PAUL HASTINGS

STAY CURRENT

July 2018

SEC Proposes Rule Designed to Permit Certain ETFs to Operate Without an Exemptive Order and Adopts Amendments to the Liquidity Rule

By The Investment Management Practice

Introduction

On Thursday, June 28, 2018, the Securities and Exchange Commission (the "SEC" or the "Commission") unanimously approved proposed Rule 6c-11[1] that would permit exchange-traded funds ("ETFs") that satisfy certain conditions to operate within the scope of the Investment Company Act of 1940 (the "1940 Act") and come directly to market without the cost and delay of obtaining an exemptive order.

According to the SEC, ETFs registered with the SEC currently represent approximately $3.4 trillion in total assets and account for approximately 15% of total net assets managed by investment companies.[2] However, because ETFs issue and redeem their shares only in transactions with authorized participants and only in large aggregations known as creation units, primarily for in-kind baskets of portfolio assets, they do not comply with provisions of the 1940 Act governing the sale and redemption of redeemable securities. As a result, under the current regulatory regime, before shares of an ETF can be sold, an ETF sponsor must receive exemptive relief from several provisions of the 1940 Act.[3]

Proposed Rule 6c-11 would remove the need for an ETF provider to obtain exemptive relief prior to launching an ETF by standardizing the conditions to which certain ETFs must adhere. According to a statement made at the open meeting on Thursday by Dalia Blass, head of the Division of Investment Management, "[c]ontinuing exemptive orders for all ETFs no longer suits the size and maturity of [the ETF] market." As a result, it is the Commission's intention to help level the playing field by creating more regulatory consistency for investors, the Commission, and fund complexes.[4]

While the proposal received unanimous approval, Commissioners Stein[5] and Jackson[6] expressed their approval of the proposal as a first step, but voiced their concerns over the need for a regulatory framework for leveraged ETFs.

I. Proposed Rule

As noted above, proposed Rule 6c-11 would permit ETFs that satisfy certain conditions to operate within the scope of the 1940 Act and come directly to market without the cost and delay of obtaining exemptive relief. Proposed Rule 6c-11 would provide exemptions for both index-based 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.[7]

Proposed Rule 6c-11 would be subject to certain conditions. The proposed conditions include the following:

1. **Transparency.** Under proposed Rule 6c-11, an ETF would be required to provide daily portfolio transparency on its website. However, unlike under prior ETF exemptive orders, dissemination of an intraday indicative value every 15 seconds would not be required under the proposed rule.

2. **Custom basket policies and procedures.** An ETF relying on proposed Rule 6c-11 would be permitted to use baskets that do not reflect a pro rata representation of the fund's portfolio or that differ from other baskets used in transactions on the same business day ("custom baskets") if the ETF adopts written policies and procedures setting forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders. It is important to note that while some ETF providers may already have policies and procedures governing the construction of baskets in order to comply with the representations and conditions of their exemptive orders, these policies and procedures would not have been subject to the requirements that the SEC is proposing for custom-basket policies and procedures under the proposal. For example, the proposal notes that the policies and procedures should detail the circumstances when the basket may omit positions that are not operationally feasible to transfer in kind.[8]

3. **Posting of a Published Basket.** The proposal would require an ETF, at the beginning of each business day, to post on its website information regarding a published basket. This may come as a surprise to some ETF providers, as not all ETF providers currently provide this information on their websites. In addition, ETFs would also be required to maintain records detailing the composition of baskets, which would allow the SEC staff to review an ETF's baskets as part of an examination.

4. **Website disclosure.** The proposed rule would require ETFs to disclose certain information on their websites, including (i) the ETF's NAV per share, market price, and premium or discount, each as of the end of the prior business day; (ii) bid-ask spreads; and (iii) historical information regarding premiums and discounts. These disclosures are intended to inform investors about the efficiency of an ETF's arbitrage process.

5. **Recordkeeping.** ETF providers would be required to preserve and maintain copies of all agreements with authorized participants.

To help create a consistent ETF regulatory framework, the proposal recommends rescinding exemptive relief previously granted to ETFs that would be able to rely on the proposed rule. SEC Chairman Jay Clayton noted at the open meeting that the Commission would "do so without placing a significant burden on existing ETFs to comply." The proposal also recommends rescinding exemptive relief permitting ETFs to operate in a master-feeder structure due to the fact that very few ETFs currently utilize such relief.[9]The proposal, however, recommends grandfathering in existing master-feeder arrangements, but preventing the formation of new arrangements, by amending relevant exemptive orders. Additionally, the proposal does not recommend rescinding exemptive relief that permits ETF fund of funds arrangements.

Lastly, the Commission is proposing several amendments to Form N-1A to provide more useful, ETF-specific information to investors who purchase ETF shares on an exchange. The Commission is also proposing that ETFs organized as unit investment trusts ("UITs") provide the same information to investors on Form N-8B-2.

Comments on the proposal will be due 60 days after publication in the Federal Register. The SEC's proposed Rule on ETFs can be found here.

II. Amendments to Liquidity Risk Management Rules

On the same day, in a 3-2 vote, the Commission also adopted certain amendments to the Liquidity Risk Management Rules ("Liquidity Rule") which effectively rescinded the requirement under the Liquidity Rule that open-end funds publicly disclose aggregated liquidity classification data, and replaced it instead with a new requirement that funds disclose information about the operation and effectiveness of their liquidity risk management program in their reports to shareholders. This represents yet another modification of the Liquidity Rule, which requires fund complexes to implement liquidity risk management programs effective December 1, 2018.

Under new rule 22e-4, each open-end fund (other than money market funds and In-Kind Exchange-Traded Funds[10]) will be required to classify each portfolio investment into one of four liquidity classifications and disclose the same on Form N-PORT. While investment-level classifications are nonpublic, Form N-PORT mandates quarterly disclosure of a fund's aggregate percentage of investments in each classification. Due to public concern regarding the potentially misleading nature of any such disclosure, the SEC's action on Thursday ends this requirement.

Under the amendments, funds would discuss in their annual or semi-annual shareholder report the operation and effectiveness of their liquidity risk management program. In addition, a fund would no longer be required to include such discussion in the fund's management discussion of fund performance.

Furthermore, the amendments to Form N-PORT provide funds with flexibility to split their portfolio holdings into more than one classification category under certain circumstances. Finally, Form N-PORT will require that funds disclose their holdings of cash and cash equivalents not reported elsewhere on the Form.

The SEC's amendment to the Liquidity Rule can be found here.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Yousuf I. Dhamee
1.213.683.6179
yousufdhamee@paulhastings.com

Arthur L. Zwickel
1.213.683.6161
artzwickel@paulhastings.com

New York

Michael R. Rosella
1.212.318.6800
mikerosella@paulhastings.com

Vadim Avdeychik
1.212.318.6054
vadimavdeychik@paulhastings.com

Bill Belitsky
1.212.318.6097
billbelitsky@paulhastings.com

Jacqueline A. May
1.212.318.6282
jacquelinemay@paulhastings.com

Gary D. Rawitz
1.212.318.6877
garyrawitz@paulhastings.com

San Francisco

David A. Hearth
1.415.856.7007
davidhearth@paulhastings.com

Washington, D.C.

Tram N. Nguyen
1.202.551.1968
tramnguyen@paulhastings.com

Wendell M. Faria
1.202.551.1758
wendellfaria@paulhastings.com

[1] Proposed Rule 6c-11 would be available to ETFs organized as open-end funds, which, according to the SEC, is the structure of choice for the vast majority of ETF providers today. ETFs organized as unit investment trusts, ETFs structured as a share class of a multi-class fund, and leveraged or inverse ETFs would not be able to rely on the proposed rule.

[2] SEC Release No. 33-10515, footnote 2, ("This figure is based on data obtained from Bloomberg. As of December 2017, there were 1,900 ETFs registered with the Commission.")

[3] To date, the SEC has issued approximately 300 exemptive orders, resulting in representations and conditions that have led to some variations in the regulatory structure for existing ETFs; see *id.* at 6; see also *id*. footnote 6, ("Since 2000, our ETF exemptive orders have provided relief for future ETFs.").

[4] See Release No. 33-10515, at 16.

[5] Statement at Open Meeting on the Proposed Rule 6c-11 under the Investment Company Act of 1940 Governing Exchange-Traded Funds (Jun. 28, 2018) available at https://www.sec.gov/news/public-statement/statement-stein-exchange-traded-funds-062818, ("[The proposal] does not broadly address the use of leveraged and inverse ETFs, which are essentially ETFs on steroids.").

[6] Statement on Investment Company Liquidity Disclosure (Jun. 28, 2018) available at https://www.sec.gov/news/public-statement/jackson-statement-investment-company-liquidity-disclosure, ("I can only reluctantly vote to propose this rule. The reason is that the proposal does nothing to address a growing group of products, known as leveraged ETFs, that pose real risks to American families who are saving for the long term. I'm concerned that we are not doing enough to protect American investors from those risks.").

[7] Release No. 33-10515, at 24.

[8] *Id*. at 94-95.

[9] The SEC did note that it is proposing grandfathering in existing master-feeder arrangements involving ETF feeder funds, but preventing the formation of new ones, by amending relevant exemptive orders. *Id*. at 141-142.

[10] In-Kind Exchange Traded Fund or In-Kind ETF means an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash and that publishes its portfolio holdings daily. Rule 22e-4(a)(9).