SEC Proposes Rule to Allow Most ETFs to Operate without Exemptive Relief

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The Securities and Exchange Commission is proposing to simplify and modernize the regulatory framework governing exchange-traded funds and enhance information to investors about the costs of purchasing ETF shares. If adopted, the proposal would, among other things: (i) allow most ETFs to operate without first obtaining exemptive relief, by relying on a proposed new rule; (ii) provide greater flexibility with respect to aspects of ETF operations than exists under exemptive relief issued in recent years, including the use of "custom baskets" for creation and redemption transactions; and (iii) require additional disclosures regarding ETFs' trading costs, including certain bid-ask spread information. The SEC's proposal also would rescind existing exemptive relief for those ETFs that are eligible to rely on the proposed rule.

The SEC unanimously voted to propose new Rule 6c-11 (Proposed Rule) under the Investment Company Act of 1940, as well as certain form amendments, designed to simplify and modernize the regulatory framework governing ETFs and enhance information provided to investors about the costs of purchasing ETF shares (Proposal).[1] Comments on the Proposal are due on or before 60 days after publication of the Proposing Release in the Federal Register. The Proposing Release has not yet been published in the Federal Register as of the date of this *OnPoint*.

An overview of the operation and regulation of ETFs and summary of the Proposal are set forth below.

Operation and Regulation of ETFs

Since their introduction in 1993, ETFs have become one of the most popular pooled investment vehicles in the United States. As of May 2018, the combined assets of ETFs in the United States were approximately $3.53 trillion.[2] ETFs, often viewed as hybrid investment products, possess characteristics similar both to mutual funds (*i.e.*, open-end management investment companies (open-end funds)) and closed-end funds. Like mutual funds and closed-end funds, ETFs are comprised of pools or baskets of securities and other instruments. Unlike mutual funds, however, ETFs do not issue and redeem *individual* shares at net asset value (NAV). Instead, shares of an ETF trade on national securities exchanges and can only be purchased or redeemed at NAV in large blocks of shares called "creation units"[3] by large financial institutions known as "authorized participants."[4] Many (but not all) ETFs transact in kind, meaning authorized participants purchase creation units by exchanging a specified "basket" of securities and other instruments for ETF shares and receive a basket upon redemption of a creation unit. To the extent there is a

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1 *See* Exchange-Traded Funds, SEC Rel. No. IC-33140 (June 28, 2018) (Proposing Release).

2 ETF Assets and Net Issuance May 2018, Investment Company Institute (June 28, 2018).

3 The Proposed Rule defines a "creation unit" as "a specified number of [ETF] shares that the [ETF] will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount if any." As discussed in the text, this definition is significant in that it omits any minimum creation unit size requirement.

4 Under the Proposed Rule, an "authorized participant" would be defined 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 authorized participant to place orders for the purchase and redemption of creation units."

difference between the basket's value and a creation unit's NAV, an amount of cash (*i.e.,* a cash balancing amount) is used to account for the difference.

Like shares of operating companies and most closed-end funds, ETF shares trade throughout the day in the secondary market at negotiated prices. As with closed-end funds, the market price of ETF shares may differ from the ETF's NAV throughout the trading day. To the extent ETF shares are trading at a premium to (above) or discount to (below) NAV, arbitrage opportunities will exist, which help ensure that the market prices of ETF shares remain at or close to NAV. For example, if an ETF's shares are trading at a premium, an authorized participant can deliver a basket to the ETF in exchange for the more valuable creation unit of ETF shares, and then sell individual ETF shares in the secondary market at a higher price to realize a profit. In the event of a discount, an authorized participant can purchase enough shares in the secondary market to assemble a creation unit and redeem those shares at the higher NAV. These transactions have the effect of increasing or decreasing, as applicable, the supply of ETF shares in the secondary market, thus tending to move the price of an ETF's shares closer to NAV.

Due to their complex and unique structure, ETFs do not satisfy certain requirements under the Investment Company Act of 1940 (1940 Act), which are described in greater detail below. As a result, an ETF sponsor must obtain individual exemptive relief from the SEC before launching an ETF complex. The SEC has now granted more than 300 individual exemptive orders that provide relief related to the formation and operation of ETFs (ETF Relief). As the terms of these orders have evolved over time, ETFs are subject to certain varying requirements, which has resulted in unequal treatment of different ETF sponsors and a segmented and inefficient approach to ETF regulation.

In March 2008, the Commission proposed a rule that would have allowed certain ETFs to operate without individual exemptive relief (2008 Proposal).[5] Then-proposed Rule 6c-11 (2008 Rule) essentially would have codified many of the conditions that the SEC had previously imposed on ETFs through individual exemptive orders. The 2008 Proposal also included proposed Rule 12d1-4, which would have provided the exemptions necessary to permit certain funds to invest in ETFs beyond the limits of Section 12(d)(1) of the 1940 Act, subject to certain conditions (Funds of Funds Relief), as well as proposed amendments to Form N-1A (the registration statement used by ETFs structured as open-end funds), which would have enhanced disclosure to investors buying and selling ETF shares in the secondary market. The 2008 Proposal was never adopted, however, as the SEC shifted its focus when the financial crisis occurred later that year.

Proposed Rule 6c-11

Scope of the Proposed Rule and Impact on Existing Exemptive Relief

Like the 2008 Rule, the Proposed Rule would allow most ETFs to operate without individual exemptive relief (Eligible ETFs). The Proposed Rule differs from the 2008 Rule and current exemptive orders in that it would not distinguish between index-based ETFs (*i.e.,* ETFs that have stated investment objectives of seeking returns that correspond to the returns of a securities index) and actively managed ETFs (*i.e.,* ETFs that pursue other investment strategies).[6] An index-based or actively managed ETF could rely on the Proposed Rule if it satisfies: (i) the definition of an ETF set forth in the Proposed Rule; and (ii) the conditions set forth in the Proposed Rule. The definition of an ETF set forth in

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5 *Exchange Traded Funds*, SEC Rel. No. IC-28193 (Mar. 11, 2008).

6 The Proposal states that developments in the market, including the evolution of indices over the past decade and the convergence of ETF practices in areas such as portfolio transparency, have obviated the need for a regulatory distinction between index-based and actively managed ETFs.

the Proposed Rule would require, among other things, that the ETF be structured as an open-end fund, as discussed further under "Definition of Exchange-Traded Fund" below. The conditions set forth in the Proposed Rule are discussed in detail in "Conditions of the Proposed Rule" below.

The following types of ETFs would ***not*** be Eligible ETFs for purposes of the Proposed Rule:

- ETFs Organized as Unit Investment Trusts (UIT ETFs). The SEC explains that, due to their unmanaged nature, UIT ETFs would require different conditions than those being proposed for open-end ETFs. The SEC also cites the declining popularity of UIT ETFs, as demonstrated by the fact that no new UIT ETFs have come to market since 2002.

- ETFs Structured as Share Classes of a Multi-Class Fund (Share Class ETFs). The SEC acknowledges that while it has previously granted exemptive orders to certain Share Class ETFs, those exemptive orders included an additional exemption from Sections 18(f)(1) and 18(i) under the 1940 Act, which most ETFs do not need. The SEC also notes that this relief raises policy considerations that it is not intending to address through the Proposed Rule.

- Leveraged ETFs.[7] The SEC explains that leveraged ETFs involve "unique considerations" and that their use of derivatives ties in to broader concerns that the SEC is currently evaluating in connection with its separate consideration of funds' use of derivatives, including "the potential staff recommendation of a re-proposal on funds' use of derivatives.". The Proposed Rule's inapplicability to leveraged ETFs is also consistent with the SEC staff's moratorium, in place since 2009, on issuing new exemptive orders for leveraged ETFs.

The Proposed Rule also would not cover: (i) exchange-traded managed funds, which are not ETFs but rather hybrids of ETFs and mutual funds; or (ii) other novel products, such as non-transparent active ETFs. The Proposed Rule could, however, indirectly pave the way for more of these products by removing applications for standard ETF exemptive orders from consideration, thus freeing up time and resources for the SEC staff to focus on more unique applications.

Significantly, the Commission proposes to rescind the ETF Relief-related portions of existing exemptive orders for Eligible ETFs, starting one year from the effective date of any final rule.[8] The Commission notes that the ability of Eligible ETFs to continue to rely on existing exemptive relief would be inconsistent with the goal of "creat[ing] a consistent, transparent and efficient regulatory framework for many ETFs." The SEC would not rescind existing exemptive orders for ETFs that are not Eligible ETFs, including UIT ETFs, Share Class ETFs and leveraged ETFs.[9]

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7 For purposes of the Proposing Release, "leveraged ETFs" are defined as ETFs that seek to provide returns that: (i) exceed the performance of an index by a specified multiple over a specified period of time; or (ii) have an inverse relationship to, or are an inverse multiple of, the performance of an index over a specified period of time.

8 Rescission would not technically be necessary in the case of exemptive orders issued in 2008 or later, as such orders include a condition providing that the ETF Relief contained therein will expire on the effective date of any SEC rule permitting the operation of ETFs. The SEC proposes to amend these orders to add a one-year grace period to provide time for these ETFs to bring their operations into compliance with the Proposed Rule.

9 As discussed below, the SEC also does not propose to rescind existing Funds of Funds Relief, but does propose rescission of certain existing relief to operate ETFs in a master-feeder structure.

Exemptions Provided by the Proposed Rule

The Proposed Rule would address the specific exemptions provided by current exemptive orders as follows:

- Treatment of ETF Shares as "Redeemable Securities". Current exemptive orders provide exemptions from Sections 2(a)(32) and 5(a)(1) of the 1940 Act to permit ETFs to redeem shares only in creation unit aggregations, rather than individual shares. These exemptions are necessary for ETFs to be viewed as open-end funds under the 1940 Act, because a key element of the definition of an "open-end company" in Section 5(a)(1) is the issuance of redeemable securities. The definition of a "redeemable security" in Section 2(a)(32) contemplates the ability of the holder thereof to redeem the security and receive its proportionate share of the fund's net assets or the cash equivalent. Rather than provide an exemption from these provisions, the Proposed Rule would classify shares of ETFs as "redeemable securities," meaning that ETFs operating in reliance on the Proposed Rule would meet the definition of an open-end company. The Proposal notes that as a result of this classification, certain exceptions from rules under the Securities Exchange Act of 1934 (Exchange Act) that apply to redeemable securities and/or open-end funds would likewise apply to ETFs relying on the Proposed Rule, as discussed under "Exchange Act Relief" below.

- Trading of ETF Shares at Market-Determined Prices. Consistent with current exemptive orders, the Proposed Rule would provide exemptions from Section 22(d) of the 1940 Act and Rule 22c-1 thereunder to permit dealers to buy and sell shares of ETFs at market prices rather than at NAV. Section 22(d) prohibits funds and dealers from selling a redeemable security to the public at a price other than the current public offering price described in the prospectus. Rule 22c-1 requires funds and dealers to sell a redeemable security at a price based on its NAV, with limited exceptions. An ETF requires exemptions from these provisions for dealers in its shares, because such shares trade in the secondary market at market prices rather than at prices described in the ETF's prospectus or based on NAV.

- In-Kind Transactions with Certain Affiliates. Consistent with current exemptive orders, the Proposed Rule would provide an exemption from Sections 17(a)(1) and (2) of the 1940 Act to permit ETFs to engage in in-kind transactions with certain affiliates. Sections 17(a)(1) and (2) prohibit an affiliated person of a fund (first-tier affiliate) or an affiliated person of such a person (second-tier affiliate) from selling any security or other property to, or purchasing any security or other property from, a fund.[10] Because in-kind creations and redemptions involve the sale and purchase, respectively, of assets to and from an ETF, these restrictions could be triggered, for example, where an authorized participant or other market participant owns 5% or more of the shares of an ETF or an investment company that is an affiliated person of the ETF.[11] As a result, the Proposed Rule would provide an exemption from Sections 17(a)(1) and (2) to permit in-kind creation and redemption transactions involving persons who are first- or second-tier affiliates of an

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[10] Under Section 2(a)(3) of the 1940 Act, the term "affiliated person" of another person includes, among others: (i) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of such other person; and (ii) any person directly or indirectly controlling, controlled by, or under common control with, such other person. Under Section 2(a)(9) of the 1940 Act, a control relationship is presumed where a person owns more than 25% of a company's outstanding voting securities.

[11] An investment company with the same investment adviser as an ETF may be deemed to be under common control with the ETF, rendering such investment company a first-tier affiliate, and the authorized participant or other market participant a second-tier affiliate, of the ETF.

ETF solely by reason of holding with the power to vote 5% or more of: (i) the ETF's shares; or (ii) any investment company that is an affiliated person of the ETF.[12]

Although the Proposing Release acknowledges that many commenters on the 2008 Rule requested that this relief be expanded to include other types of affiliates, such as broker-dealers affiliated with an ETF's investment adviser, the SEC indicates that it preliminarily believes that such expansion would not be appropriate at this time given the flexibility proposed for custom baskets, as described below.[13] However, the SEC is soliciting additional comment on this point, including with respect to whether further conditions could be added to the Proposed Rule to minimize the potential risks of overreaching by other types of affiliates.

- Additional Time for Delivering Redemption Proceeds. Consistent with current exemptive orders, the Proposed Rule would provide an exemption from Section 22(e) of the 1940 Act, under certain circumstances, to permit ETFs to pay authorized participants redemption proceeds in more than seven days. Section 22(e) prohibits funds from suspending or delaying the right of redemption for more than seven days after the tender of a security for redemption. Delivery cycles for transferring foreign investments to redeeming investors, as well as local market holiday schedules, make it difficult for ETFs that hold foreign investments and redeem creation units in kind to comply with this provision. The exemption set forth in the Proposed Rule would apply where local market holidays, a series of consecutive holidays and/or extended delivery cycles for transferring foreign investments to redeeming authorized participants prevent an ETF from delivering a foreign investment[14] to an authorized participant within seven days. Instead, the ETF would be required to deliver the foreign investment as soon as practicable, and in any event within 15 days after the authorized participant's tender of ETF shares.

  This proposed exemption is notable for multiple reasons. By its terms, the proposed exemption permits delayed delivery only with respect to the particular foreign investment, and not the entire basket as permitted in current exemptive relief. In addition, the proposed exemption includes a "sunset provision," providing for its automatic expiration in 10 years. The SEC has included this provision because it expects that technological advancements and "changes in market infrastructures" will result in additional shortening of settlement cycles. Further, as discussed below under "Other Differences from Current Exemptive Relief," the Proposed Rule would eliminate the requirement under current exemptive relief for an ETF to include

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[12] The Proposed Rule differs from current exemptive orders in that it does not specifically state that the exemption from Sections 17(a)(1) and (2) would apply to first- or second-tier affiliates of an ETF by reason of holding with the power to vote in excess of 25% of the ETF's shares or an affiliated fund's shares. It may be noted, however, that because the language "5% or more" would also encompass "in excess of 25%," and the related discussion in the Proposing Release does not suggest that the SEC intends to limit the scope of this exemption to exclude control affiliates, it does not appear that the scope of the proposed relief would differ from that provided in current exemptive relief.

[13] The "affiliated person" definition in Section 2(a)(3) of the 1940 Act also includes any officer, director, partner, copartner, employee or investment adviser of a fund. As a result, a broker-dealer affiliated with an ETF's investment adviser may be a second-tier affiliate of the ETF.

[14] A "foreign investment" for purposes of the Proposed Rule is defined as "any security, asset or other position of the ETF issued by a foreign issuer as that term is defined in [Rule 3b-4 under the Exchange Act], and for which there is no established United States public trading market, as that term is used in Item 201 of Regulation S-K under the Securities Act of 1933 (17 CFR 227.201)." The SEC notes that this definition would preclude reliance on the relief where the foreign investment could be traded on a U.S. market.

disclosure in its statement of additional information (SAI) regarding foreign holidays that may result in redemption delays.

Although current exemptive orders also provide Funds of Funds Relief, the SEC is not yet re-proposing Rule 12d1-4 and has indicated that it does not intend to address Funds of Funds Relief at this time. Instead, ETFs could continue to rely on the Funds of Funds Relief in their existing exemptive orders, which would not be rescinded in connection with the Proposal. This approach would maintain consistency with other open-end funds, which often seek Funds of Funds Relief in stand-alone exemptive applications unrelated to ETF operations.[15]

Many existing exemptive orders also provide exemptions from certain provisions of the 1940 Act to permit ETFs to operate as feeder funds in a master-feeder structure (Master-Feeder Relief). The SEC notes certain concerns with existing Master-Feeder Relief, in particular the possibility that ETFs transacting in kind will nonetheless bear costs associated with cash transactions by other feeder funds. In light of these concerns, and having observed that ETF sponsors seem to have limited interest in this structure, the SEC is proposing to: (i) rescind the portions of existing exemptive orders that relate to Master-Feeder Relief for ETFs that did not rely on such relief as of June 28, 2018; and (ii) amend the portions of existing exemptive orders that relate to Master-Feeder Relief, for ETFs that did rely on such relief as of June 28, 2018, to prevent the formation of additional feeder funds.

Definition of "Exchange-Traded Fund"

The definition of "exchange-traded fund" under the Proposed Rule incorporates certain requirements with respect to ETF operations. Under the Proposed Rule, an "exchange-traded fund" would be defined as "a registered open-end management company:

(i) That issues (and redeems) creation units to (and from) authorized participants in exchange for a basket and a cash balancing amount if any; and

(ii) Whose shares are listed on a national securities exchange and traded at market-determined prices."[16]

As noted above, the definition of "creation unit" in the Proposed Rule does not incorporate a minimum creation unit size. This differs from current exemptive relief, which often sets forth a specified minimum, and would give an ETF flexibility to set its creation unit size at an amount the ETF believes to be appropriate based on its investment strategy and other factors. However, as discussed below under "Exchange Act Relief," an ETF may continue to be subject to minimum creation unit size requirements under certain Exchange Act relief on which ETFs rely.

With respect to redemption of creation units, the Proposing Release notes that ETFs (like other open-end funds) are only permitted to suspend redemptions under the circumstances set forth in Section 22(e) of the 1940 Act, and are

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[15] The Commission's spring 2018 regulatory agenda indicates that the SEC's Division of Investment Management is considering proposal of a rule and rule amendments permitting funds of funds arrangements, including those involving ETFs, without the need to obtain exemptive relief. Accordingly, it is possible that an exemptive rule relating to funds of funds arrangements will be proposed at a later date. ETF sponsors that intend to rely on the Proposed Rule and that do not have Funds of Funds Relief may need to obtain individual Funds of Funds Relief in the event the Proposed Rule is finalized prior to the adoption of an exemptive rule relating to funds of funds.

[16] The SEC notes that the requirement that shares trade at market-determined prices is not intended to require a minimum amount of trading volume, but instead to differentiate ETFs from other types of listed products, such as exchange-traded managed funds, that trade based on NAV.

subject to the 2% limitation on redemption fees set forth in Rule 22c-2 under the 1940 Act.[17] Significantly, the Proposal adds that, given the role of creation and redemption transactions in facilitating the arbitrage process, an ETF "generally may suspend the issuance of creation units only for a limited time and only due to extraordinary circumstances" and "could not set transaction fees so high as to effectively suspend the issuance of creation units."

The Proposed Rule would explicitly recognize the ability of an ETF to sell or redeem individual shares in connection with transactions such as reorganizations, mergers, conversions or liquidations, on the date of the transaction. This builds on statements in certain exemptive applications contemplating individual redeemability in connection with a termination.

Conditions of the Proposed Rule

In order to rely on the Proposed Rule, an ETF would be required to comply with various conditions. The conditions would be similar in many ways to conditions under current ETF Relief, but also would reflect certain differences that the SEC "believe[s] will improve the overall regulatory framework for [ETFs]." The table below sets forth the conditions included in the Proposed Rule[18] and notes the differences between those conditions and the conditions that apply under current ETF Relief, including instances where current relief includes an express condition not contained in the Proposed Rule. The table is based on recent exemptive orders granted by the SEC (*i.e.*, relief issued from approximately 2010 to present); there may be differences in ETFs' existing exemptive relief requirements, in particular for those ETFs with older exemptive orders (*i.e.*, relief issued in approximately 2009 or earlier).

Topic	Proposed Rule Condition	Comparison to Current Exemptive Relief
Website Disclosure – Holdings and Baskets	Each business day, an ETF must disclose prominently on its website, which is publicly available and free of charge, 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: i. The portfolio holdings (*i.e.*, the securities, assets or other positions held by the ETF) that will form the basis of the next calculation of current NAV per share;[19] ii. 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	Currently, daily disclosure of portfolio holdings is only required for: (i) actively managed ETFs; (ii) ETFs that seek to track an index for which a first- or second-tier affiliate of the ETF or its investment adviser or distributor serves as index provider (Self-Indexing ETFs); and (iii) 130/30 and long/short index-based ETFs. Accordingly, ETFs that seek to track third-party indices are generally not required to disclose holdings daily, but would be required to do so under the Proposed Rule. In addition, ETFs are not currently required to post a basket on their websites daily, but instead must only disseminate basket information through the National Securities Clearing Corporation.

[17] ETFs generally charge a fixed transaction fee for creation and redemption transactions, together with a variable fee designed to compensate the ETF for brokerage and other costs associated with any portion of the creation or redemption transaction effected in cash.

[18] A condition prohibiting operation of leveraged ETFs in reliance on the Proposed Rule is described above and accordingly is omitted from the chart.

[19] The Proposed Rule would explicitly require an ETF to reflect changes in the ETF's portfolio holdings in the first calculation of NAV per share on the first business day following the trade date (*i.e.*, T + 1). There is no comparable express condition under current exemptive relief, although the condition is consistent with statements made in support of current exemptive relief.

Topic	Proposed Rule Condition	Comparison to Current Exemptive Relief
	iii. The estimated cash balancing amount, if any. The ETF must present the description, amount, value and unrealized gain/loss for each portfolio holding or basket asset in the manner prescribed in Article 12 of Regulation S-X.	There is currently no prescribed format for disclosure of holdings, although the exchanges' "generic listing standards" for actively managed ETFs, as well as orders approving exchange rule changes pursuant to Rule 19b-4 under the Exchange Act to list certain ETFs (19b-4 Orders), require certain specified information.[20]
Website Disclosure – Current NAV and Market Price	Each business day, an ETF must disclose prominently on its website, which is publicly available and free of charge, the ETF's current NAV per share, market price, and premium or discount, each as of the prior business day. "Market price" is defined as: 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 between the national best bid and national best offer as of that time.	The disclosure required is generally consistent with disclosure required today, except that the Proposed Rule would provide more specificity with respect to the "market price" information to be used. Under current exemptive relief, either the market closing price or the midpoint of the bid/ask spread at the time of calculation may be used (with no "more accurately reflect" qualifier for use of the midpoint of bid/ask spread or specific reference to the national best bid and national best offer).
Website Disclosure – Premium and Discount	Each business day, an ETF must disclose prominently on its website, which is publicly available and free of charge: i. 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 since that year (or the life of the ETF, if shorter); ii. A line graph showing ETF share premiums or discounts for the most recently completed calendar year and the most recently completed calendar quarters since that year (or the life of the ETF, if shorter); and iii. If the ETF's premium or discount is greater than 2% for more than seven consecutive trading days, a discussion of the factors that are reasonably believed to have materially contributed to the premium/discount, which must be maintained on the website for at least one year thereafter.	While not an express condition to exemptive relief, Form N-1A currently requires an ETF to include tabular premium and discount information in its prospectus and annual report. This inclusion may be omitted if an ETF provides a website that can be used to obtain the information required to be included in the prospectus. The line graph and disclosure where an ETF's premium or discount is greater than 2% for more than seven consecutive trading days would reflect new requirements not currently imposed by exemptive relief.

[20] Where an ETF is not eligible for listing pursuant to the generic listing standards adopted by an exchange, the exchange must obtain a 19b-4 Order to list the ETF. The conditions of a particular 19b-4 Order apply only to the ETF(s) to which the 19b-4 Order relates.

Topic	Proposed Rule Condition	Comparison to Current Exemptive Relief
Construction of Baskets	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. If the ETF utilizes a custom basket (described further below under “Custom Baskets”), these written policies and procedures also must: i. Set 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 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.	Current exemptive relief does not explicitly require written policies and procedures governing basket construction, although ETFs may have such procedures as part of procedures to comply with their exemptive relief. In addition, as discussed in greater detail below under “Custom Baskets,” current exemptive relief does not generally permit the use of custom baskets. However, older exemptive relief may permit custom baskets without any express requirement to adopt policies and procedures. In addition, current relief frequently includes an express condition that prohibits an ETF’s investment adviser, directly or indirectly, from causing any authorized participant (or any investor on whose behalf an authorized participant may transact with the ETF) to acquire any basket instrument for that ETF through a transaction in which the ETF could not engage directly.
Listing on a National Securities Exchange	While not included in the list of express conditions, the definition of “exchange-traded fund” in the Proposed Rule would require that an ETF’s shares be listed on a national securities exchange and traded at market-determined prices.	Shares of an ETF must be listed on an exchange.
Marketing Restrictions	No marketing disclosure requirements.	Current relief places certain restrictions on the marketing of ETFs. Specifically, an ETF may not be advertised or marketed as an open-end fund or a mutual fund, and advertising material containing certain information must prominently disclose that shares are not individually redeemable and can be purchased and redeemed only in creation units. The Proposing Release indicates that the SEC no longer believes these requirements are needed, given retail investors’ familiarity with ETFs.

The Proposed Rule would also add recordkeeping requirements that are not imposed by current exemptive relief. Specifically, the Proposed Rule would require ETFs to maintain the following records for no less than five years, the first two in an easily accessible place: (i) written agreements between authorized participants and an ETF or its service providers permitting the authorized participants to transact with the ETF in creation units (authorized participant agreements);[21] and (ii) certain specified information about each basket used to effectuate a creation or

[21] The SEC notes its belief that most ETFs already retain authorized participant agreements, but is proposing to make this an express requirement “for avoidance of doubt.”

redemption transaction, including information about the basket instruments[22] and, for custom baskets, a statement that the basket complied with the ETF's custom basket procedures, discussed below.

Custom Baskets

One of the most noteworthy aspects of the Proposed Rule is the fact that it would afford ETFs the flexibility to use "custom baskets" for creation and redemption transactions. Under the Proposed Rule, custom baskets are defined as baskets[23] that (i) reflect a non-representative selection of the ETF's portfolio holdings or (ii) differ from baskets used for other creation and redemption transactions on the same business day.

Although certain older exemptive orders do not restrict the use of custom baskets, more recent exemptive orders require ETFs to use baskets that correspond *pro rata* to their portfolio holdings, with certain limited exceptions.[24] As explained in the Proposal, the shift toward more stringent restrictions on basket composition was intended to address the concern that authorized participants could leverage their relationships with ETFs to "cherry pick" more desirable securities away from ETFs or "dump" less desirable securities onto ETFs. As described in the Proposal, however, the SEC now recognizes that there are significant potential benefits to using custom baskets in circumstances beyond those carved out as exceptions in recent exemptive orders. These potential benefits include, among others, narrower bid-ask spreads, more efficient arbitrage, lower transaction costs and tax efficiencies. As a result, ETFs relying on older exemptive orders that provide flexibility to use custom baskets are at a competitive advantage. The Proposed Rule would remove this restriction for all ETFs, thereby leveling the playing field.

As set forth in the table above, each ETF relying on the Proposed Rule would be required to adopt certain written policies and procedures relating to the construction of baskets.[25] In order to utilize custom baskets under the Proposed Rule, an ETF would be required to adopt an expanded version of these written policies and procedures governing the use of custom baskets (custom basket procedures) and comply with certain recordkeeping requirements related to custom basket transactions. The SEC indicates that the requirement to implement custom basket procedures would help protect against "cherry-picking," "dumping" and other abuses related to custom basket composition. An ETF's custom basket procedures would be part of its Rule 38a-1 compliance program and as such

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22 The Proposing Release notes that the purpose of this requirement is to "allow [the SEC] staff to review an ETF's baskets as part of an examination."

23 Specifically, under the Proposed Rule, a "basket" would be defined as "the securities, assets or other positions in exchange for which an [ETF] issues (or in return for which it redeems) creation units." Thus, ETFs may transact on an in-kind basis, on a cash basis, or both.

24 As described in the Proposing Release, recent exemptive orders contain exceptions from the *pro rata* requirement in limited circumstances, such as: (i) where bonds cannot be broken up beyond certain minimum sizes needed for transfer and settlement; (ii) where rounding is needed to eliminate fractional shares; and (iii) where the basket includes positions (such as "to be announced" transactions, short positions, and derivatives) that cannot be transferred in kind. For index-based ETFs, current exemptive relief also permits: (i) the use of a "representative sampling" of the ETF's portfolio, provided that, among other things, the representative sampling is the same for all authorized participants on a given day; and (ii) the use of a non-*pro rata* basket for temporary periods to effect changes to holdings as a result of an index rebalancing.

25 Such procedures would be required to set forth the methodology used to construct standard (non-custom) baskets, including: (i) circumstances where holdings would be omitted due to operational challenges of transferring in kind; (ii) when and how representative sampling would be used in the construction of baskets; and (iii) for index-based ETFs, how changes to the portfolio to effect an index rebalancing would be made.

would be subject to the oversight of the ETF's board of directors/trustees, which the SEC notes would provide an additional layer of protection with respect to use of custom baskets.

As noted above, an ETF's custom basket procedures would need to set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, as well as identify the employees of the ETF's investment adviser who would be responsible for reviewing custom baskets for compliance with the parameters. The Proposing Release emphasizes that such procedures must be specific as to the methodology and process used for construction and acceptance of custom baskets.[26] The Proposing Release further specifies that the procedures should address compliance testing and assessment of whether the parameters continue to be appropriate, and should include a process to be followed to the extent revisions to, or deviations from, the parameters are desired. In addition, the Proposing Release suggests that ETFs consider the implementation of reasonable controls to avoid inappropriate distinctions in treatment of different authorized participants, as well as whether, prior to approval, the components of custom baskets should be subject to review by employees other than portfolio managers.

Other Differences from Current Exemptive Relief

Current exemptive relief for ETFs is based on various material representations made by applicants, which impose other requirements beyond the explicit conditions of the orders. Many of the requirements associated with these material representations would be eliminated under the Proposed Rule, potentially allowing ETFs more flexibility with respect to their operations. These include:

- Disclosure of Intraday Indicative Value (IIV). Current exemptive relief contemplates dissemination of an IIV, or intraday estimate of an ETF's NAV per share, at regular intervals throughout the trading day. The SEC notes that market makers generally use their own proprietary algorithms, rather than publicly-disseminated IIVs, to value shares throughout the trading day. Accordingly, the SEC is not proposing to include this requirement in the Proposed Rule. As IIV disclosure is also required by exchange listing standards and 19b-4 Orders, the requirement would continue to apply absent further action by the exchanges.

- Requirements Applicable to Self-Indexing ETFs. Current exemptive relief imposes various requirements on Self-Indexing ETFs. In addition to full portfolio transparency as described above, the relief requires that, among other things: (i) the registration statement prominently disclose that the index provider is an affiliated index provider and describe the nature of the affiliation; (ii) the adviser's Form ADV include a discussion of any affiliated index provider and any attendant material conflicts of interest; (iii) the adviser's compliance policies and procedures include provisions designed to minimize conflicts of interest among a Self-Indexing ETF and affiliated accounts seeking to track the same index; (iv) the ETF's board periodically review the ETF's use of the affiliated index provider; and (v) the affiliated index provider permit the Self-Indexing ETF to use the index at no cost to the ETF. Although these requirements would no longer apply under the Proposed Rule, Self-Indexing ETFs and their investment advisers and index providers should nonetheless consider whether some or all of these steps remain appropriate based on general fiduciary duty, disclosure, and conflicts of interests principles, as well as other 1940 Act restrictions on affiliated transactions.

- Disclosure of Foreign Holiday Schedules. In order to rely on current Section 22(e) relief, an ETF must disclose in its SAI those holidays that are expected to prevent the delivery of redemption proceeds in seven

[26] The Proposing Release states that such policies and procedures should include details regarding the circumstances in which cash, securities or other positions would be substituted as compared to the published basket.

calendar days and the maximum number of days (up to 15 calendar days) needed to deliver the proceeds. The SEC does not propose to include this as a requirement of the Proposed Rule, on the basis that this information is not relevant to investors on the secondary market, as well as the SEC's belief that information regarding possible delays is generally covered in authorized participant agreements. An ETF sponsor should review its authorized participant agreements to confirm that this information is in fact covered.

- Permitted Index Components. Under current exemptive relief, index-based ETFs must seek investment results that correspond, before fees and expenses, to the performance of a "securities index." This means derivatives that do not qualify as "securities" within the meaning of the 1940 Act (*e.g.*, swaps, futures on broad-based indices) cannot be included in the index. Given the lack of distinction between index-based and actively managed ETFs under the Proposed Rule, and therefore the elimination of any requirements specific to index-based ETFs, this requirement would no longer apply. Nonetheless, an ETF that seeks to track an index containing derivatives would generally not be able to rely on the exchanges' generic listing standards; therefore, in order to be listed, such an ETF would need a 19b-4 Order.

- 80% Test for Index-Based ETFs. The Proposed Rule would eliminate the requirement under current exemptive relief for an index-based ETF to invest at least 80% of its assets, exclusive of collateral held from securities lending, in the component securities of its underlying index. Nonetheless, in the release adopting Rule 35d-1 under the 1940 Act, which relates to fund names, the SEC indicated that "[i]ndex funds … generally would be expected to invest more than 80% of their assets in investments connoted by the applicable index," even though reference to an index would not itself trigger the Rule 35d-1 requirements.[27] Accordingly, an index-based ETF would generally need to continue to follow a policy of investing at least 80% of its assets in index components, although the elimination of the exemptive relief requirement could potentially give ETFs more flexibility in defining this policy (such as by including derivative instruments that provide exposure to index components for purposes of the 80% test).

- Other Portfolio Requirements. Due to the lack of distinction between index-based ETFs and actively managed ETFs noted above, various representations in current exemptive relief relating to investment strategies and portfolio instruments would be eliminated, including: (i) for index-based ETFs, expected tracking error of less than 5% relative to the index; (ii) for actively managed ETFs, an explicit requirement that the board periodically review and approve the use of derivatives; (iii) for both index-based and actively managed ETFs, a prohibition on investment in depositary receipts that the adviser deems to be illiquid, for which pricing information is not readily available, or for which an affiliated person serves as the depositary bank; and (iv) for 130/30 and long/short index-based ETFs, specific requirements with respect to relative long and short exposures. While the elimination of these requirements would not necessarily result in changes to ETF operations, ETFs and investment advisers would have the flexibility to consider the best approach in these areas – such as board oversight of derivatives and evaluation of liquidity – consistent with practices for the entire fund complex, rather than in the specific context of ETF exemptive relief.

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[27] *See* Investment Company Names, SEC Rel. No. IC-24828 (Jan. 17, 2001). Rule 35d-1 requires a fund to adopt an 80% policy meeting certain requirements, to the extent its name suggests a focus on a particular type of investment, industry, or country or geographic region or suggests that the fund's investments are tax-exempt. Where an ETF's name triggers the Rule 35d-1 requirements, ETFs often rely on the 80% policy required by the exemptive relief to satisfy both the exemptive relief and Rule 35d-1 requirements.

Exchange Act Relief

Given that ETFs are exchange-traded, their structure also implicates certain provisions of the Exchange Act. However, as under the 1940 Act, the ETF structure is not specifically contemplated by the Exchange Act. Accordingly, ETFs generally seek relief from the Exchange Act sections and rules set forth below. This relief is largely provided in a series of "class" letters, meaning the letters can be relied on by ETFs meeting the requirements set forth therein without the need for separate relief. These include the SIA Letter,[28] the Equity Class Letter,[29] the Fixed-Income Class Letter,[30] and Frequently Asked Questions about Regulation M.[31] ETFs that do not meet the requirements of the applicable class letters or guidance may apply for separate relief.

- Section 11(d)(1). ETFs seek an exception to permit broker-dealers, including broker-dealers that are also authorized participants, to extend credit with respect to ETF shares, subject to certain conditions.
- Rule 11d1-2. ETFs request relief to allow broker-dealers to treat ETF shares as "securities issued by a registered open-end investment company or unit investment trust as defined in the [1940 Act]," thereby providing an exemption from Section 11(d)(1) to permit extension of credit on shares of the ETFs, provided they have been held for more than 30 days.
- Rule 10b-10. ETFs request relief to allow broker-dealers to omit specific information about an ETF's component securities from confirmations relating to ETF trades.
- Rules 15c1-5 and 15c1-6. ETFs request relief to allow broker-dealers to effect transactions in ETF shares without disclosing a control relationship with an issuer of an ETF's component securities or its participation or interest in a distribution of a component security.
- Rules 101 and 102 of Regulation M. ETFs seek relief to permit treatment of ETF shares as "redeemable securities issued by an open-end management investment company or a unit investment trust," and therefore as "excepted securities" for purposes of Rules 101 and 102. These rules are anti-manipulation provisions that generally prohibit distribution participants and affiliated purchasers from purchasing ETF shares during the "restricted period," which is ongoing for an ETF in light of its continuous distribution.
- Rule 10b-17. Given that ETFs are unable to predict the amount of a dividend 10 days in advance, ETFs seek relief with respect to notice requirements regarding dividend amounts. Specifically, ETFs request to rely on the rule's exception for "redeemable securities issued by open-end investment companies and unit investment trusts registered with the Commission under the [1940 Act]."

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28 Securities Industry Association (pub. avail. Nov. 21, 2005).

29 Class Relief for Exchange Traded Index Funds (pub. avail. Oct. 24, 2006) (providing class relief for equity index-based ETFs).

30 Class Relief for Fixed Income Exchange-Traded Funds (pub. avail. Apr. 9, 2007) (providing class relief for fixed-income index-based ETFs).

31 Frequently Asked Questions About Regulation M (last revised Sept. 10, 2010) (providing Regulation M relief for actively managed ETFs).

- Rule 14e-5. ETFs seek relief to permit "covered persons" with respect to a tender offer involving an ETF's component securities to engage in secondary market transactions in the ETF's shares and redeem ETF shares in creation unit aggregations during the existence of such tender offer.

Relief with respect to these provisions is subject to various conditions, including conditions relating to: creation unit size; number of component securities and/or issuers held by the ETF; maximum percentage weighting of holdings; and IIV disclosure. These conditions differ based on the letter or series of letters (or guidance) on which the ETF relies, which depends on whether the ETF is index-based or actively managed, as well as on its investments (*e.g.*, equity securities, fixed-income securities, shares of other ETFs).

One of the key open questions prior to the Proposal's issuance was whether it would cover Exchange Act relief, thereby eliminating the need for ETFs to rely on the patchwork of exemptions provided to date and/or seek individual relief. In the Proposal, the SEC partially addressed the need for Exchange Act relief through its proposal to classify shares of ETFs relying on the Proposed Rule as "redeemable securities." Based on such classification, these ETFs would thereby become eligible for: (i) the Rule 11d1-2 exemption for "securities issued by a registered open-end investment company;" and (ii) the exceptions provided in Rules 101 and 102 of Regulation M and Rule 10b-17 for "redeemable securities" issued by open-end funds.

The Proposal, as drafted, would not address the relief from Section 11(d)(1) of the Exchange Act and Rules 10b-10, 15c1-5, 15c1-6 and 14e-5 thereunder, although the SEC seeks comment as to whether ETFs relying on the Proposed Rule should be exempted from other Exchange Act provisions. To the extent such provisions are not addressed, ETFs would continue to be required to comply with certain conditions to rely on existing Exchange Act relief with respect to these provisions. For example:

- Equity index-based ETFs relying on the Rule 14e-5 relief provided by the Equity Class Letter would need to continue to comply with the conditions therein, including the requirement that a creation unit consist of 50,000 shares or such other amount where the value of a creation unit is at least $1 million at the time of issuance.

- For relief with respect to Section 11(d)(1) of the Exchange Act and Rules 10b-10, 15c1-5 and 15c1-6 thereunder, ETFs would need to comply with: (i) the SIA Letter's requirement to invest in at least 20 component securities, with no one security constituting more than 25% of the total value of the ETF; or (ii) for a fixed-income index-based ETF that does not meet this requirement, the various requirements of the Fixed-Income Class Letter (including a creation unit size requirement that mirrors the Equity Class Letter).[32] In addition, Section 11(d)(1) relief would continue to be subject to the condition that the selling broker-dealer not receive from the ETF (or an affiliated person of the ETF) any payment, compensation or other economic incentive to promote the sale of the ETF.

- ETFs relying on the Equity Class Letter or the Fixed-Income Class Letter will also be required to publicly disseminate the ETF's IIV.

Accordingly, these requirements could limit the flexibility otherwise afforded by the Proposed Rule.

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32 *See* Ameristock Fixed-Income ETF Trust (pub. avail. June 29, 2007) (permitting a fixed-income ETF that meets the requirements of the Fixed-Income Class Letter to rely on the SIA Letter).

Proposed Amendments to Disclosure Forms

Proposed Amendments to Form N-1A

The Proposal would amend Form N-1A (the registration form used by ETFs structured as open-end funds) to expand the disclosure requirements for ETFs: (i) to require the inclusion of more ETF-specific information designed for investors that buy and sell ETF shares in the secondary market; and (ii) make certain other changes. Notably, the new requirements under Form N-1A would apply to all ETFs using that form, even ETFs that cannot rely on the Proposed Rule. In connection with the proposed amendments, the SEC is seeking comment on whether there should be a separate registration form specifically designed for ETFs.

Definitions

The proposed amendments include two changes to the Definitions section of Form N-1A: (i) amendment of the definition of "Exchange-Traded Fund" to add a reference to the Proposed Rule; and (ii) removal of the definition of "Market Price" and certain related references, as other proposed amendments to the form would make it unnecessary to include this definition.

Fee Table

The proposed amendments include several significant changes to Item 3 of Form N-1A, which relates to fees and expenses. While the majority of these changes would only apply to ETFs, *two of the changes would apply to all open-end funds*: (i) a clarification that the fees and expenses reflected in a fund's fee and expense table may be higher where an investor *sells*, and not just buys or holds, shares; and (ii) the addition of a statement that investors may be subject to other fees, such as brokerage commissions and fees paid to financial intermediaries, that are not reflected in a fund's fee and expense table.[33]

The majority of the ETF-specific changes to Item 3 of Form N-1A would be presented as a series of six Questions and Answers (Q&As) that would be added below the fee and expense table in a new section called "Exchange-Traded Fund Trading Information and Related Costs." The six Q&As are set forth below:

> Q&A 1: *What information do I need to know about how the Exchange-Traded Fund ("ETF") trades?*
>
> Individual shares of an ETF may only be bought and sold in the secondary market through a broker or dealer at a market price. The market price can change throughout the day due to the supply of and demand for ETF shares, and changes in the value of the Fund's underlying investments, among other reasons. Because ETF shares trade at market prices rather than net asset value, shares may trade at a price greater than net asset value (premium) or less than net asset value (discount).

33 This is essentially an expanded version of the disclosure contemplated under the SEC staff's interpretative guidance regarding "clean shares" as set forth in a response to a request from Capital Group. *See* Response of the Office of Chief Counsel Division of Investment Management (pub. avail. Jan. 11, 2017). In light of this change, the SEC proposes to eliminate the form provision requiring ETFs to modify the narrative disclosure to specify that the information does not reflect brokerage commissions investors may bear in connection with purchases and sales of ETF shares.

Q&A 2: *What costs are associated with trading shares of an ETF?* An investor may incur costs when buying or selling shares on an exchange that are in addition to the costs described above. Examples include brokerage commissions, costs attributable to the bid-ask spread, and costs attributable to premiums and discounts.
Q&A 3: *What is the bid-ask spread?* The bid-ask spread is the difference between the highest price a buyer is willing to pay to purchase shares of the Fund (bid) and the lowest price a seller is willing to accept for shares of the Fund (ask). The bid-ask spread can change throughout the day due to the supply of or demand for ETF shares, the quantity of shares traded, and the time of day the trade is executed, among other factors. For the ETF's most recent fiscal year ended [___], the median bid-ask spread was XX.XX%.
Q&A 4: *How does the bid-ask spread impact my return on investment?* The impact of the bid-ask spread depends on your trading practices. For example, based on the ETF's fiscal year-end data, purchasing $10,000 worth of ETF shares and then immediately thereafter selling $10,000 worth of ETF shares (*i.e.*, a "round-trip"), your cost, in dollars, would be as follows: For a SINGLE round-trip (each trade being $10,000) Assuming mid-range spread cost: $ _____ Assuming high-end spread cost: $ _____
Q&A 5: *But what if I plan to trade ETF shares frequently?* Based on the ETF's most recent fiscal year-end data, completing 25 round-trips of $10,000 each, your cost, in dollars, would be as follows: For 25 round-trips (each trade being $10,000) Mid-range spread cost: $ _____ High-end spread cost: $ _____
Q&A 6: *Where can I get more trading information for the ETF?* The ETF's website at [www.[Series-SpecificLandingPage.com]] includes recent information on the Fund's net asset value, market price, premiums and discounts, as well as an interactive calculator you can use to determine how the bid-ask spread would impact your specific investment.

The proposed amendments also would require an ETF to provide this information on its website, together with an interactive calculator in a clear and prominent format (as mentioned in Q&A 6). The interactive calculator would provide investors with a mechanism to customize the ETF's Item 3 calculations based on an investor's investment amount and anticipated number of trades.

The proposed amendments include instructions regarding calculation of the median bid-ask spread, mid-range spread cost, and high-end spread cost. The form amendments would specify that median bid-ask spread be calculated by: (i) dividing the difference between the ask and the bid by the midpoint of the ask and the bid for each

10-second interval throughout each trading day of the ETF's most recent fiscal year;[34] (ii) sorting the spreads from lowest to highest; and (iii) using the middle number if there is an odd number of spread intervals, and the average of the two middle numbers if there is an even number of spread intervals. The median bid-ask spread would be used as an input for the mid-range spread cost information, and the 95th percentile spread (calculated using the same steps (i) and (ii)) would be used to calculate the high-end spread cost information.

In connection with these changes, the SEC proposes to remove Item 6(c)(i) of Form N-1A, as the information covered by this subsection would be moved to Item 3, Q&A 1 or is currently covered by Form N-CEN.[35]

Premium/Discount Information

Currently, Item 11(g)(2) of Form N-1A requires an ETF to disclose in its prospectus premium/discount information for the most recently completed calendar year and most recently completed calendar quarters since that year, and Item 27(b)(7)(iv) requires an ETF to disclose in its annual report premium/discount information for the most recently completed five fiscal years, in each case unless the information required to be included in the prospectus is posted on the ETF's website. The SEC believes that this information would be duplicative of the more up-to-date premium/discount information that would be available on the ETF's website under the Proposed Rule, and therefore proposes to eliminate these form requirements.[36]

Disclosure Requirements Inapplicable to ETFs

Under current Form N-1A, ETFs that transact in creation units of not less than 25,000 shares are exempt from certain disclosure requirements. Specifically, if an ETF transacts in creation units of not less than 25,000 shares, it may omit: (i) fee table disclosure regarding fees charged in connection with purchases and redemptions;[37] (ii) disclosures required by Items 6(a) and (b), relating to minimum initial and subsequent investment requirements and the process for redeeming shares; and (iii) disclosures required by Items 11(a)(2), (b) and (c), relating to the timing for NAV calculation and the price at which purchases and redemptions are effected, as well as the procedures for purchasing and redeeming fund shares. The SEC proposes to allow all ETFs to omit these disclosures, regardless of creation unit size. The SEC explains that it no longer believes these requirements are beneficial as it now has a better understanding than it did at the time these requirements were adopted as to the relationship between retail investors and authorized participants and the flow of information about how to purchase and redeem shares.

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34 The requirement to include median bid-ask spread information and spread cost examples in an ETF's prospectus, as well as the related website disclosure and interactive calculator, would not apply (and the form would prohibit its inclusion) where the ETF was initially listed after the beginning of the most recently completed fiscal year.

35 Item 6(c)(i) of Form N-1A requires an ETF to: (i) specify the number of shares it will issue or redeem in exchange for a basket; (ii) explain that the individual shares of the ETF may only be purchased and sold on a national securities exchange through a broker-dealer; and (iii) disclose that the price of ETF shares is based on the market price and, as a result, shares may trade at a premium or discount.

36 As noted above, the new requirements under Form N-1A would apply to all ETFs using that form, even ETFs not relying on the Proposed Rule. As such, ETFs that are not relying on the Proposed Rule would appear no longer to be subject to a requirement to disclose premium/discount information in their prospectuses and annual reports or on their websites, unless specifically required by their exemptive relief.

37 Under Instruction 1(e)(ii) to Item 27(d)(1) of Form N-1A, these fees are also excluded for purposes of calculating the expense examples included in shareholder reports for such ETFs.

Proposed Amendments to Form N-8B-2

As the SEC believes that investors should receive consistent disclosure for all ETFs, including UIT ETFs, the SEC is proposing amendments to Form N-8B-2 (the registration form for unit investment trusts) to conform to the proposed amendments to Item 3 of Form N-1A.

Amendments to Form N-CEN

The SEC is proposing amendments to Item C.7 of Form N-CEN (the new form for registered investment company annual reports), which requires funds to disclose their reliance on certain exemptive rules during the reporting period, to refer to the Proposed Rule. The SEC is also proposing to remove the reference to “DTC Participants” from the definition of “Authorized Participant” in Form N-CEN, to match the definition that would be used in the Proposed Rule. The Proposing Release notes that this change would also eliminate the need for future amendments in the event that additional clearing agencies register with the SEC.

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