)(2) of the 1940 Act, allowing ETFs to operate as feeder funds in a master-feeder structure. The Proposing Release, however, cites the apparent lack of interest in this structure, noting that only one fund complex has established master-feeder arrangements involving ETF feeder funds. The Commission also expresses the concern that "if an ETF feeder fund transacts with a master fund on an in-kind basis, but non-ETF feeder funds transact with the master fund on a cash basis, all feeder fund shareholders would bear costs associated with the cash transactions." For the foregoing reasons, the Commission is proposing to rescind the master-feeder relief granted to ETFs that do not rely on the relief as of the date of the Proposed Rule—i.e., June 28, 2018. The Commission is also proposing to grandfather existing master-feeder arrangements involving ETF feeder funds, but prevent the formation of new ones by amending relevant exemptive orders.

2. *ETFs with Non-Transparent or "Partially Transparent" Portfolios*

Because the Commission is proposing to require full transparency for all ETFs under the Proposed Rule, ETFs that cannot satisfy this requirement would be unable to rely on the Proposed Rule. In this connection, the Proposing Release seeks comment on whether the Commission should consider exemptions for ETFs with non-transparent or "partially transparent" portfolios. The Commission also seeks comment on whether "a rule of general applicability would be the appropriate means to provide an exemption for ETFs using a novel arbitrage mechanism."

3. *Exchange-Traded Managed Funds*

As noted above, the proposed definition of "exchange-traded fund" under the Proposed Rule would require that the ETF's shares be traded at market-determined prices. Notably, this requirement is designed to, among other things, distinguish ETFs from other products that are listed on exchanges, but trade at NAV-based prices—i.e., exchange-traded managed funds ("ETMFs"). Thus, the Proposed Rule would not apply to ETMFs, which, as the Proposing Release explains, are not ETFs, but rather hybrids between mutual funds and ETFs. Unlike ETFs, secondary market transactions in ETMFs do not occur at a market-determined price. Rather, they occur at the next-determined NAV plus or minus a market-determined premium or discount that may vary during the trading day.

4. *Self-Indexed ETFs*

In a departure from historical exemptive relief, the Proposed Rule does <u>not</u> impose additional conditions on ETFs that use an affiliated index provider (i.e., "self-indexed ETFs") and, thus, these ETFs are treated the same as ETFs with an unaffiliated index provider. The Commission seeks comment on potential specific requirements for self-indexed ETFs, such as whether self-indexed ETFs should be required to adopt additional policies and procedures designed to further limit information sharing between portfolio management and index management personnel.

D. *Exemptive Relief under the Proposed Rule*

The Proposed Rule would grant exemptive relief from certain provisions of the 1940 Act that would otherwise prohibit several features essential to the operation of ETFs. These exemptions are similar to the relief that the Commission has granted under exemptive orders.

Specifically, the Proposed Rule would permit an ETF that satisfies the requirements and conditions of the Rule to:

1. redeem shares only in creation unit aggregations;

2. permit ETF shares to be purchased and sold at market prices rather than at NAV per share;

3. engage in in-kind transactions with certain affiliates;[13] and

4. in certain limited circumstances, pay authorized participants the proceeds from the redemption of shares in more than seven days.[14]

Treatment of ETF Shares as "Redeemable Securities"

Unlike historical exemptive orders, the Proposed Rule would not exempt shares of ETFs from the definition of "redeemable security" in Section 2(a)(32) of the 1940 Act or from the definition "open-end company" in Section 5(a)(1) of the 1940 Act. Instead, the Proposed Rule would classify shares of eligible ETFs as "redeemable securities," within the meaning of Section 2(a)(32)—even though only authorized participants may redeem ETF shares—and any ETF operating in compliance with the rule's conditions and requirements would meet the definition of "open-end company" and be regulated as such. Consequently, ETFs relying on the Proposed Rule would get the benefit of the exemptions in Rules 101(c)(4) and 102(d)(4) of Regulation M and Rule 10b-17(c) under the Securities Exchange Act of 1934 (the "Exchange Act")—each of which provides exceptions for "redeemable securities" issued by open-end investment companies—in connection with secondary market transactions in ETF shares and the creation or redemption of creation units.[15] Similarly, ETFs relying on the Proposed Rule would become eligible for the exemption in Rule 11d1-2 under the Exchange Act for "securities issued by a registered open-end investment company" (relating to the extension of margin credit by broker-dealers). Because ETFs relying on the Proposed Rule would be eligible for the foregoing exemptions, exemptive relief from these Exchange Act rules would no longer be necessary.[16]

Affiliated Transactions Relief

The Proposed Rule would provide exemptions from Sections 17(a)(1) and (a)(2) of the 1940 Act with respect to the deposit and receipt of baskets to 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 an 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.

The Commission believes that this particular exemptive relief is necessary to facilitate the efficient functioning of the arbitrage mechanism since, without it, any market participant that becomes an affiliated person of the ETF due to its holdings would be prohibited from engaging in arbitrage using an in-kind basket. The Commission's view is that this relief is appropriate because all purchases and redemptions of creation units are at an ETF's next-calculated NAV, and the securities deposited or delivered upon redemption would be valued in the same manner, using the same standards, as those securities are valued for purposes of calculating the ETF's NAV.

Notably, the Commission is not expanding the relief to cover additional types of affiliated relationships, such as broker-dealers that are affiliated with the ETF's adviser, despite the support for

such expanded relief from several commenters on the 2008 Proposal. On this point, the Proposing Release states, “we preliminarily do not believe that it is appropriate to expand the scope of affiliated persons covered by the exemption at the same time that we are permitting additional flexibility with respect to custom baskets . . . limiting the types of affiliates that are permitted to rely on this exemption would serve as an additional protection against potential disparate treatment in connection with an ETF’s receipt or delivery of baskets.”

Additional Time for Delivering Redemption Proceeds

The Proposed Rule would grant relief from Section 22(e) of the 1940 Act to permit an ETF to delay satisfaction of a redemption request for more than seven days if a local market holiday, or series of consecutive holidays, the extended delivery cycles for transferring foreign investments to redeeming APs, or the combination thereof prevents timely delivery of the foreign investment included in the ETF’s basket. To rely on this exemption, an ETF would be required to deliver foreign investments as soon as practicable, but in no event later than 15 days after the tender to the ETF.[17] This proposed exemption would permit a delay in the delivery of foreign investments only if the foreign investments are being transferred in kind as part of the basket. Among other things, the Commission requests comment on whether the rule should permit the delayed delivery of the entire basket—instead of the specific foreign investments in a basket—if the basket is composed substantially of foreign investments subject to potential delays in the delivery of settlement proceeds.

Notably, in light of the continued movement toward shorter settlement times in markets around the world, the Commission believes that the relief from Section 22(e) does not need to be permanent. Therefore, the Commission proposes to include a sunset provision; the exemption from Section 22(e) would expire ten years from the rule’s effective date.

IV. Conditions for Reliance on the Proposed Rule

The Proposed Rule would require ETFs to comply with certain conditions that are similar to the conditions required by the Commission for exemptive orders but also reflect certain changes based on the Commission’s regulatory experience with ETFs.

A. Issuance and Redemption of Shares

Process

ETFs must issue and redeem creation units to and from authorized participants in exchange for baskets and a cash balancing amount (if any). This requirement, according to the Proposing Release, is designed to preserve an orderly creation unit issuance and redemption process between ETFs and APs which, in turn, “is of central importance to the arbitrage mechanism, which forms the basis for several of the [Proposed Rule’s] exemptive provisions.”

Definition of Authorized Participant

The Proposed Rule would define an “authorized participant” as a member or participant of a clearing agency registered with the Commission, which has a written agreement with the ETF or one of its service providers that allows the AP to place orders for the purchase and redemption of creation units.

This definition differs from the definition of authorized participant that the Commission recently adopted with Form N-CEN, which, in relevant part, defines the term as a broker-dealer that is also a member of a clearing agency registered with the Commission or a DTC Participant and that has a written agreement with the ETF or one of its service providers that allows the AP to place orders to purchase and redeem creation units. The proposed AP definition also differs from the definition of AP in the Commission's exemptive orders and Form N-CEN because it does not include a specific reference to an AP's participation in DTC since DTC is itself a clearing agency. Nevertheless, in the Commission's view, the proposed definition is largely consistent with existing exemptive relief, while eliminating unnecessary terms. The Proposing Release notes that the Commission is proposing a corresponding amendment to Form N-CEN.

Definition of Creation Unit; No Minimum Size Requirement

The Proposed Rule would define "creation unit" to mean a specified number of ETF shares that the ETF will issue to (or redeem from) an AP in exchange for the deposit (or delivery) of a basket and a cash balancing amount (if any). The Proposing Release notes that ETFs have stated in exemptive applications that they would establish a specific creation unit size—i.e., a minimum number of shares. Consistent with the 2008 Proposal, however, the Commission does not believe it is necessary to mandate a particular maximum or minimum creation unit size for all types of ETFs. The Commission also does not propose to expressly require that an ETF establish creation unit sizes reasonably designed to facilitate arbitrage—a requirement that was included in the 2008 Proposal. The Commission cites commenters on the 2008 Proposal who believed that the proposed standard was too vague and that an ETF is not likely to have an incentive to establish creation unit sizes that would be too large or too small to facilitate effective arbitrage. Agreeing with this view, the Commission believes that an ETF would establish a size that is appropriate for market demand given its investment strategies and objectives. Moreover, the Commission notes that the conditions in the Proposed Rule designed to promote effective arbitrage are better suited for that purpose than conditions related to creation unit size.

Notwithstanding the requirement that an ETF generally issue and redeem shares only in creation unit size aggregations, the Proposed Rule would permit an ETF to sell or redeem individual shares on the day of consummation of a reorganization, merger, conversion or liquidation. The Commission believes that permitting ETFs to conduct redemptions with investors other than APs in these limited circumstances is operationally necessary to facilitate these actions.

B. Listing on a National Securities Exchange

The Proposed Rule defines "exchange-traded fund," in part, to mean a fund that issues shares that are listed on a national securities exchange and traded at market-determined prices. The Proposing Release states that listing on an exchange is one of the fundamental characteristics that distinguishes an ETF from other types of open-end funds and is one reason that ETFs need certain exemptions from the 1940 Act and the rules thereunder. Additionally, trading on an exchange is critical to the functioning of the arbitrage mechanism.

C. Portfolio Holdings

1. *Transparency of Portfolio Holdings*

The Proposed Rule would require an ETF to disclose prominently on its website, which is publicly available and free of charge, the portfolio holdings that will form the basis for each calculation of NAV per share. The portfolio holdings disclosure must be made each business day before the opening of regular trading on the primary exchange listing the ETF's shares and before the ETF starts accepting orders for the purchase or redemption of creation units.

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. This means that changes in an ETF's portfolio holdings would be reflected on a T+1 basis. This condition is consistent with current ETF practices and enables an ETF to disclose at the beginning of the business day the portfolio that will form the basis for the next NAV calculation, helping to facilitate the efficient functioning of the arbitrage process.

2. *Disclosure of Securities, Assets or Other Investment Positions*

Under the Proposed Rule, the term "portfolio holdings" is defined to mean an ETF's securities, assets or other positions. As a result, an ETF would be required to disclose its cash holdings, as well as holdings that are not securities or assets, including short positions or written options. The Commission believes that this disclosure requirement would: (i) offer more comprehensive information about an ETF's portfolio holdings compared to other disclosure methods; (ii) allow market participants to effectively value the entirety of the ETF's portfolio; and (iii) facilitate the arbitrage mechanism by allowing APs and others to more effectively hedge their exposure to a particular ETF.

The Proposed Rule would require that portfolio holdings information be presented and contain information regarding description, amount, value and/or unrealized gain/loss (as applicable) in the manner required by Article 12 of Regulation S-X, which addresses the form and content of fund financial statements.

3. *Dissemination of an Intraday Indicative Value*

Unlike the 2008 Proposal and historical exemptive orders, the Proposed Rule does not require the dissemination of an intraday estimate of an ETF's NAV per share—known as an "intraday indicative value" or "IIV." This change reflects the Commission's understanding that market makers calculate their own intraday value of an ETF's portfolio using proprietary algorithms and that the "dissemination lag of the IIV"—it is available every 15 seconds or 60 seconds for international ETFs—is too long for efficient market making. Moreover, the Commission believes that the Proposed Rule's required daily disclosure of portfolio holdings provides sufficient information for market makers to use their own methodologies to calculate an ETF's estimated intraday value.

D. Baskets

1. *Policies and Procedures Generally*

The Proposed Rule would require each ETF relying on the Rule to adopt and implement written policies and procedures governing the construction of baskets and the process that would be used

for the acceptance of baskets, including the methodology that the ETF would use to construct baskets. For instance, as the Proposing Release notes, the policies and procedures should detail the circumstances when the basket may omit positions that are not operationally feasible to transfer in kind. These policies and procedures should also address: (i) the use of representative sampling to create baskets, including when and how it would be used; and (ii) the process of replicating changes in the ETF's portfolio holdings resulting from rebalancing or reconstitution of the ETF's securities market index, if applicable.

2. *Definition of Custom Baskets*

There are two types of "custom baskets" identified in the Proposed Rule:

First type of custom basket:

Baskets composed of a non-representative selection of the ETF's portfolio holdings (e.g., baskets that do not reflect: (i) a pro rata representation of the ETF's portfolio holdings; (ii) a representative sampling of the ETF's portfolio holdings; or (iii) changes due to a rebalancing or reconstitution of the ETF's securities market index, if applicable).

Second type of custom basket:

Different baskets used in transactions on the same business day (e.g., (i) if an ETF exchanges a basket with an AP that reflects a representative sampling of the ETF's portfolio holdings and a different basket with either the same or another AP that represents a different representative sampling, both baskets would be custom baskets; or (ii) if an ETF substitutes cash in lieu of a portion of basket assets for a single AP, that basket would be a custom basket).

3. *Custom Basket Policies and Procedures*

The Proposed Rule would provide an ETF with the flexibility to use "custom baskets" if the ETF has adopted written policies and procedures: (i) setting forth 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 deviation from, those parameters; and (ii) specifying 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[18] ("custom basket policies and procedures").[19]

According to the Proposing Release, custom basket policies and procedures should:

(i) provide specific parameters regarding the methodology and process that the ETF would use to construct or accept each custom basket; and

(ii) describe the ETF's approach for testing compliance with the custom basket policies and procedures and assessing (including through back testing or other periodic reviews) whether the parameters continue to result in custom baskets that are in the best interests of the ETF and its shareholders.

These policies and procedures should be "consistently applied." The Proposing Release also advises that ETFs consider adopting "reasonable controls to prevent inappropriate differential treatment among authorized participants."

4. *Basket Flexibility*

The Proposing Release acknowledges that where an ETF uses in-kind creations and redemptions, the composition of the basket is a key aspect of the effective functioning of the arbitrage mechanism. In addition, the Proposing Release notes that basket composition is important to ETF portfolio management, in that a portfolio manager can use the creation and redemption process to execute changes in the ETF's portfolio efficiently, without incurring the additional expense of trades in the market. However, when an ETF does not have flexibility to manage basket composition, "it may result in undesired changes to the portfolio, such as the loss of desirable bonds when paying redemptions in kind."

Basket flexibility also is an area where certain ETF sponsors may have a competitive advantage over others. On this point, the Proposing Release notes that early exemptive orders for ETFs organized as open-end funds included few explicit restrictions on baskets. However, as the ETF industry grew, the Commission issued exemptive orders that placed tighter restrictions on ETFs' composition of baskets. The Commission, according to the Proposing Release, now recognizes that there are many circumstances where allowing baskets to differ from a pro rata representation or allowing the use of different baskets for different APs could benefit the ETF and its shareholders and help ETFs operate more efficiently, including more efficient arbitrage and narrower bid-ask spreads. Therefore, the Commission believes it is appropriate to provide additional basket flexibility, subject to conditions designed to address concerns about potential "overreaching"—i.e., the risk that APs could dictate the composition of baskets to the detriment of other ETF investors, who might be "left holding shares of an ETF with a less liquid or less desirable portfolio of securities." This allowance, subject to "heightened process requirements," would also give a consistent structure to ETFs relying on the Proposed Rule and remove a barrier to entry for new ETFs.

E. Website Disclosure

The Proposed Rule would require an ETF to disclose prominently on its website, which is publicly available and free of charge, information regarding a published basket that will apply to orders for the purchase and redemption of creation units each business day. In addition, the Proposed Rule would require an ETF to disclose on its website the following information:

- the ETF's daily NAV, market price, and premium or discount, each as of the end of the prior business day;
- the median bid-ask spread for the ETF's most recent fiscal year; and
- historical information about the extent and frequency of an ETF's premiums and discounts, including both a table and 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.[20]

Notably, the Commission is also proposing to require ETFs to provide an interactive calculator in a "clear and prominent format on the ETF's website" that would enable investors to customize certain hypothetical bid-ask spread data to the investor's specific investing situation.[21]

Significant and/or Persistent Deviations between Market Price and NAV Per Share

The Proposed Rule also would require any ETF whose premium or discount was greater than 2% for more than seven consecutive trading days to post that information on its website, along with a

discussion of the factors that are reasonably believed to have materially contributed to the premium or discount. This information would be required to be posted to an ETF's website on the trading day immediately following the day on which its premium or discount triggered this provision (i.e., on the trading day immediately following the eighth consecutive trading day on which the ETF had a premium or discount greater than 2%). If the foregoing requirement is triggered, the ETF would be required to maintain the required disclosure on its website for at least one year following the first day it was posted.

F. Excluded Conditions

1. *Marketing*

Historical exemptive orders and the 2008 Proposal included a condition requiring each ETF to identify itself in any sales literature as an ETF that does not sell or redeem individual shares and to explain that investors may purchase or sell individual ETF shares on a national securities exchange through a broker. In view of both the Commission's belief that retail investors generally understand that individual ETF shares may be purchased and sold only on secondary markets, and that proposed website and registration statement disclosures are intended to provide retail investors with more useful information about ETFs, the Proposed Rule does not include a marketing disclosure requirement.

2. *Dissemination of IIV*

As noted above, in contrast to historical exemptive orders and the 2008 Proposal, the Proposed Rule does not include a requirement to disseminate an ETF's IIV.

G. Recordkeeping Requirements

1. *Authorized Participant Agreements*

Although the Commission believes that most ETFs are currently preserving copies of their written authorized participant agreements, "for avoidance of doubt," the Proposed Rule expressly requires that ETFs relying on the Proposed Rule preserve and maintain copies of all such agreements. This requirement was not part of the 2008 Proposal.

2. *Basket Information*

The Proposed Rule requires ETFs to maintain records setting forth the following information for each basket exchanged with an AP:

- the names and quantities of the positions composing the basket;
- identification of the basket as a "custom basket" and a record stating that the custom basket complies with the ETF's custom basket policies and procedures (if applicable);
- cash balancing amounts (if any); and
- the identity of the AP conducting the transaction.

ETFs would be required to maintain such records for at least five years, the first two years in an easily accessible place.

V. Effect of Proposed Rule on Prior Exemptive Orders

The Commission is proposing to rescind exemptive relief previously issued to ETFs with the exception of (i) relief from Section 12(d)(1) included in prior orders, and (ii) orders relating to UIT ETFs, leveraged ETFs and share class ETFs. With respect to master-feeder ETFs, the Commission proposes to rescind all prior relief other than master-feeder ETFs relying on exemptive relief as of the date of the Proposed Rule. The Commission also proposes to grandfather existing master-feeder arrangements involving ETF feeder funds, but prevent the formation of new ones, by amending relevant exemptive orders.

Automatic Expiration Condition

Most ETF exemptive orders include a condition stating that the relief permitting the operation of ETFs would expire on the effective date of any Commission rule that provides relief permitting the operation of ETFs.[22] The Commission proposes to amend these existing orders to provide that the ETF relief contained therein will terminate one year following the effective date of any final rule in order to allow a transition period.

VI. Other Disclosure Changes

The Commission is proposing several amendments to Form N-1A designed to provide investors who purchase ETF shares in secondary market transactions with additional information regarding ETFs, including information regarding costs associated with an investment in ETFs. Among other things, the Commission is also requesting comment on whether it should create a new ETF-specific registration form. Several important proposed changes concern Item 3 of Form N-1A—the fees and expenses table. These changes include the following—which would apply to both mutual funds and ETFs:

- narrative disclosure clarifying that, in addition to the current disclosures relating to investors who buy or hold shares, the fees and expenses reflected in the table may be higher for investors if they sell shares; and
- a statement that investors may be subject to other fees not reflected in the table, such as brokerage commissions and fees to financial intermediaries.

Proposed Changes that Affect ETFs

For ETFs only, a new section in Item 3 would require disclosure of certain ETF trading information and trading costs, formatted as a series of six questions and answers. These questions include:

- What information do I need to know about how the ETF trades?
- What costs are associated with trading shares of an ETF?
- What is the bid-ask spread?
- How does the bid-ask spread impact my return on investment?
- But what if I plan to trade ETF shares frequently?
- Where can I get more trading information for the ETF?

In addition to the proposed amendments to Item 3, the Commission is proposing to remove the requirement from Item 6 that currently requires an ETF to specify the number of shares the ETF issues or redeems in exchange for the deposit or delivery of baskets. Also proposed to be eliminated are certain other disclosures concerning primary transactions through authorized participants—information that is not relevant to retail investors.

Proposed Amendments to Form N-8B-2

Although UIT ETFs are not included within the scope of the Proposed Rule, the Commission is proposing to amend Form N-8B-2—the form for unit investment trusts—to require UIT ETFs to provide disclosures that mirror certain of the proposed disclosure changes in Form N-1A, including changes that correspond to the proposed changes to Item 3 of Form N-1A concerning fees and costs.

Proposed Amendments to Form N-CEN

The Commission is proposing to add to Form N-CEN a requirement that ETFs report if they are relying on Rule 6c-11. In addition, as noted earlier, the Commission is changing the definition of "authorized participant" in Form N-CEN to exclude the specific reference to an AP's participation in DTC in order to obviate the need for future amendments if additional clearing agencies become registered with the Commission.

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Comments on the Proposed Rule and amendments are due on or before October 1, 2018.

The SEC's Proposing Release is available at:

https://www.sec.gov/rules/proposed/2018/33-10515.pdf

If you have any questions, please contact Deborah Bielicke Eades, deades@vedderprice.com or Nathaniel Segal, nsegal@vedderprice.com of Vedder Price's Investment Services group, or any other Vedder Price attorney with whom you have worked.

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[1] *See* Exchange-Traded Funds, SEC Release No. IC-33140 (Jun. 28, 2018) (the "Proposing Release"). The Proposed Rule was adopted by a unanimous vote of the Commission.
[2] In her keynote address at the Investment Company Institute's 2018 Mutual Funds and Investment Management Conference on March 19, 2018, the Director of the Commission's Division of Investment Management, Dalia Blass, indicated that a uniform ETF rule was a high priority for the Division (available at: https://www.sec.gov/news/speech/speech-blass-2018-03-19).
[3] Index-based ETFs have stated investment objectives of maintaining returns that correspond to the returns of a securities index.
[4] An actively managed ETF is a type of ETF that has one or more portfolio managers that exercise discretion over the composition of the ETF's portfolio, rather than passively following an index. However, the distinction between index-based and actively managed ETFs has blurred with the advent of "smart beta" strategies, among others, which, for instance, may follow an index while taking into consideration volatility and/or other factors or weightings.
[5] Because of their unique structure, ETFs must obtain exemptive relief from certain provisions of the 1940 Act in order to operate. Specifically, an ETF generally is required to file an exemptive application requesting an order granting relief from: (i) Sections 2(a)(32) and 5(a)(1) of the 1940 Act so that the ETF may register under the

1940 Act as an open-end fund and issue shares that are redeemable only in creation units; (ii) Section 22(d) and Rule 22c-1 to permit the purchase and sale of individual ETF shares in the secondary market at negotiated prices; and (iii) Sections 17(a)(1) and (a)(2) to permit in-kind purchases and redemptions of creation units by persons that may be affiliated with the ETF by reason of owning more than 5%, and in some cases more than 25%, of its outstanding securities. Certain ETFs, such as those that track foreign indices, also have obtained relief under Section 6(c) from Section 22(e) of the 1940 Act so that they may satisfy redemption requests more than seven days after the tender of a creation unit for redemption due to delivery cycles for securities in the local market. ETFs have also generally obtained relief from Section 24(d) of the 1940 Act to permit secondary market sales of ETF shares unaccompanied by a full "statutory" prospectus, provided that a shorter "product description" was provided instead.

[6] *See* Exchange-Traded Funds, SEC Release No. IC-28193 (Mar. 11, 2008).

[7] *See* Actively Managed Exchange-Traded Funds, SEC Release No. IC-25258 (Nov. 8, 2001).

[8] *See* Request for Comment on Exchange-Traded Products, SEC Release No. 34-75165 (Jun. 12, 2015).

[9] The 2008 Proposal would not have distinguished between index-based ETFs and actively managed ETFs, except in one respect; under the 2008 Proposal, an index-based ETF would have been required to have a stated investment objective of obtaining returns that correspond to the returns of a securities index, whose provider discloses on its website the identities and weightings of the component securities and other assets of the index (i.e., index transparency) and an actively managed ETF would have been required to disclose the identities and weightings of the portfolio securities and other assets held by the ETF on the ETF's website each business day (i.e., full portfolio transparency). Because "all ETFs that could rely on the [Proposed Rule] currently provide full portfolio transparency," the Commission does not believe it is necessary to distinguish between index-based ETFs and actively managed ETFs in this manner.

[10] Leveraged and inverse ETFs refer to ETFs that seek to 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.

[11] Proposed Rule 6c-11(c)(4) states that the ETF may 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.

[12] The Commission has granted ETFs exemptive relief from Section 18 of the 1940 Act, subject to various conditions, to allow a sponsor to operate a share class ETF.

[13] Section 17(a) of the 1940 Act generally prohibits an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security or other property to or purchasing any security from the company. In the context of ETFs, Section 17(a) prohibits in-kind purchases and redemptions of creation units by affiliated persons of the ETF.

[14] 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 Proposing Release notes that this prohibition can cause operational difficulties for ETFs that hold foreign investments and exchange in-kind baskets for creation units since, for instance, local market delivery cycles for transferring foreign investments and local market holiday schedules may occasionally require a delivery process exceeding seven days.

[15] Generally, Rule 101 of Regulation M is an anti-manipulation regulation that, subject to certain exemptions, prohibits any "distribution participant" and its "affiliated purchasers" from bidding for, purchasing or attempting to induce any person to bid for or purchase, any security which is the subject of a distribution until after the applicable restricted period, except as specifically permitted in Regulation M. Paragraph (c)(4) of Rule 101 exempts from its application redeemable securities issued by an open-end management investment company (as such terms are used in the 1940 Act). While Rule 101 covers the activities of underwriters, broker-dealers and others participating in a distribution, Rule 102 governs the activities of issuers, selling security holders and their respective affiliated purchasers. Rule 102 prohibits the same activities during the same restricted period as Rule 101.

[16] The Proposing Release seeks comment on whether the Commission should provide relief from various other provisions under the Exchange Act.

[17] In contrast, the 2008 Proposal would have allowed up to 12 days to deliver redemption proceeds without an offsetting requirement to deliver "as soon as practicable" and without a sunset provision. Unlike the 2008 Proposal, the Commission is not requiring an ETF to disclose in its registration statement the foreign holidays that it expects may prevent timely delivery of foreign securities, and the maximum number of days that it anticipates it will need to deliver the foreign securities. The Proposing Release provides two reasons for the exclusion of the foregoing requirement: (1) the Commission does not believe this disclosure is relevant to investors who purchase ETF shares on the secondary market since the settlement of these investors' ETF trades would be unaffected by the potential delay; and (2) the Commission does not believe that registration statement disclosures are necessary given that these delays are typically covered by the authorized participant agreement.

[18] The Proposing Release suggests that an ETF may want to consider whether employees outside of portfolio management should review the components of custom baskets before approving a creation or redemption.

[19] The Proposing Release notes that a subset of the ETFs operating under exemptive relief has basket flexibility that would not be broadened by the Proposed Rule. However, such ETFs would be required to adopt and implement written policies and procedures related to the construction of baskets and the process for the acceptance of baskets by the ETF.

[20] For new ETFs that do not yet have this information, the Proposed Rule would require the ETF to post this information for the life of the fund.

[21] Recognizing that requiring ETFs to create a web-based interactive calculator "is not without cost, especially for smaller fund complexes," the Commission is proposing that an ETF that had its initial listing on a national securities exchange after the beginning of its most recently completed fiscal year would not be required to provide an interactive calculator on its website. Such ETFs would also not be required to include the ETF's median bid-ask spread or the spread cost example in its Item 3 disclosure, which are among the proposed amendments to Form N-1A for ETFs. See Section V. Other Disclosure Changes.

[22] The Proposing Release states that the Commission began including the automatic expiration condition in ETF exemptive orders in 2008 and that, of the approximately 300 orders that provide ETF exemptive relief, approximately 200 include this automatic expiration condition.