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SEC Proposes Rule and Disclosure Amendments for ETFs

[31275]

July 5, 2018 TO: ICI Members
Investment Company Directors
ICI Global Members
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee SUBJECTS: Exchange-Traded Funds (ETFs) RE: SEC Proposes Rule and Disclosure Amendments for ETFs

Last week, the SEC unanimously proposed a new rule (Rule 6c-11) under the Investment Company Act of 1940 that would permit exchange-traded funds that satisfy certain conditions to operate without first obtaining an exemptive order from the SEC.[1] In connection with the proposed rule, the SEC proposes to rescind certain exemptive orders that have been granted to ETFs and their sponsors. The SEC also is proposing 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. Finally, the SEC is proposing related amendments to Form N-CEN. Comments on the proposal, which is summarized below, are due 60 days after publication in the Federal Register.

1. Scope of Proposed Rule 6c-11

Open-End Funds

Proposed Rule 6c-11 would define an ETF as a registered open-end management investment company that (i) issues (and redeems) creation units to (and from) authorized participants in exchange for a basket and a balancing amount (if any); and (ii) issues shares that are listed on a national securities exchange and traded at market-determined prices.

Rule 6c-11 would not be available to ETFs organized as unit investment trusts,[2] ETFs structured as a share class of a multi-class fund, and leveraged or inverse ETFs. Instead, these ETFs would continue to rely on their existing exemptive orders.

Index-based ETFs and Actively Managed ETFs

Proposed Rule 6c-11 would provide exemptions for both index-based ETFs and actively managed ETFs, but would 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. The SEC believes that permitting index-based and actively managed open-end ETFs to operate under the proposed rule subject to the same conditions would provide a level playing field among those market participants. The Release also acknowledges that the proliferation of highly customized and complicated indexes has blurred the distinction between these products.

Leveraged ETFs

Proposed Rule 6c-11 includes a condition that prevents leveraged ETFs from relying on the rule. The Release refers to "leveraged ETFs" as ETFs that seek, directly or indirectly, to provide returns that exceed the performance of a market index by a specified multiple or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time. The Release also notes that a leveraged ETF seeks to amplify the returns of its underlying index or to profit from a decline in the value of its underlying index and pursues its strategy by rebalancing its portfolio on a daily basis to maintain a constant leverage ratio. According to the SEC, this daily reset, and the effects of compounding, can result in performance that differs significantly from some investors' expectations of how index investing generally works. Leveraged ETFs, and their use of derivatives, also may raise issues under Section 18 of the Investment Company Act, which the SEC is evaluating as part of its broader consideration of the use of derivatives by registered funds and business development companies.

As a result of the SEC's ongoing consideration regarding funds' use of derivatives, the SEC does not believe at this time that it is appropriate to permit additional leveraged sponsors to form leveraged ETFs or operate under proposed Rule 6c-11.[3]

2. Exemptive Relief under Proposed Rule 6c-11

Proposed Rule 6c-11 would 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.[4]

Treatment of ETF Shares as "Redeemable Securities"

Under proposed Rule 6c-11, an ETF, as defined in the rule, would be considered to issue a "redeemable security" within the meaning of Section 2(a)(32) of the Investment Company Act.[5] The Release notes that the arbitrage mechanism is central to the operation of an ETF and serves to keep the market price of ETF shares at or close to the ETF's NAV per share. As a result, even though only authorized participants may redeem creation units directly from the ETF at NAV per share, investors are able to sell their ETF shares on the secondary market at or close to NAV, similar to investors in an open-end fund that redeem their shares directly from the fund at NAV per shares.

In addition, the Release notes that rules under the Securities Exchange Act of 1934 that apply to redeemable securities issued by an open-end fund would apply to ETFs relying on the proposed rule, such as 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. Similarly, ETFs relying on Rule 6c-11 would fall within the "registered open-end investment company" exemption in Rule 11d1-2 under the Exchange Act.

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 SEC's exemptive orders and the 2008 proposal, proposed Rule 6c-11 would 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. The Release notes that the arbitrage mechanism and the conditions in the proposed rule designed to promote a properly functioning arbitrage mechanism (discussed below) have adequately addressed, over the significant operating history of ETFs, the potential concerns regarding shareholder dilution and unjust discrimination that these provisions were designed to address. The arbitrage mechanism also has kept the deviation between the market price of ETFs and NAV per share, each calculated as of the close of trading each day, generally relatively small. As discussed below, to the extent that there are instances where bid-ask spreads widen, or premiums and discounts persist, the proposed rule and disclosure amendments would require ETFs to disclose certain information on their website.

Affiliated Transactions

Section 17(a) of the Investment Company Act generally prohibits an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security or other property to or purchasing any security from the company. Purchases and redemptions of ETF creation units are typically effected in kind, and Section 17(a) prohibits these in-kind purchases and redemptions by affiliated persons of the ETF.

Proposed Rule 6c-11 would 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. According to the SEC, this relief is necessary to facilitate the efficient functioning of the arbitrage mechanism. Without it, an authorized participant or other market participant that becomes an affiliated person of the ETF due to its holdings would be prevented from engaging in arbitrage using an in-kind basket. This, in turn, could have the adverse effect of limiting the pool of market participants that could engage in arbitrage.

The proposed Rule 6c-11 exemption is similar to the exemption in the 2008 proposal, subject to certain additional conditions related to custom baskets (discussed below). Importantly, the Release notes that the SEC preliminarily does not believe that it is appropriate to expand the scope of affiliated persons covered by the exemption, such as broker-dealers affiliated with the ETF's adviser, at the same time that it is permitting additional flexibility with respect to custom baskets.

Additional Time for Delivering Redemption Proceeds

Section 22(e) of the Investment Company Act generally prohibits a registered open-end management investment company from postponing the date of satisfaction of redemption requests for more than seven days after the tender of a security for redemption. The Release notes that this prohibition can cause operational difficulties for ETFs that hold foreign investments and exchange in-kind baskets for creation units. For example, local market delivery cycles for transferring foreign investments to redeeming investors, together with local market holiday schedules, can sometimes require a delivery process in excess of seven days.

Rule 6c-11 would grant relief from section 22(e) to permit an ETF to delay satisfaction of a redemption request for more than seven days if a local market holiday, or series of consecutive holidays, the extended delivery cycles for transferring foreign investments to redeeming authorized participants, or the combination thereof prevents timely delivery of the foreign investment included in the ETF's basket. To rely on this exemption, an ETF would be required to deliver foreign investments as soon as practicable, but in no event later than 15 days after the tender to the ETF. This proposed exemption thus would permit a delay in the delivery of foreign investments only if the foreign investment is being transferred in kind as part of the basket. In addition, given the continued movement toward shorter settlement times in markets around the world, the SEC believes that the relief from Section 22(e) does not need to be permanent. Accordingly, Rule 6c-11 would include a sunset provision that would expire ten years from the rule's effective date.[6]

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

Proposed Rule 6c-11 would require ETFs to comply with certain conditions that would allow them to operate within the scope of the Investment Company Act, and that are designed to protect investors and to be consistent with the purposes fairly intended by the policy and provisions of the Act. These conditions are generally consistent with the conditions the SEC has imposed under its exemptive orders. The conditions also reflect certain changes to the conditions the SEC has imposed under its exemptive orders that, based on 26 years of experience regulating ETFs, it believes will improve the overall regulatory framework for ETFs.

In addition to the requirements included in the definition of "exchange-traded fund" relating to the issuance and redemption of shares and listing on a national securities exchange, the proposed conditions include the following:

Portfolio Transparency

Under proposed Rule 6c-11, an ETF would be required to provide daily portfolio transparency on its website. The portfolio holdings[7] disclosure must be made each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting orders for the purchase or redemption of creation units. In addition, the proposed rule would require the portfolio holdings that form the basis for the ETF's NAV calculation to be the ETF's portfolio holdings as of the close of business on the prior business day. Changes in an ETF's holdings of portfolio securities would therefore be reflected on a T+1 basis. The Release notes that this condition is consistent with current ETF practices and enables an ETF to disclose at the beginning of the business day the portfolio that will form the basis for the next NAV calculation, helping to facilitate the efficient functioning of the arbitrage process.

To standardize the manner in which portfolio holdings are presented on the ETF's website, the proposed rule would require that portfolio holdings information be presented and contain information regarding description, amount, value and/or unrealized gain/loss (as applicable) consistent with Article 12 of Regulation S-X, which sets forth the form and content of fund financial statements.

Baskets

Proposed Rule 6c-11 would require each ETF relying on the rule to adopt and implement written policies and procedures governing the construction of baskets and the process that would be used for the acceptance of baskets. In addition, the proposed rule would provide an ETF with the flexibility to use "custom baskets" 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 proposed rule also would require an ETF to disclose prominently on its website information regarding a published basket that will apply to orders for the purchase or redemption of creation units each business day.

Specifically, Rule 6c-11 would require ETFs to 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. These policies and procedures would be required to cover the methodology that the ETF would use to construct baskets. For example, the policies and procedures should detail the circumstances when the basket may omit positions that are not operationally feasible to transfer in kind, when the ETF would use representative sampling of its portfolio to create its basket, and how the ETF would sample in those circumstances. The policies and procedures also should detail how the ETF would replicate changes in the ETF's portfolio holdings as a result of the rebalancing or reconstitution of the ETF's securities market index, if applicable.

Custom Baskets. The proposed rule defines two particular types of baskets as "custom baskets." First, baskets that are composed of a non-representative selection of the ETF's portfolio holdings, which would include, but not be limited to, baskets that do not reflect: (i) a pro rata representation of the ETF's portfolio holdings; (ii) a representative sampling of the ETF's portfolio holdings; or (iii) changes due to a rebalancing or reconstitution of the ETF's securities market index, if applicable. Second, baskets used in transactions on the same business day. For example, if an ETF exchanges a basket with an authorized participant that reflects a representative sampling of the ETF's portfolio holdings and a different basket with either the same or another authorized participant that represents a different representative sampling, both baskets would be custom baskets. Similarly, if an ETF substitutes cash in lieu of a portion of basket assets for a single authorized participant, that basket would be a custom basket.

The SEC believes that the use of custom baskets presents an increased risk that the ETF may be subject to improper pressure by an authorized participant to create specific baskets that favor that authorized participant. As a result, an ETF using custom baskets must adopt policies and procedures that: (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 deviation 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 ("custom basket policies and procedures").

The Release notes that an ETF's basket policies and procedures (including its custom basket policies and procedures) should be covered by the ETF's compliance program and other requirements under Rule 38a-1 under the Investment Company Act. For example, an ETF would be required to preserve the basket policies and procedures pursuant to the requirements of Rule 38a-1(d)(1). The SEC believes that the ETF's board of directors' oversight of the ETF's compliance policies and procedures, as well as their general oversight of the ETF, would provide an additional layer of protection for an ETF's use of custom baskets.

Basket Website Disclosure. Proposed Rule 6c-11 also would require an ETF to post on its website information regarding a published basket at the beginning of each business day, as well as the estimated cash balancing amount if any.[8] This "published" basket must be disclosed before the opening of trading of the ETF's shares and before the ETF begins accepting orders for the purchase or redemption of creation units to be priced based on the ETF's next calculation of NAV. This requirement is designed to mitigate possible inefficiencies in the arbitrage mechanism that could result from delaying the publication of an ETF's basket. Under this requirement, an ETF would publish a basket that it would accept if presented by any authorized participant in exchange for creation units (or present to an authorized participant redeeming creation units). Thus, if an ETF planned to use only custom baskets on a particular business day (*e.g.*, a basket reflecting a non-representative selection of the ETF's portfolio holdings), it would be required to post a custom basket as its "published" basket; however, the rule would only require an ETF to publish one basket per day, even on occasions where an ETF uses multiple custom baskets.

Website Disclosure

Proposed Rule 6c-11 would require ETFs to disclose certain information on their websites. Specifically, the proposed rule would 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;[9] (ii) median bid-ask spread information; 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).[10] The proposed rule also would require any ETF whose premium or discount was 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.

4. Recordkeeping

Under the proposed rule, one of the defining characteristics of authorized participants is that they have a written agreement with an ETF or one of the ETF's service providers allowing the authorized participant to purchase or redeem creation units directly from the ETF. Given that these agreements are critical to understanding the relationship between the authorized participant and the ETF, proposed Rule 6c-11 would require that ETFs preserve and maintain copies of these agreements. The Release notes that this requirement is designed to provide the SEC's examination staff with a basis to determine whether the relationship between the ETF and the authorized participant is in compliance with the requirements of proposed Rule 6c-11 and other provisions of the Investment Company Act and rules thereunder. The SEC did not include this requirement in the 2008 proposal.

The SEC also is proposing to require ETFs to maintain information regarding the baskets exchanged with authorized participants. In particular, the proposed rule would require an ETF to maintain records setting forth the following information for each basket exchanged with an authorized participant: (i) the names and quantities of the positions composing the basket; (ii) identification of the basket as a "custom basket" and a record stating that the custom basket complies with the ETF's custom basket policies and procedures (if applicable); (iii) cash balancing amounts (if any); and (iv) the identity of the authorized participant conducting the transaction. These records would provide the SEC's examination staff with a basis to understand how baskets are being used by ETFs, as well as to evaluate compliance with the rule and other provisions of the Investment Company Act and rules thereunder. In particular, the Release notes that these records would allow the examination staff to evaluate whether the use of custom baskets is appropriate.

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

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

The SEC is proposing to amend and rescind the exemptive relief it has issued to ETFs that would be permitted to rely on the proposed rule. The rescission of orders would specifically be limited to the portions of an ETF's exemptive order that grant relief related to the formation and operation of an ETF. The SEC also is proposing to rescind the master-feeder relief granted to ETFs that do not rely on the relief as of the date of this proposal (June 28, 2018), preventing the formation of new master-feeder arrangements. The proposal would 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.

The Release notes that beginning in 2008 the SEC began including a condition in its ETF exemptive orders stating that the relief permitting the operation of ETFs would expire on the effective date of any SEC rule that provides relief permitting the operation of ETFs. Of the approximately 300 orders the SEC has issued that provide ETF exemptive relief, about 200 include this automatic expiration condition, and thus the ETF relief would terminate if and when proposed Rule 6c-11 is adopted and goes into effect. To provide time for ETFs to transition to Rule 6c-11, however, the SEC proposes to amend these existing orders to provide that the ETF relief contained in those orders will terminate one year following the effective date of any final rule.

Moreover, to limit any hardship that revocation of existing exemptive relief would have on current ETFs with orders that do not automatically expire, the SEC is proposing a one-year period after the effective date before it rescinds that exemptive relief to give those ETFs time to bring their operations into conformity with the requirements of proposed Rule 6c-11.

The SEC does not propose to rescind the exemptive relief of ETFs that would not be permitted to rely on the proposed rule. Specifically, the SEC does not propose to rescind the exemptive relief for ETFs organized as UITs, ETFs that are organized as a share class of a fund, or leveraged 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.

6. Amendments to Form N-1A

The SEC is proposing 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. The proposal also would eliminate certain disclosures that would be duplicative of the proposed amendments to Item 3 of Form N-1A regarding the exchange-traded nature of ETFs. Finally, the SEC is requesting comment on whether it should create a new ETF-specific registration form.

Item 3 of Form N-1A

Item 3 of Form N-1A requires funds to include a table describing the fees and expenses investors may pay if they buy and hold shares of the fund. Item 3 does not currently distinguish between ETFs and mutual funds, and only requires disclosure of sales loads, exchange fees, maximum account fees and redemption fees that funds charge directly to shareholders. The SEC therefore is proposing several amendments to this Item to clarify that there are certain fees that are not reflected in the fee table for both mutual funds and ETFs and to require new disclosure requirements that capture ETF-specific trading information and costs. Like all information disclosed in Items 2, 3, or 4 of Form N-1A, the information disclosed in amended Item 3 would have to be tagged and submitted in a structured data format.

Changes That Affect Mutual Funds and ETFs. The SEC is proposing a narrative disclosure that would clarify that, in addition to the current disclosures relating to investors who buy or hold shares, the fees and expenses reflected in the Item 3 expense table may be higher for investors if they sell shares of the fund. This amendment would be applicable to both mutual funds and ETFs given that an investor may incur expenses other than redemption fees when selling shares of either a mutual fund or ETF. For example, although less common than they were in the past, an investor may incur a back-end sales load when selling a mutual fund share. Likewise, an investor may bear costs associated with bid-ask spreads when selling ETF shares.

The SEC also is proposing to require a statement that investors may be subject to other fees not reflected in the table, such as brokerage commissions and fees to financial intermediaries.

Changes That Affect ETFs. Because ETF shares are exchange-traded, secondary market investors in ETF shares are subject to trading costs, such as bid-ask spreads, that are not currently required to be disclosed under Item 3. The Release notes that trading costs, like all costs and expenses, affect investors' returns on their investment. As a result, the SEC is proposing a new section, formatted as a series of question and answers ("Q&As"), in Item 3 that would require disclosure of certain ETF trading information and trading costs.[11] The six proposed Q&A disclosures would require information relating to the trading of ETFs on the secondary market and the costs associated with such trading. The specific question and answer disclosures are shown on page 155 in the Release.

7. 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 SEC is proposing to amend Form N-8B-2 to require UIT ETFs to provide disclosures that mirror certain of the proposed disclosure changes in Form N-1A.

8. 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 is proposing to add to Form N-CEN a requirement that ETFs report if they are relying on Rule 6c-11.

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endnotes

[1] *See* Investment Company Act Release No. 33140 (June 28, 2018) (the "Release"), *available at* https://www.sec.gov/rules/proposed/2018/33-10515.pdf. The SEC proposed, but never adopted, an ETF rule in 2008. *See* Investment Company Act Release No. 28193 (March 11, 2008), 73 FR 14618 (March 18, 2008) ("2008 proposal").

[2] This is consistent with the 2008 proposal.

[3] The SEC staff has not supported new exemptive relief for leveraged ETFs since 2009.

[4] The exemptive orders also provide relief allowing certain types of funds to invest in ETFs beyond the limits of Section 12(d)(1) of the Investment Company Act. The proposed rule does not include this relief; however, with the exception of certain master-feeder relief discussed below, would not rescind the relief from Section 12(d)(1).

[5] This is consistent with the 2008 proposal. In contrast, the exemptive orders provide an exemption from the definition of "redeemable security" in Section 2(a)(32) or from the definition of "open-end company" in Section 5(a)(1) of the Investment Company Act. The SEC believes it is more appropriate for the proposed rule to address these questions of status by classifying ETF shares as "redeemable securities" and thus any ETF operating in compliance with the rule's conditions and requirements would meet the definition of open-end company.

[6] The 2008 proposal would have allowed up to 12 days to deliver redemption proceeds without an offsetting requirement to deliver as soon as practicable and without a sunset provision. The 2008 proposal also would have required an ETF to disclose in its registration statement the foreign holidays it expects may prevent timely delivery of foreign securities, and the maximum number of days that it anticipates it will need to deliver the foreign securities. The SEC believes this disclosure is not relevant to investors who purchase ETF shares on the secondary market because the settlement of these investors' ETF trades would be unaffected by the potential delay and such delays are typically covered by the authorized participant agreement.

[7] Portfolio holdings is defined to mean an ETF's securities, assets, or other positions. As a result, an ETF would be required to disclose its cash holdings, as well as holdings that are not securities or assets, including short positions or written options.

[8] The 2008 proposal did not expressly contemplate that an ETF would be permitted to substitute other securities in lieu of other basket assets. That proposal also did not require ETFs to disclose their baskets.

[9] This requirement is consistent with the SEC's exemptive orders and generally consistent with the 2008 proposal.

[10] Historical information regarding premiums and discounts is a condition in many of the SEC's exemptive orders and required by Form N-1A.

[11] An ETF that had its initial listing on a national securities exchange after the beginning of its most recently completed fiscal year would not report the same trading information and related costs.