THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 53 No. 18 October 28, 2020

RECENT DEVELOPMENTS IN ETF REGULATION

A new rule adopted by the SEC allows many ETFs to operate without first obtaining exemptive relief. After addressing the ETF structure and regulatory framework, the authors describe the new rule in detail. They then turn to new exchange listing standards for ETFs, semi-transparent active ETF exemptive relief, and no-action relief for index-based funds to exceed diversification limits.

By Stephanie A. Capistron, Jeremy I. Senderowicz, and Aiman Tariq *

In contrast to mutual funds and closed-end funds, U.S. exchange-traded funds ("ETFs") have a relatively brief history as a form of pooled investment vehicle. First introduced in 1993, ETFs possess characteristics of both open-end and closed-end funds and until recently required exemptive relief from certain regulatory requirements in order to operate as such. As the market for ETFs has grown, the regulatory landscape for these products has evolved, with a recent trend toward regulatory harmonization and operational flexibility for ETFs.

This article discusses recent regulatory developments relating to ETFs. First, it provides background regarding ETF structure and regulation. It then discusses a new rule adopted by the Securities and Exchange Commission that allows many ETFs to operate without first obtaining exemptive relief, as well as the recent adoption of exchange listing standards that fully implement the flexibility provided by the new rule. It next discusses the SEC's issuance of the first exemptive orders permitting the operation of actively managed ETFs that do not disclose their full holdings on a daily basis. Lastly, it discusses a recent no-action letter that, although not limited to ETFs, is significant for the ETF industry, given the number of ETFs that operate as index funds.

BACKGROUND

ETF Structure

ETFs are pooled investment vehicles that have certain characteristics of both mutual funds (*i.e.*, open-end investment companies) and closed-end funds. Shares of an ETF are listed on a national securities exchange and trade throughout the day at market price rather than net asset value ("NAV"), and can also only be purchased or redeemed from the ETF at NAV in "creation unit" aggregations (typically 25,000 shares or more) by large financial institutions referred to as "authorized participants;" all other investors buy and sell ETF shares on an exchange. Unlike mutual funds, however, shares are not individually redeemable; they may only be redeemed in creation unit aggregations and only by authorized participants. In many cases, ETFs transact

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with authorized participants in kind, meaning an authorized participant delivers a basket of securities and other instruments when purchasing ETF shares and receives a basket when redeeming ETF shares.

Like shares of closed-end funds that trade on an exchange, the prices at which ETF shares trade may be above (at a premium to) or below (at a discount to) NAV. Historically, however, ETF shares have generally not traded at the same levels of premiums or discounts at which closed-end fund shares often trade. Instead, market participants can take advantage of differences between an ETF's market price and NAV in an "arbitrage mechanism" that generally allows shares of an ETF to trade at prices at or close to NAV. For example, where an ETF's shares are trading at a discount, an authorized participant can purchase the shares necessary to form a creation unit and redeem those shares directly from the ETF, receiving the higher NAV and realizing a profit. The reverse occurs where an ETF is trading at a premium (*i.e.*, the authorized participant purchases a creation unit directly from the ETF at NAV and sells the shares at the higher market price). In either case, the authorized participant's transaction activity tends to move the market price of shares closer to NAV.

The first ETFs sought to track the returns of underlying indices, and many of the ETFs available in the market today are index-based ETFs. However, the market has also expanded to include actively managed ETFs (or "active ETFs"), as discussed in greater detail in the following sections.

Regulatory Framework

The ETF structure is not contemplated by the Investment Company Act of 1940, and exemptions from certain 1940 Act requirements are therefore necessary to operate under this structure. Until recently, ETF sponsors were required to obtain individual exemptive orders before entering the ETF market. These orders generally provided relief from the following provisions of the 1940 Act and rules thereunder:

- Sections 2(a)(32) and 5(a)(1), which set forth the definitions of "redeemable security" and "open-end company," in order to allow the ETF to register as an open-end investment company and issue and redeem shares only in creation unit aggregations.[1]
- Section 22(d) and Rule 22c-1, which require the sale of shares to occur at the price described in the prospectus and generally at NAV, in order to allow shares of the ETF to trade at market price.
- Sections 17(a)(1) and 17(a)(2), which prohibit affiliated persons from engaging in certain transactions with a fund, in order to allow certain affiliated persons to effect in-kind creation and redemption transactions with the ETF.[2] The relief extends to persons affiliated with an ETF solely as a result of owning five percent or more of the ETF or another fund for which the investment adviser or an affiliate serves as investment adviser.[3]

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[1] Under Section 2(a)(32), a "redeemable security" is "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." Section 5(a)(1) provides that an "open-end company" is "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer."

[2] Section 17(a)(1) makes it unlawful for an affiliated person of a fund, or affiliated person of such a person, "[k]nowingly to sell any security or other property to" the fund, with certain exceptions. Section 17(a)(2) makes it unlawful for such a person "[k]nowingly to purchase from such [fund]…any security or other property (except securities of which the seller is the issuer)." Where an affiliated person transacts in kind with a fund, it involves the purchase or sale, as applicable, of the securities being exchanged for shares.

[3] The term "affiliated person" of another person is defined under Section 2(a)(3) of the 1940 Act to include "any person directly or indirectly owning, controlling, or holding with power to vote, five per centum or more of the outstanding voting securities of such other person" and "any person directly or indirectly controlling, controlled by, or under common control with, such other person," among others. Under Section 2(a)(9), "control" is defined as "the power to exercise a controlling influence over the management or policies of a company, unless such power is

- Section 22(e), which requires the payment of redemption proceeds within seven days of receipt of a redemption request, in order to permit an ETF that invests in non-U.S. securities and transacts in kind to delay the payment of redemption proceeds for more than seven days, up to a specified maximum, as a result of local market holidays.

The relief above is subject to various conditions and other material representations, including full daily holdings disclosure in the case of active ETFs.[4] However, the specific requirements of exemptive orders have varied over time, resulting in unequal treatment of ETF sponsors with respect to certain provisions. For example, while more recent ETF orders require an ETF's creation and redemption basket to correspond *pro rata* to its holdings, with limited exceptions, older exemptive orders provide more flexibility with respect to basket construction.

ETF exemptive orders generally also provide relief to allow other registered investment companies to invest in an ETF's shares in excess of the limits of Section 12(d)(1) of the 1940 Act, subject to certain conditions.[5] Among other things, these conditions require the acquiring fund to enter into a participation agreement with the ETF as well as the adoption of certain procedures. This relief is not necessary for a fund to operate as an ETF, but without such relief acquiring funds cannot invest in the ETF in excess of the Section 12(d)(1) limits, absent the availability of a different exemption. Accordingly, ETF sponsors generally obtain this relief together with their ETF exemptive relief as a matter of course.

Separately, ETFs also require relief from certain provisions of the Securities Exchange Act of 1934, and rules thereunder, which like the 1940 Act do not specifically contemplate funds like ETFs that are traded on an exchange while simultaneously issuing new shares on a continuous basis.[6] In the past, many ETFs relied on "class" letters issued by the SEC staff to grant the relevant relief under the Exchange Act and applicable rules thereunder ("Exchange Act relief"), which were available to any ETFs that met the requirements of the letters (such as requirements as to diversification).[7] ETFs that were unable to rely on class relief needed to apply for individual Exchange Act relief, which was obtained through a separate process from the 1940 Act relief described above.

In addition, as a listed issuer, an ETF is subject to the rules of the exchange on which its shares are listed, generally NYSE Arca, Inc., Cboe BZX Exchange, Inc., or The Nasdaq Stock Market LLC ("Nasdaq," and collectively with NYSE Arca and Cboe BZX, "Exchanges"). Over time the Exchanges adopted generic listing standards for both index-based and active ETFs that allowed ETFs meeting the requirements of the rules to list without an SEC order for an Exchange rule change pursuant to Rule 19b-4 under the Exchange Act.[8] These rules apply on both an initial and continuous basis, and impose various quantitative standards based on the asset class of the underlying index constituents (for index-based ETFs) or holdings (for active ETFs).[9] An ETF that cannot meet these requirements must go through the Rule 19b-4 process to obtain specific

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solely the result of an official position with such company" and is presumed where a person owns more than 25 percent of the voting securities of a company.

[4] Exemptive orders for index-based ETFs generally do not require daily holdings disclosure, except for certain ETFs (e.g., an ETF that seeks to track an index for which its investment adviser is the index provider).

[5] Under Section 12(d)(1)(A), a registered investment company ("acquiring fund") is prohibited from acquiring shares of another fund ("acquired fund") if, after such acquisition, the acquiring fund will own in the aggregate (i) more than three percent of the acquired fund's outstanding voting securities; (ii) securities issued by the acquired fund with a value in excess of five percent of the total assets of the acquiring fund; or (iii) securities issued by the acquired fund and all other investment companies with a value in excess of 10 percent of the total assets of the acquiring fund. Section 12(d)(1)(B) contains corresponding restrictions on an acquired fund's sale of shares to an acquiring fund.

[6] These include Section 11(d)(1), Rule 10b-10, Rule 10b-17, Rule 11d1-2, Rule 14e-5, Rules 15c1-5, and 15c1-6, and Rules 101 and 102 of Regulation M.

[7] *See, e.g.,* Class Relief for Exchange Traded Index Funds, Oct. 24, 2006 (class letter for equity index-based ETFs that requires, among other things, that an ETF relying on the relief consist of a basket of 20 or more component securities, with no one component security constituting more than 25 percent of the ETF's total value).

[8] *See* NYSE Arca Rules 5.2-E(j)(3) (index-based ETFs) and 8.600-E (active ETFs); Cboe BZX Rules 14.11(c) (index-based ETFs) and 14.11(i) (active ETFs); and Nasdaq Rules 5705(b) (index-based ETFs) and 5735 (active ETFs).

[9] For example, the rules include requirements relating to diversification, average daily trading volumes (for equity constituents/holdings), and minimum original principal amount outstanding (fixed income constituents/holdings).

approval for listing, which can take several months. In addition to the quantitative standards, the Exchanges also imposed various other requirements, including dissemination of an intraday indicative value ("IIV"), or intraday estimate of an ETF's NAV per share, at regular intervals throughout the trading day.

ADOPTION OF RULE 6C-11

In September 2019, the SEC adopted Rule 6c-11 under the 1940 Act (the "ETF Rule"), which allows ETFs that meet certain conditions to operate without first obtaining the 1940 Act exemptive relief described above.[10] By superseding the individualized exemptive relief for ETFs that are eligible to rely on the ETF Rule, Rule 6c-11 creates a more consistent framework for the regulation of ETFs. The ETF Rule took effect December 23, 2019 and existing exemptive relief for ETFs eligible to rely on the rule will be rescinded one year from that date, by which time such ETFs must be operating in compliance with the rule.

The ETF Rule is the second iteration of Rule 6c-11, which was originally proposed in 2008[11] but was not adopted after the financial crisis led to a shift in SEC focus. The rule was then re-proposed in June 2018.[12] The ETF Rule does not merely codify the conditions of existing exemptive orders, but instead modernizes the regulatory framework for ETFs and provides greater flexibility with respect to ETF operations. The following summarizes certain noteworthy aspects of the ETF Rule.

Custom Baskets

Unlike newer exemptive relief, the ETF Rule permits an ETF to utilize creation and redemption baskets consisting of a non-*pro rata* selection of the ETF's portfolio holdings and/or creation and redemption baskets that differ from those utilized for other creation or redemption transactions effected the same day. To rely on this flexibility, an ETF must adopt policies and procedures relating to the use of custom baskets that specifically address the parameters for construction and acceptance of baskets that are in the best interests of the ETF and its shareholders, and identify the titles or roles of the employees of the ETF's investment adviser responsible for reviewing baskets for compliance with the parameters.[13] These requirements are an expanded version of more general procedures required with respect to basket construction under the ETF Rule.

Elimination of Distinctions Between Index-Based and Active ETFs

The ETF Rule eliminates the distinctions between index-based ETFs and active ETFs that exist under current relief, making all ETFs relying on the ETF Rule subject to the same requirements. This has several implications, the most significant of which is that all ETFs relying on the rule — including index-based ETFs that seek to track third-party indices — are required to disclose their full holdings on a daily basis. As a practical matter, however, this is likely to have limited impact, as information about index constituents is publicly available and many index-based ETFs disclose their full holdings daily even if not required to do so. Similarly, the ETF Rule does not include the requirement of current exemptive relief that an index-based ETF invest at least 80 percent of its assets in index constituents, but an index-based ETF would generally continue to be subject to such a requirement based on statements in the SEC's release adopting Rule 35d-1 under the 1940 Act (relating to fund names).[14]

Disclosure Requirements

As proposed, the ETF Rule would have resulted in significant disclosure changes, including a requirement for an ETF to provide an interactive calculator on its website allowing an investor to calculate trading costs based on certain inputs. The disclosure changes reflected in the final version of the rule and amendments to Form N-1A (the registration form for open-end

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[10] Exchange-Traded Funds, Inv. Co. Act Rel. No. IC-33646 (Sept. 25, 2019) ("Adopting Release").

[11] Exchange-Traded Funds, Inv. Co. Act Rel. No. IC-28193 (Mar. 11, 2008).

[12] Exchange-Traded Funds, Inv. Co. Act Rel. No. IC-33140 (June 28, 2018).

[13] An ETF must also comply with certain recordkeeping requirements.

[14] Investment Company Names, Inv. Co. Act Rel. No. IC-24828 (Jan. 17, 2001) ("We note, however, that the 80% investment requirement is not intended to create a safe harbor for investment company names. A name may be materially deceptive and misleading even if the investment company meets the 80% requirement. Index funds, for example, generally would be expected to invest more than 80% of their assets in investments connoted by the applicable index."). In its recent request for comment on the regulatory framework for fund names, the SEC discussed how the growth in the number of index funds has presented challenges with respect to the application of Rule 35d-1. *See* Request for Comment on Fund Names, Inv. Co. Act Rel. No. IC-33809 (Mar. 2, 2020).

investment companies)[15] are not as extensive as proposed, but do result in certain changes to ETF disclosures. Among other things, an ETF must disclose its median bid-ask spread over the past 30 days on its website.[16] In addition, the Form N-1A amendments require certain narrative disclosures regarding trading costs and, for ETFs that do not rely on the rule, median bid-ask spread disclosures (either on the ETF's website or in its prospectus). The ETF Rule does not, however, require dissemination of an ETF's IIV, as is required under existing exemptive relief.

Exchange Act Relief

Unlike exemptive orders, which provide an *exemption* from the definition of "redeemable security," shares of an ETF that rely on the ETF Rule are *classified* as "redeemable securities." Furthermore, the Adopting Release extends this classification to shares of all ETFs, whether or not they rely on the ETF Rule. The classification is noteworthy given that certain of the Exchange Act rules from which ETFs have historically sought relief contain exceptions or exemptions for redeemable securities and/or open-end investment companies, and all ETFs are now eligible to rely on these exceptions or exemptions.[17]

In order to address the remaining Exchange Act provisions and rules from which ETFs seek Exchange Act relief, the SEC also issued conditional exemptive relief from these provisions and rules at the same time it adopted the ETF Rule.[18] This relief eliminates certain of the requirements of existing Exchange Act relief and further streamlines the ETF regulatory framework, but unlike the interpretation above is available only for ETFs that rely on the ETF Rule.

Section 12(d)(1) Relief

As noted above, ETFs generally apply for Section 12(d)(1) relief at the same time as they apply for ETF relief. While the adoption of the ETF Rule results in the rescission of exemptive relief for ETFs that are able to rely on the rule, this impacts only ETF relief, and not Section 12(d)(1) relief. Instead, the SEC has separately issued a proposal to adopt Rule 12d1-4 under the 1940 Act, which would permit acquiring funds to invest in acquired funds in excess of the Section 12(d)(1) limits, subject to certain requirements.[19]

Rule 12d1-4 would generally replace existing exemptive relief, but has not been adopted to date. To provide new ETF market entrants with the same flexibility as existing ETF sponsors, the Adopting Release provides that ETFs without Section 12(d)(1) relief can nonetheless enter into fund of funds arrangements subject to the conditions of recent ETF exemptive orders (until such time as the SEC adopts a fund of funds rule).

NEW EXCHANGE LISTING STANDARDS

While the ETF Rule significantly modernized the regulatory framework for ETFs, the existing Exchange requirements could have limited the flexibility otherwise afforded to ETFs relying on the rule, absent further action by the Exchanges. Accordingly, subsequent to the adoption of the ETF Rule, the Exchanges proposed changes to their rules in order to eliminate many of the requirements under the existing rules and thereby further harmonize the regulatory framework for ETFs. The SEC granted orders approving these rule changes in April 2020.[20]

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[15] As certain current ETFs are organized as unit investment trusts, conforming changes are also made to Form N-8B-2, which is the registration form for such vehicles. However, given the lack of recent ETF launches using this structure, the ETF Rule does not cover ETFs organized as unit investment trusts.

[16] The "bid-ask spread" is the difference between the highest bid price (*i.e.*, price a buyer is willing to pay) and lowest offer price (*i.e.*, price at which a seller is willing to sell). Specific calculation requirements for this metric are set forth in the ETF Rule.

[17] Rule 10b-17 and Rule 11d1-2 under the Exchange Act and Rules 101 and 102 of Regulation M contain such provisions.

[18] Order Granting a Conditional Exemption from Exchange Act Section 11(d)(1) and Exchange Act Rules 10b-10, 15c1-5, 15c1-6, and 14e-5, Rel. No. 34-87110 (Sept. 25, 2019).

[19] Fund of Funds Arrangements, Inv. Co. Act Rel. No. IC-33329 (Dec. 19, 2018).

[20] Notice of Filing of Amendment No. 4 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 4, to Adopt Nasdaq Rule 5704 Governing the Listing and Trading of Exchange Traded Fund Shares, Rel. No. 34-88561 (Apr. 3, 2020); Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 2, to Adopt BZX Rule 14.11(l) Governing the Listing and Trading of Exchange-Traded Fund Shares, Rel. No. 34-88566 (Apr. 6, 2020); and Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 2, to Adopt NYSE Arca Rule 5.2-E(j)(8) Governing the Listing and Trading of Exchange-Traded Fund Shares, Rel. No. 34-88625 (Apr. 13, 2020).

Under these new listing standards, an ETF that relies on the ETF Rule is able to list automatically, without satisfaction of the various quantitative requirements under the existing rules. This change provides ETFs relying on the rule with greater flexibility as to their operations and substantially decreases the amount of time needed to list an ETF that would not previously have qualified for listing without a 19b-4 rule change. In addition, the new listing standards no longer require dissemination of an ETF's IIV, consistent with elimination of this requirement under the ETF Rule. In order to rely on these standards, an ETF must comply with the conditions of the ETF Rule, among other requirements. However, certain of the requirements under the new standards are retained from the existing standards, notably the requirement to implement firewalls to prevent the sharing of non-public information regarding an ETF's underlying index or portfolio.

SEMI-TRANSPARENT ACTIVE ETF EXEMPTIVE RELIEF

As described above, a condition of the ETF Rule, consistent with existing exemptive relief for active ETFs, is that an ETF must disclose its full holdings on a daily basis. However, such daily disclosure can present challenges with respect to certain active ETF strategies, including concerns about third parties replicating an active ETF's investment strategy and/or trading ahead of the ETF. Accordingly, over the past decade several applicants have filed requests for exemptive relief to operate active ETFs that do not disclose their full holdings daily. In evaluating these requests, the SEC and its Staff have focused on, among other things, the alternative to daily holdings disclosure proposed by applicants and whether that alternative arbitrage mechanism could facilitate effective arbitrage.[21]

In 2019, the SEC issued the first exemptive orders permitting the operation of active ETFs that do not disclose their full holdings on a daily basis (the "Orders").[22] The issuance of the Orders is a significant development for active managers that may be interested in launching ETFs, but have been deterred by the requirement to make their holdings available to the market each day. This section describes different alternatives to daily holdings disclosure contemplated by the Orders and certain key features of the Orders.

Alternatives to Daily Holdings Disclosure

The alternatives under the Orders generally fall into two broad categories: (i) disclosure of a verified intraday indicative value ("VIIV") with creations and redemptions through a confidential account, as contemplated by the Precidian Order (the "Precidian Model") or (ii) disclosure of a basket of securities or other instruments designed to perform similarly to the ETF's portfolio, as contemplated by the Blue Tractor Order, Natixis Order, Fidelity Order, and T. Rowe Order (the "Tracking Portfolio Models").[23]

Under the Precidian Model, an ETF disseminates its VIIV to the market every second throughout the trading day in order to provide information about the value of the ETF's shares. The VIIV differs from intraday indicative values for existing ETFs, in that the VIIV is disclosed more frequently (every second rather than every 15 seconds), and the ETF and its investment adviser are responsible for the calculation.[24] With respect to creations and redemptions, an ETF operating under the Precidian Model generally issues and redeems shares in exchange for a basket of securities that corresponds *pro rata* to the ETF's portfolio holdings.

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[21] Precidian ETFs Trust, *et al.*, Inv. Co. Act Rel. No. IC-31300 (Oct. 21, 2014) (indicating an intent to deny an earlier iteration of the approach proposed by Precidian Funds LLC on the basis that the "[a]pplicants ha[d] not provided an adequate substitute for portfolio transparency such that the proposed ETFs would consistently trade at or close to NAV").

[22] Precidian ETFs Trust, *et al.*, Inv. Co. Act Rel. No. IC-33477 (May 20, 2019) ("Precidian Order"); Blue Tractor ETF Trust and Blue Tractor Group, LLC, Inv. Co. Act Rel. No. IC-33710 (Dec. 10, 2019) ("Blue Tractor Order"); Natixis ETF Trust II,

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et al., Inv. Co. Act Rel. No. IC-33711 (Dec. 10, 2019) ("Natixis Order"); Fidelity Beach Street Trust, *et al.*, Inv. Co. Act Rel. No. IC-33712 (Dec. 10, 2019) ("Fidelity Order"); and T. Rowe Price Associates, Inc. and T. Rowe Price Equity Series, Inc., Inv. Co. Act Rel. No. IC-33713 (Dec. 10, 2019) ("T. Rowe Order"). The SEC had previously issued relief with respect to "exchange-traded managed funds," which are hybrids of ETFs and mutual funds that do not disclose their full holdings daily and trade on an exchange at prices based on NAV. Eaton Vance Management, *et al.*, Inv. Co. Act Rel. No. IC-31333 (Nov. 6, 2014).

[23] This article focuses on the exemptive relief granted in 2019, and does not discuss all approaches for which exemptive applications have been filed and/or are pending.

[24] The ETF employs both a primary and secondary calculation engine to provide two independent calculations, as well as a pricing verification agent to compare these calculations in real time. In addition, an ETF is required to adopt policies and procedures governing VIIV calculation and dissemination.

Authorized participants effect creations and redemptions through a confidential brokerage account with an appointed agent/representative (referred to as an "AP Representative"). The AP Representative, but not the authorized participant, is given the names and quantities of instruments that constitute a creation and redemption basket each day. Authorized participants instruct the AP Representative to buy or sell positions in the portfolio instruments to permit creations or redemptions, as applicable.

The Tracking Portfolio Models vary from application to application, but in general contemplate disclosure of a basket of securities (or an index) that is expected to perform similarly to the ETF's portfolio, and that can therefore be used by market participants to value and hedge their positions in ETF shares. The degree of expected overlap between a tracking portfolio and the ETF's portfolio varies by application, as does the amount of information to be disclosed to the market regarding the relationship between the tracking portfolio and actual portfolio (*e.g.*, tracking error, overlap). In general, the tracking portfolio also constitutes the ETF's creation and redemption basket on a given day.

Other Features of the Orders

In addition to the arbitrage mechanism described above, there are certain other notable differences between the terms and conditions of the Orders and the exemptive relief for existing active ETFs. These include the following:

- Limitations on investments: an active ETF operating in reliance on the Orders may generally invest only in certain securities that trade on a U.S. exchange contemporaneously with the ETF's shares (and, for an ETF using a Tracking Portfolio Model, common stocks listed on a foreign exchange that trade contemporaneously with the ETF's shares). The types of U.S. exchange-listed securities in which an ETF may invest include, for example: common stocks; American depositary receipts; shares of other ETFs; and futures (provided the ETF would be permitted to invest directly in the reference asset). In addition, an ETF may not: hold short positions; borrow for investment purposes; or purchase a security that is an illiquid investment (as defined in Rule 22e-4(a)(8) under the 1940 Act) at the time of investment.

- Board oversight: the Orders impose specific obligations on the active ETF's investment adviser and board of directors/trustees relating to oversight of the arbitrage mechanism. To the extent that predetermined premium/discount or bid/ask spread thresholds are exceeded (or tracking error thresholds between a tracking portfolio and actual portfolio, in the case of an ETF using a Tracking Portfolio model), the adviser must promptly call a meeting of the board to consider the continuing viability of the ETF and appropriate remedial measures.

- Disclosure: an active ETF operating in reliance on an Order must provide certain disclosures to investors about the differences between the ETF and traditional ETFs. These disclosures include, for example, a specified legend to be included in a prominent location on the outside cover page of the ETF's prospectus, on the ETF's website, and in its marketing materials. The legend will highlight that the ETF "is different from traditional ETFs" and that the lack of daily holdings disclosure could "create additional risks," including increased trading costs and larger premiums and discounts.

- Compliance with Regulation Fair Disclosure: although ETFs are not subject to Regulation Fair Disclosure, an active ETF operating in reliance on an Order is required to comply with Regulation Fair Disclosure as if it applied to the ETF.

NO-ACTION RELIEF FOR INDEX-BASED FUNDS TO EXCEED DIVERSIFICATION LIMITS

As noted above, many ETFs are index-based ETFs, meaning they seek to track the performance of an underlying index. The Staff of the SEC's Division of Investment Management recently granted no-action relief that would permit an index-based fund (not solely an index-based ETF) to exceed the limits applicable to a "diversified company" under Section 5(b)(1) of the 1940 Act without shareholder approval, subject to certain conditions.[25] This relief provides an index-based fund greater flexibility in carrying out its index-tracking strategy and minimizing tracking error where the weightings of the underlying index constituents become inconsistent with the 1940 Act diversification requirements.

1940 Act Diversification Requirements

In general terms, a "diversified company" is defined under Section 5(b)(1) of the 1940 Act to mean a fund that, with respect to 75 percent of its total assets, invests no more than five percent of its assets in a single issuer and holds no more than 10 percent of the voting

[25] Stradley Ronon Stevens & Young, LLP, June 24, 2019.

securities of a single issuer.[26] A fund that does not meet these requirements is a "non-diversified" company.[27]

Under Section 13(a)(1), a fund cannot change its subclassification from diversified to non-diversified without shareholder approval. Accordingly, where weightings of issuers in a diversified index-based fund's underlying index change, such that the fund could not track the composition of the index without becoming non-diversified, the fund would generally need to seek shareholder approval to become non-diversified or potentially incur tracking error due to its deviation from index constituent weightings.

No-Action Relief

In the no-action letter, the Staff indicates that it will not recommend enforcement action against an index-based fund that exceeds the diversification limits "to the extent necessary to approximate the composition of the fund's target broad-based index." In order to rely on this no-action position, a fund must add disclosure to its registration statement reflecting the fund's ability to exceed these limits, together with related risks, and also provide shareholder notice of the updated diversification policy, in each case as described in detail in the incoming request letter.

While the relief provides flexibility to certain index funds, there are some limitations with respect to funds that can rely on the relief. Specifically, the relief is only available to a fund that seeks to track an index that (i) is "broad-based" and (ii) "was created by an index provider that is not an affiliated person of the index-based fund, its investment adviser or principal underwriter, or an affiliated person of such persons, and was not created solely for the index-based fund or its affiliated persons." In addition, the fund must implement its investment strategy "by investing all or substantially all of its assets in securities that comprise the index in approximately the same proportion as such securities' weighting in the index," such that the relief would generally be available only for funds that use a full replication approach (rather than a representative sampling strategy).

CONCLUSION

The regulatory landscape for ETFs continues to evolve, creating new opportunities for asset managers. With the adoption of the ETF Rule and further developments with respect to ETFs that do not disclose their full holdings daily, this will likely continue to be an area of interest. ■

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[26] More specifically, Section 5(b)(1) provides that a "diversified company" is "a management company which meets the following requirements: at least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than five per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer."

[27] 15 U.S.C. § 80a-5(b)(2).