

MEMO# 31984

September 30, 2019

SEC Adopts ETF Rule and Issues Related Exchange Act Relief

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TO: ICI Members
Investment Company Directors
ICI Global Members
Accounting/Treasurers Committee
Chief Compliance Officer Committee
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee
ICI Global Exchange Traded Funds Committee
SEC Rules Committee
Small Funds Committee SUBJECTS: Exchange-Traded Funds (ETFs) RE: SEC Adopts ETF Rule and Issues Related Exchange Act Relief

Last week, the SEC unanimously adopted Rule 6c-11 under the Investment Company Act of 1940 that will permit ETFs that satisfy certain conditions to operate without first obtaining an exemptive order from the SEC.[\[1\]](#) In connection with the rule, the SEC will rescind certain exemptive orders that have been granted to ETFs and their sponsors. The SEC also adopted certain disclosure amendments to Form N-1A and Form 8B-2 to provide investors who purchase and sell ETF shares on the secondary market with additional information regarding ETF trading costs and related amendments to Form N-CEN. In addition to the rule and form amendments, the SEC also issued an exemptive order that harmonizes certain related relief under the Securities Exchange Act of 1934.

The rule, form amendments, and related exemptive relief will become effective 60 days after publication in the Federal Register. The Commission is providing a transition period for the amendments to Forms N-1A, N-8B-2, and Form N-CEN of one year following the amendments' effective date.

I. Scope of Rule 6c-11

Open-End Funds

Rule 6c-11 will be available to ETFs organized as open-end funds, but it will *not be* available to ETFs organized as unit investment trusts, ETFs structured as a share class of a multi-

class fund, leveraged or inverse ETFs,[\[2\]](#) and non-transparent ETFs. Instead, these ETFs will continue to rely on their existing exemptive orders.

Index-based ETFs and Actively Managed ETFs

Rule 6c-11 will provide exemptions for both index-based ETFs and actively managed ETFs, but will not by its terms establish different requirements based on whether an ETF's investment objective is to seek returns that correspond to the returns of an index.

II. Exemptive Relief under Proposed Rule 6c-11

Rule 6c-11 will provide ETFs within the scope of the rule with exemptions from certain provisions of the Investment Company Act that are necessary to allow ETFs to operate. These exemptions are generally consistent with the relief the SEC has given to ETFs under their current exemptive orders.

Treatment of ETF Shares as “Redeemable Securities”

The release provides that shares of all ETFs, whether or not eligible to rely on Rule 6c-11, are considered “redeemable securities” within the meaning of Section 2(a)(32) of the Investment Company Act, and should be regulated as open-end funds within the meaning of Section 5(a)(1) of the Act. ETF Shares therefore are eligible for the “redeemable securities” exceptions in Rules 101(c)(4) and 102(d)(4) of Regulation M and Rule 10b-17(c) under the Exchange Act in connection with secondary market transactions in ETF shares and the creation or redemption of creation units. ETFs similarly will qualify for the “registered open-end investment company” exemption in Rule 11d1-2 under the Exchange Act. The proposal would have granted that status only to ETFs relying on Rule 6c-11, but commenters including ICI, requested that status be extended to all ETFs.

Trading of ETF Shares at Market-Determined Prices

The Investment Company Act and its rules require redeemable securities to be sold at NAV. Consistent with the proposal, Rule 6c-11 will provide exemptions from Section 22(d) and Rule 22c-1 to permit trading of shares on the secondary market at market-determined prices that may be different than the ETF's current NAV.

Affiliated Transactions

Consistent with the proposal, Rule 6c-11 will provide exemptions from Sections 17(a)(1) and (a)(2) of the Investment Company Act with regard to the deposit and receipt of baskets to a person who is an affiliated person of an ETF (or who is an affiliated person of such a person) solely by reason of: (i) holding with the power to vote 5 percent or more of an ETF's shares; or (ii) holding with the power to vote 5 percent or more of any investment company that is an affiliated person of the ETF.

Although a number of commenters asked the Commission to expand the relief to cover additional types of affiliated relationships, such as exempting broker-dealers affiliated with the ETF's adviser, or permitting an ETF's adviser or its affiliates to transact with the ETF to provide in-kind seed capital to the ETF, the rule was adopted as proposed. The release notes that because Rule 6c-11 is generally intended to codify existing relief for ETFs, the Commission did not believe that it is appropriate to expand the scope of affiliated persons covered by the exemptions as part of this rulemaking, although such exemptions may be considered within its regular exemptive applications process.

Additional Time for Delivering Redemption Proceeds

Rule 6c-11 will grant relief from Section 22(e) of the Investment Company Act to permit an ETF to delay satisfaction of a redemption request for more than seven days if a local market holiday, or series of consecutive holidays, or the extended delivery cycles for transferring foreign investments to redeeming authorized participants prevents timely delivery of the foreign investment included in the ETF's basket. To rely on this exemption, an ETF will be required to deliver foreign investments as soon as practicable, but in no event later than 15 days after the tender to the ETF. Unlike the proposal, Rule 6c-11 *does not* contain a 10-year sunset provision with respect to this relief.

Under the proposal, Rule 6c-11 would have defined "foreign investment" as an investment for which there is no "established U.S. public trading market." Commenters, including ICI, expressed concern that this requirement could make the exemption from Section 22(e) unavailable whenever a foreign issuer has issued a security in the United States. Instead, Rule 6c-11 will define "foreign investment" as an investment that "is traded on a trading market outside of the United States."

III. Conditions for Reliance on Proposed Rule 6c-11

ETFs relying on Rule 6c-11 must comply with certain conditions that will allow them to operate within the scope of the Investment Company Act.

Portfolio Transparency

Rule 6c-11, will require ETFs to provide daily portfolio transparency on its website; however, the rule includes several modifications from the proposal, including modifications regarding the required timing and presentation of the portfolio holdings disclosure.

- **Timing**

Rule 6c-11 will require portfolio holdings to be posted before the commencement of trading on the ETF's primary listing exchange. This is a welcome change from the proposal, which would have required daily holdings to be posted before the ETF accepts creation or redemption orders, essentially precluding "T-1" creation or redemption orders (where an ETF order is placed the day before the order is processed to accommodate transactions in certain non-US markets while those markets are open). Many commenters, including ICI, objected to this aspect of the proposal.

- **Presentation**

Rule 6c-11 will require an ETF to disclose standardized information regarding each portfolio holding, but it will not require this information to be presented and contain information in the manner prescribed within Article 12 of Regulation S-X. In response to concerns and suggestions of commenters, including ICI, the rule instead requires ETFs to disclose a subset of the information required by the listing exchanges' current generic listing standards for actively managed ETFs.

Baskets and Custom Baskets

Rule 6c-11 will require ETFs to adopt and implement written policies and procedures governing the construction of baskets and the process that will be used for the acceptance of baskets. In addition, the rule will provide an ETF with the flexibility to use "custom

baskets”^[3] if the ETF has adopted written policies and procedures that detail parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders. The proposal also would have required an ETF to post information regarding one published basket on its website each business day. Commenters, including ICI, generally did not support this aspect of the proposal noting, for example, that the contents of an ETF’s basket are irrelevant and possibly confusing for secondary market investors. After consideration of these comments, the Commission agreed to eliminate this aspect of the proposal.

Website Disclosure

Rule 6c-11 will require ETFs to disclose certain information on their websites. Specifically, the rule will require disclosure regarding: (i) the ETF’s NAV per share, market price, and premium or discount, each as of the end of the prior business day; (ii) median bid-ask spread information calculated over the most recent 30-day period; and (iii) historical information regarding premiums and discounts (both a table and line graph showing the ETF’s premium and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year). The rule also will require any ETF whose premium or discount is greater than 2 percent for more than seven consecutive trading days to post that information on its website, along with a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount.

After considering comments, including those from ICI, the release notes that the Commission modified certain of the bid-ask spread requirements to make the disclosure more cost-effective for ETFs, while maintaining or enhancing the utility for investors. As proposed, the rule would have required an ETF to disclose the median bid-ask spread for the ETF’s most recent fiscal year on its website *and* in its prospectus. The Commission also shortened the look-back period for calculating the bid-ask spread from the most recent fiscal year to the most recent 30-day period on a rolling basis and modified the proposal to require that an ETF use the NBBO in calculating median bid-ask spreads as a way to increase consistency and comparability of this disclosure across ETFs.

Finally, the Commission was persuaded by ICI and other commenters not to adopt the bid-ask spread examples in the prospectus or the proposed interactive calculator that would have allowed an investor to customize the hypothetical bid-ask spread calculations to its specific investing situation.

IV. Recordkeeping

Consistent with the proposal, Rule 6c-11 will require that an ETF preserve and maintain copies of all written agreements between an authorized participant and the ETF (or one of the ETF’s service providers). Rule 6c-11 also will require ETFs to maintain information regarding the baskets exchanged with authorized participants. ETFs will be required to maintain these records for at least five years, the first two years in an easily accessible place.

V. Effect of Proposed Rule 6c-11 on Prior Orders

Effective one year following the effective date of Rule 6c-11, the Commission will rescind those portions of its prior ETF exemptive orders that grant relief related to the formation and operation of an ETF. The Commission also will rescind the master-feeder relief granted to ETFs that do not rely on the relief as of the date of the proposal (June 28, 2018), preventing the formation of new master-feeder arrangements.

The Commission will not rescind the relief from Section 12(d)(1) and Sections 17(a)(1) and (a)(2) under the Investment Company Act relating to fund of funds arrangements involving ETFs. ETFs relying on Rule 6c-11 that do not already have fund of funds relief may enter into fund of funds arrangements, provided that they satisfy the terms and conditions for fund of funds relief in recent ETF exemptive orders.

The Commission will not rescind the exemptive relief of UIT ETFs, leveraged/inverse ETFs, share class ETFs, or non-transparent ETFs. Instead, the Release notes that it is appropriate for ETFs seeking to utilize these structures to continue to request SEC relief through its exemptive application process, and for the SEC to continue to make facts-and-circumstances-based determinations regarding whether such relief is appropriate for any particular applicant.

The Release also notes that of the approximately 300 orders the SEC has issued that provide ETF exemptive relief, about 200 include a condition in its ETF exemptive orders stating that the relief permitting the operation of ETFs will expire on the effective date of any SEC rule that provides relief permitting the operation of ETFs. To provide time for ETFs to transition to Rule 6c-11, the Commission will amend these orders to provide that the ETF relief contained in those orders will terminate one year following the effective date of the rule.

VI. Amendments to Form N-1A

The SEC adopted several amendments to Form N-1A, which are designed to provide investors who purchase ETF shares in secondary market transactions with additional information regarding ETFs, including information regarding costs associated with an investment in ETFs.

As noted above, the Commission did not adopt the proposed Q&A section in Item 3 that would have required information relating to the trading of ETFs on the secondary market and the costs associated with such trading, including hypothetical bid-ask spread examples.

Instead, the amendments to Form N-1A will provide an ETF that does not rely on Rule 6c-11 with the option of providing the median bid-ask spread information required by Rule 6c-11 on its website or the median bid-ask spread over the ETF's most recent fiscal year in its prospectus. Similarly, ETFs not relying on Rule 6c-11 must include premium and discount information in both the prospectus and the annual report unless they choose to comply with the Rule 6c-11 website disclosure requirements.

VII. Amendments to Form N-8B-2

Form N-8B-2 is the registration form under the Investment Company Act for UITs that are currently issuing securities and is used for registration of ETFs organized as UITs. The Commission adopted several amendments to Form N-8B-2 that will mirror the Form N-1A amendments.

VIII. Amendments to Form N-CEN

Form N-CEN is a structured form that requires registered funds to provide census-type information to the SEC on an annual basis. Item C.7. of Form N-CEN requires management companies to report whether they relied on certain rules under the Investment Company Act during the reporting period. The SEC added to Form N-CEN a requirement that ETFs report if they are relying on Rule 6c-11.

IX. Exemptive Relief and Interpretations Under the Exchange Act

Although relief under Rule 6c-11 is limited to exemptions under the Investment Company Act, commenters, including ICI, urged the Commission to harmonize with Rule 6c-11 certain Exchange Act relief that ETFs currently rely on in order to operate. Specifically, commenters expressed concern that the conditions that have been associated with Exchange Act relief are duplicative, or in some cases, inconsistent with other requirements applicable to ETFs. Agreeing that such relief could further reduce regulatory complexity and administrative delay, and eliminate potential inconsistencies between Rule 6c-11 and the related Exchange Act relief that ETFs have obtained to operate, the Commission issued an exemptive order that harmonizes certain related relief under the Exchange Act, including relief from Section 11(d)(1) of the Exchange Act and Exchange Act Rules 10b-10, 15c1-5, 15c1-6, and 14e-5. The exemptive order is effective 60 days after publication of the Rule 6c-11 adopting release in the Federal Register.

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endnotes

[1] See Investment Company Act Release No. 33646 (September 25, 2019), *available at* <https://www.sec.gov/rules/final/2019/33-10695.pdf> .

[2] The release notes that leveraged/inverse ETFs' use of derivatives raises issues under Section 18 of the Investment Company Act and that the Commission has been evaluating these issues as part of a broader consideration of derivatives use by registered funds and BDCs.

[3] Consistent with the proposal, Rule 6c-11 defines a custom basket to mean (i) a basket that is composed of a non-representative selection of the ETF's portfolio holdings; or (ii) a representative basket that is different from the initial basket used in transactions on the same business day.

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