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Non-Transparent Actively Managed ETFs

Time for an Alternative Approach to Evaluating the Case for Exemptive Relief?

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Non-transparent actively managed exchange-traded funds (non-transparent ETFs) have the potential to transform the ETF landscape. Regulatory approval, however, has been elusive and ETF sponsors continue to face significant challenges in obtaining the exemptive relief needed to launch these products.[1]

Historically, the primary concern of the Securities and Exchange Commission (SEC) in granting ETF sponsors the necessary relief to launch ETFs has been the ETF arbitrage process, which ensures that ETF shares trade in the marketplace at or close to NAV. The SEC has considered portfolio transparency to be critical to the effective functioning of the arbitrage process and, as a result, full portfolio transparency has been a condition of all exemptive orders for actively managed ETFs issued by the SEC to date.

In evaluating applications for exemptive relief for non-transparent ETFs, the SEC has focused on whether the applicant has proposed an effective substitute for portfolio transparency to keep market prices of ETF shares at or close to NAV. As a result, applicants for non-transparent ETF relief (applicants) have the burden of proving to the SEC that the nature and scope of the information the applicant intends to disseminate to the marketplace (the Methodology) will be an effective substitute for portfolio transparency, without any actual trading experience under the Methodology to point to. Given the task it has assigned itself, the SEC also has a significant challenge. It must evaluate on a case-by-case basis the methodology proposed by an applicant and make subjective judgments as to the efficacy of that Methodology without any actual trading data to analyze (at best the SEC may be provided back-tested hypothetical data).

In view of the foregoing, it is perhaps not surprising that notwithstanding the number of well thoughtout applications for non-transparent ETF exemptive relief, which have been on file with the SEC for several years,[2] the SEC has not yet granted such relief to any applicant. Nor has there been any public indication that the logjam of applications for non-transparent ETF relief will be lifted anytime soon.[3]

As a result of its focus on ensuring that non-transparent ETFs do not trade at significant discounts or premiums to NAV, the SEC has, in a significant sense, evolved into a merit regulator of the ETF market. While this may have been appropriate at earlier stages of ETF development, now that ETFs are a mature product in a well-established ecosystem, merit regulation no longer seems necessary or appropriate. Perhaps the time is right for the SEC to consider a different approach to exemptive relief for non-transparent ETFs, one rooted largely in

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enhanced disclosures intended to ensure that investors understand the key distinctions between non-transparent and transparent ETFs and the manner in which they can be expected to trade in the marketplace. A disclosure oriented approach would take the SEC out of the awkward and time-consuming role of arbiter of the merits of specific investment products and allow the marketplace, rather than a regulator's judgment, to determine how well a non-transparent ETF product has been designed.

In order to grant exemptive relief under Section 6(c) of the Investment Company Act of 1940, as amended (the 1940 Act), the SEC must find that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act. Each of these elements is evaluated below in the context of a potential alternative to the current approach.

Exemptive Relief Must Be Consistent with Policies and Provisions of the 1940 Act

One of the provisions from which ETFs need exemptive relief is Section 22(d) of the 1940 Act. Section 22(d) prohibits a dealer from selling a redeemable security that is being offered to the public by or through an underwriter at other than the current public offering price described in the prospectus. Rule 22c-1 under the 1940 Act generally requires that a dealer selling or redeeming or repurchasing a security does so only at a price based on its NAV. Because ETF shares are purchased and sold on an exchange at market price and not at the price specified in the ETF's prospectus, nor at NAV, exemptive relief from Section 22(d) and Rule 22c-1 is required.

In the 2014 Notice, the SEC indicated that in order to grant relief from Section 22(d) for a non-transparent ETF, it must be able to determine that the applicant's proposed Methodology will result in a close tie between market prices and NAV.[4] According to the 2014 Notice, Section 22(d) is designed to ensure that all fund shareholders are treated equitably when purchasing and selling fund shares and that a close tie between NAV and market prices is necessary in order to make the finding that ETF shareholders are being treated equitably.[5]

Prior to the 2014 Notice, the SEC had not expressly conditioned Section 22(d) relief upon a finding that there will be an effective process to insure that shares will trade at or close to NAV, and it is respectfully submitted that, for the reasons discussed below, Section 22(d) could reasonably be interpreted not to impose such a requirement.

The legislative and administrative history of Section 22(d) was reviewed at length in an appendix to the release proposing Rule 22d-6 (which was later adopted as Rule 22d-1) (the appendix).[6] The appendix indicates that there is little in the 1940 Act's legislative history to explain the purpose of the section, but in the years since Section 22(d)'s adoption, arguments have been advanced that it was designed to address three abuses in the distribution of mutual fund shares that predated 1940.

The first abuse was dilution caused by riskless trading schemes by principal underwriters and dealers, which was possible under the system of backward pricing that existed prior to the adoption of Rule 22c-1 in 1968.[7] The adoption of Rule 22c-1 eliminated the opportunity for this type of abuse.

The second potential abuse was the creation of unauthorized secondary markets, which allegedly caused disruption in the distribution of mutual fund shares. Section 22(d), accordingly, is designed to ensure an orderly distribution of shares by contract dealers by eliminating price competition from non-contract dealers who could offer investors shares at less than the published sales price and who could pay a little more than the published redemption price.[8] ETFs, including non-transparent ETFs, are traded in the secondary market at market prices and, therefore, clearly do not give rise to this concern.

The appendix states that the third purpose, arguably addressed by Section 22(d), is to prevent discrimination among investors resulting from

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payment of differing prices. Presumably, it is this third purpose to which the SEC was referring when it stated the requirement that shareholders be treated equitably when purchasing and selling fund shares.

With regard to this third purpose, the appendix notes that if "Section 22(d) addresses the prevention of price discrimination at all it is clear that the Section was not intended to prevent all discrimination, but what might be termed as *unjust discrimination*"[9] (emphasis added). In support of the view that Section 22(d) does not require that all investors pay the same price for their fund shares, the appendix states that, "the Commission has followed the premise that discrimination is not unjust and thus for the purpose of Section 22(d) not violated if there is a rational basis for a variation in a sales load."[10]

Section 22(d) was obviously not drafted with ETFs in mind. ETFs, by design, allow investors to create and redeem shares in the primary market at NAV and purchase and sell shares in the secondary market at market prices. While it is true that investors who purchase and sell shares in the secondary market pay or receive a different price for shares than investors in the primary market, there is clearly a rational basis for the difference in prices paid in the primary and secondary markets. The ETF structure is intended to facilitate an arbitrage process that utilizes behavior of arbitrageurs in the primary market to minimize the premium or discount to NAV at which shares would otherwise trade in the secondary market. There is no *unjust* discrimination among investors. To the contrary, the structure is intended to benefit purchasers and sellers in the secondary market in the form of lower premiums or discounts than would exist absent the ability of arbitrageurs and other market participants to create and redeem shares at NAV.

In view of the foregoing, a reasonable argument can be made that all ETFs, including non-transparent ETFs, are structured in a manner consistent with the third purpose of Section 22(d), that is, to prevent unjust discrimination among investors regardless of how closely tied market prices are to NAV. As a result, an inquiry into the magnitude of premiums and discounts likely to result from a particular Methodology should not be necessary in order to grant non-transparent ETFs exemptive relief from Section 22(d).[11]

ETFs, including non-transparent ETFs, need exemptive relief from a number of other provisions of the 1940 Act, including Section 2(a)(32) (to enable ETFs to be treated as issuing redeemable securities), Section 17(a) (to enable more than 5 percent holders to create and redeem in kind) and Section 22(e) (to permit ETFs that invest in non-US securities to extend the date of payment of redemption proceeds in certain circumstances). The SEC, however, has not suggested that non-transparent ETFs raise any unique regulatory concerns under these provisions.

Exemptive Relief Must Be Necessary or Appropriate in the Public Interest

The market for fully transparent actively managed ETFs has been slow to develop, in large part due to the fact that many active managers are reluctant to disclose their portfolios because of concerns that this will open up the possibility for others to replicate, and possibly undermine, the portfolios' trading strategy.

Because non-transparent ETFs do not raise these concerns, active managers are likely to be more receptive to making available in the non-transparent ETF structure their active trading strategies. As a result, to the extent that ETF sponsors are enabled to offer non-transparent ETFs to investors, the number of active strategies available to investors in the form of an ETF should increase. Investors would thereby benefit in the form of a greater variety of investment choices.

It is understandable that the SEC initially proceeded cautiously with respect to actively managed ETFs and required full portfolio transparency as a condition of exemptive relief. This approach afforded the SEC the opportunity to evaluate how actively managed ETFs trade in the marketplace and whether any opportunities for abuse exist or the products otherwise raise regulatory concerns. We now have had several years of trading experience,

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and no material regulatory concerns unique to actively managed ETFs have arisen. In addition, the ETF market has grown substantially, and ETFs are now more widely understood by investors. Given the maturation of the ETF market, it seems that progression to the next stage of development, that is, non-transparent ETFs, can be facilitated without concerns about disruption of the current ETF market.

Exemptive Relief Must Be Consistent with the Protection of Investors

Sponsors of non-transparent ETFs have an economic incentive to ensure that their Methodology provides sufficient information to the marketplace to facilitate an effective and efficient trading market for their product, since any non-transparent ETF that trades at wide discounts and premiums and/or bid-ask spreads will likely not succeed. As a result, sponsors can be expected to carefully vet with APs and market makers their proposed Methodology to ensure that APs and market makers believe the Methodology will support an effective arbitrage process.

One of the SEC's investor protection concerns appears to be that, despite the best efforts of sponsors, the arbitrage process could break down and a product could trade at wide discounts and premiums and/or bid-ask spreads. It would seem, however, that these concerns can be readily addressed through disclosure requirements designed to insure that investors understand the nature of the product they are purchasing and selling and the risks related thereto. The risks of non-transparent ETFs are related to the manner in which they may trade in the marketplace. Risks of this nature can be effectively addressed in clear, plain English risk disclosures readily understandable by retail investors.

For example, the ETF prospectus could be required, among other things, to clearly and prominently disclose (a) *on the cover page* that—(i) the ETF is a non-transparent ETF, (ii) non-transparent ETFs are likely to trade at higher premiums and discounts to NAV and wider bid-ask spreads than fully transparent ETFs, and (iii) as a result of higher premiums and discounts investors may pay significantly more or receive significantly less than the underlying value of the shares purchased or sold, and (b) *in the summary*—the key distinctions between transparent and non-transparent ETFs. The foregoing suggested disclosure requirements are by no means intended to be exhaustive. Different or additional requirements might well be considered.

In the 2014 Notice, the SEC also expressed concern that any breakdown in the pricing or ability to price a non-transparent ETF could damage market confidence in secondary trading of ETFs generally. While it would seem that the ETF market is sufficiently well established that any trading issues that may arise respecting the trading of non-transparent ETFs should not have spillover effects on the ETF market generally, to minimize these concerns, a different naming convention for non-transparent ETFs (similar to the approach taken for ETMFs) could be used to accentuate the differences between non-fully transparent and fully transparent ETFs. Use of a distinctive name for non-transparent ETFs would immediately focus investor attention on the fact that the fund they are purchasing may have different risk characteristics than a traditional ETF.

Relief could also be conditioned upon additional board oversight requirements, such as a requirement for ongoing review of premiums and discounts and obligations to take certain action if premiums or discounts exceed prescribed thresholds.

Conclusion

The current approach of the SEC in evaluating the case for exemptive relief for non-transparent ETFs is consistent with its historical focus on the effectiveness of the ETF arbitrage process. This approach, however, has had the unfortunate effect of stifling the launch of new and innovative investment products and limiting the investing public's access to a wide variety of active trading strategies in an ETF structure.

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For the reasons discussed above, including (i) the maturation of the ETF market, (ii) the increased awareness and understanding of ETFs on the part of retail investors, (iii) the readily understandable nature of the risks posed by the non-transparent ETF structure as compared to traditional ETFs and (iv) the market forces that should incentivize ETF sponsors to devise structures that facilitate ETF arbitrage, it should be possible to develop a disclosure oriented framework for exemptive relief that would not be dependent upon SEC review of the likely effectiveness of any particular Methodology proposed by an applicant, but would still be consistent with Section 6(c) standards for exemptive relief. While a disclosure-oriented approach would represent a departure from long standing practices, hopefully the SEC will be willing to at least consider the potential benefits of a new and different approach.

NOTES

1 The SEC has granted exemptive relief for a different type of exchange traded product—exchange-traded managed funds (ETMFs). *See Eaton Vance Management et al.,* Investment Company Release No. 31361 (Dec. 2, 2014). ETMFs are similar to ETFs in that they are traded on an exchange and can be created and redeemed in kind at net asset value per share (NAV). ETMFs differ from ETFs, however, in that purchases and sales in the secondary market are effected at NAV plus or minus a specified spread to NAV, not at market prices. An ETMF is essentially a hybrid of a mutual fund and an ETF.

2 Since at least 2007, a number of applications with differing approaches have been filed with the SEC requesting exemptive relief that would allow actively-managed ETFs to maintain a degree of non-transparency over their holdings. These applications generally propose an alternative to full portfolio transparency—various patented processes that range from providing confidential portfolio holdings to an agent that provides indicative pricing and in-kind transactions through a confidential brokerage account (the AP Agent applications) to disclosing portfolio data that represent, but do not wholly reveal, the full contents of the ETF's portfolio daily (the Tracking Portfolio applications).

The AP Agent applications include applications filed by Precidian (*Precidian ETFs Trust et al.* (Precidian) (File No. 812-14405) (Dec. 22, 2014, as amended on Aug. 11, 2015, Sept. 21, 2015 and May 2, 2017)), BlackRock (*BlackRock Fund Advisors et al.* (File No. 812-14579) (Nov. 12, 2015)) and J.P. Morgan (*J.P. Morgan Exchange-Traded Fund Trust et al.* (File No. 812-14790) (June 28, 2017)). These applications contemplate in-kind creation/redemption transactions through a confidential brokerage account with an agent acting for the benefit of the authorized participant (AP). The ETF would confidentially provide AP Agents, before the commencement of trading each business day, the ETF's portfolio holdings and relative weightings for that day. This information is designed to permit APs to instruct their agents to buy and sell positions to permit bona fide arbitrage, while also protecting the proprietary investment strategies of the ETF's adviser. In lieu of daily portfolio transparency, the ETF will publicly disclose other data, including providing once-per-second "verified" indicative pricing.

The Tracking Portfolio applications include applications filed by T. Rowe Price (*T. Rowe Price Associates, Inc. et al.* (File No. 812-14214) (Sept. 23, 2013, as amended on Mar. 14, 2014)), Fidelity (*Fidelity Beach Street Trust et al.* (File No. 812-14364) (Sep. 26, 2014)), Cohen & Steers (*Cohen & Steers Capital Management, Inc. et al.* (File No. 812-14379) (Oct. 20, 2014)) and Blue Tractor (*Blue Tractor ETF Trust et al.* (File No. 812-14625) (Mar. 14, 2016, as amended on Sep. 28, 2016 and Feb. 1, 2017)). While each of these applications is different from the others, the common theme is that each application sets forth a proprietary method of disclosing certain information about the ETF's portfolio, in lieu of full daily portfolio transparency, that the sponsor believes to be sufficiently correlated to the ETF's portfolio in order to enable effective portfolio arbitrage. In addition, Fidelity has filed a separate Tracking Portfolio

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application that proposes a new type of closed-end interval fund that is intended to increase the liquidity of fund shares relative to other closed-end funds while reducing the market price discount relative to NAV(*Fidelity Bromfield Street Trust et al.* (File No. 812-14687) (Aug. 11, 2016)).

3 The applications filed by Precidian for non-transparent ETF relief illustrate the difficulties faced by sponsors. The initial application filed by Precidian contemplated that the intraday indicative NAV (IIV), which would be disseminated at 15-second intervals, would be the primary pricing signal to market participants. In a notice issued to Precidian on October 21, 2014 (Investment Company Act Release No. 31302) (the 2014 Notice), the SEC stated that it intended to deny Precidian's request for exemptive relief. The 2014 Notice discussed at length the shortcomings of IIV as a pricing signal and concluded that the use of IIV as a pricing signal would not result in effective arbitrage. Precidian withdrew its application and filed a new application in which it sought to address the concerns identified in the 2014 Notice. In particular, Precidian proposed the use of a verified IIV and the dissemination of portfolio values at fractions of a second to APs. In a letter dated Apr. 17, 2015 (April 2015 Letter), the SEC Staff informed Precidian that the Staff was unwilling to support the new application in its current form. Among other reasons for rejecting the new application, the SEC stated that the use of a verified IIV, together with the dissemination of real time values to APs at fractions of a second, would most likely result in the ability of APs to reverse engineer the portfolio. Through May 2, 2017, Precidian has amended the new application three times.

The 2014 Notice and the April 2015 Letter taken together suggest that in order to satisfy the SEC, the methodology proposed by an Applicant must provide sufficient information to the marketplace to support effective ETF arbitrage but not be so precise as to enable reverse engineering.

4 *See* 2014 Notice n.3 at text accompanying n.12.

5 *See* 2014 Notice at text accompanying n.55.

6 *See Exemption From Section 22(d) to Permit the Sale of Redeemable Securities at Prices That Reflect Different Sales Loads,* Investment Company Act Release No. 13183 (Apr. 22, 1983).

7 Under backward pricing, the price of a mutual fund was based upon the fund's NAV determined at the close of the market on the previous day. As a result, in a rising market, an investor could purchase fund shares near the end of the day based upon the previous day's valuation knowing the actual NAV at which shares could be redeemed the next day was greater. For most investors who were required to pay sales loads, the potential profit from this strategy was outweighed by the sales load. Section 22(d) insured that insiders and favored investors who were previously able to purchase shares without a sales load were also required to pay a sales charge. Forward pricing, which more directly addressed the riskless trading concern, was resisted by the fund industry and Section 22(d), as enacted, was the compromise modeled on an Ohio securities provision that was designed to address insider riskless trading. *See* "Investment Trusts and Investment Companies: Hearings on S. 3580, Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3rd Sess. 15 (1940)" (Senate Hearings). *See also* Protecting Investors: A Half Century of Investment Company Regulation (Protecting Investors) at 301.

8 This purpose was first stated in an opinion by the general counsel to the SEC in response to an inquiry as to the degree of discretion an underwriter has to reduce sales loads in sales above $25,000. *See* Investment Company Act Release No. 89 (March 13, 1940). The general counsel stated that the underwriter may not have discretion to discriminate between purchases of a like amount of securities. *See* appendix at n.34.

9 *See* appendix at text accompanying n.38.

10 *See* appendix at text accompanying n.42.

11 In considering the weight that should be accorded Section 22(d) in evaluating applications for non-transparent ETF exemptive relief, it is worth noting that the SEC has at various times over the years

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considered requesting the repeal of Section 22(d). *See* Protecting Investors at 303–314. In this regard, the Division of Investment Management has stated that, "changing circumstances reflecting both regulatory and marketplace developments have eliminated the rationale that apparently prompted enactment and retention of Section 22(d)," *See* Protecting Investors at 307.

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