

September 2019

Follow @Paul_Hastings



SEC Adopts Long Awaited "ETF Rule"

By [The Investment Management Practice](#)

Introduction

In July 2018, our team published an [Alert](#) detailing the Securities and Exchange Commission's (the "SEC" or the "Commission") proposed Rule 6c-11¹ (the "ETF Rule" or the "Adopted Rule") that would permit exchange-traded funds ("ETFs") that satisfy certain conditions to operate within the scope of the Investment Company Act of 1940, as amended (the "1940 Act") and come directly to market without the cost and delay of obtaining exemptive relief. On Thursday, September 26, 2019, SEC voted to approve Rule 6c-11, under the 1940 Act and, in addition, granted an exemption to broker-dealers, and certain other persons that engage in ETF transactions, from certain provisions under the Securities Exchange Act of 1934 (the "Exchange Act").

According to the Commission, ETFs registered with the SEC currently represent approximately \$3.32 trillion in total assets and account for approximately 16% 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

The ETF Rule removes 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. With the adoption of the ETF Rule, new entrants that meet its conditions will no longer incur the costs associated with obtaining exemptive relief nor be subject to delays while they wait for the SEC to grant exemptive relief. Moreover, the ETF Rule puts ETF managers on a level playing field, regardless of where they obtained their relief. Because not all ETF exemptive relief was created equally, some participants benefitted from more favorable exemptive relief simply because of when that relief was obtained. The ETF Rule standardizes the conditions for those who meet its conditions.

I. Adopted Rule

As noted above, the ETF Rule will 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. The ETF Rule will provide exemptions for both index-based and transparent actively managed ETFs, and will not treat them differently.⁴ The Adopted Rule, however, does not apply to leveraged, inverse, non-transparent, share classes, or ETFs structured as UITs; all of these will need to continue to rely on exemptive relief.

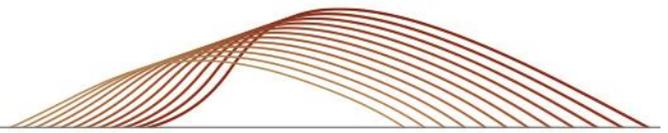


ETFs seeking to rely on the Adopted Rule will be subject to certain conditions. The conditions include the following:

1. **Transparency.** Under the Adopted Rule, an ETF will be required to prominently disclose full, daily portfolio transparency on its website.⁵ Additionally, unlike under prior ETF exemptive orders, dissemination of an intraday indicative value every 15 seconds is not required under the rule.⁶
2. **Custom basket policies and procedures.** An ETF relying on the Adopted Rule will be permitted to use baskets that do not reflect a pro rata representation of the fund's portfolio or that differ from initial 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, to date, these policies and procedures have not been subject to the requirements under the Adopted Rule. For example, the rule 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.⁷
3. **Website disclosure.** The Adopted Rule requires 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;⁸ (iii) historical information regarding premiums and discounts; and (iv) the existence of a premium or discount greater than 2% lasting for more than seven consecutive trading days.⁹ These disclosures are intended to inform investors about the efficiency of an ETF's arbitrage process.
4. **Recordkeeping.** The Adopted Rule requires that ETF providers preserve and maintain copies of all agreements with authorized participants.¹⁰

Unlike the 2018 proposal, the required time and presentation of the portfolio holdings disclosure must now be made on the morning of each business day before regular trading begins on the ETF's primary listing exchange. Previously, ETFs were required to disclose portfolio holdings both before regular trading begins, and before accepting orders for the purchase/redemption of creation units.¹¹ This change was made to accommodate T-1 orders. The content of the required disclosures has also changed. While the proposed rule would have required disclosure of information in the manner prescribed by Article 12 of Regulation S-X, the Adopted Rule requires only disclosure of "(1) ticker symbol, (2) CUSIP or other identifier, (3) description of holding, (4) quantity of each security or other asset held, and (5) percentage weight of the holding in the portfolio."¹²

In another change from the 2018 proposal, the Commission has decided not to include the basket publication requirements in the Adopted Rule. The Rule 6c-11 Adopting Release (the "Adopting Release") noted that the basket publication requirement added little value, and that the daily online disclosure of portfolio holdings will provide market participants with "necessary tools to determine if an arbitrage opportunity exists and to hedge the ETF's portfolio."¹³



The ETF Rule will be effective 60 days after its publication. To help create a consistent ETF regulatory framework, the Commission will rescind prior exemptive relief one-year following the effective date of the ETF Rule.¹⁴ The SEC noted that “[it] continue[s] to believe that the one-year period . . . is sufficient to give ETFs . . . time to bring their operations in conformity with the requirement of the Adopted Rule.”¹⁵ The SEC is also rescinding exemptive relief permitting ETFs to operate in a master-feeder structure, but is grandfathering in master-feeder arrangements that relied on exemptive relief as of June 28, 2018.¹⁶ Additionally, the SEC is not rescinding exemptive relief that permits ETF fund of funds arrangements until the Commission approves a new SEC rule which will allow registered investment companies to invest in other funds beyond the limits of Section 12(d)(1) of the 1940 Act.¹⁷

The Commission is also amending Form N-1A in order to provide ETF-specific information to investors.¹⁸ The amendments to Form N-1A include:

- Adding the term “selling” to current narrative disclosure requirements to clarify that the fees and expenses reflected in the expense table may be higher for investors if they buy, hold, and sell shares of the fund;
- Streamlined narrative disclosures relating to ETF trading costs, including bid-ask spreads;
- Requiring ETFs that do not rely on the Adopted Rule to disclose median bid-ask spread information on their websites or in their prospectus;
- Excluding ETFs that provide premium/discount disclosures in accordance with the Adopted Rule from the premium and discount disclosure requirements in Form N-1A; and
- Eliminating disclosures relating to creation unit size and disclosures applying only to ETFs with creation unit sizes of less than 25,000 shares.

Moreover, ETFs organized as unit investment trusts (“UITs”) are required to provide the following information to investors on Form N-8B-2:¹⁹

- Definitions for Exchange-Traded Fund and Market Price;
- Information Concerning Fees and Costs;
- Information Concerning Purchase and Sale of Fund Shares; and
- Table Showing Premium and Discount Information.

As noted above, the adoption of the ETF Rule creates uniform regulatory requirements and greater certainty in terms of cost and time when forming new ETFs or launching a new ETF business. For example, in the past not all exemptive relief was created equal; some exemptive orders may have permitted custom baskets while certain later exemptive relief did not. This put some ETF providers at a competitive disadvantage. With the adoption of the ETF Rule, all ETF providers that are able to rely on the Adopted Rule will generally be on the same regulatory playing field. The regulatory certainty that the Adopted Rule provides to the ETF industry should result in further ETF innovation, and may bring new ETF providers into the market.

The SEC’s Adopted Rule can be found [here](#).



II. Granted Exemptions

In order to reduce regulatory complexity and administrative delay, the Commission has granted broker-dealers, and certain other persons that engage in transactions with ETFs relying on the Adopted Rule, relief from section 11(d)(1) of the Exchange Act and rules 10b-10, 15c1-5, 15c1-6, and 14e-5 under the Exchange Act. The exemptions are designed to simplify the offering and operating process for ETFs.²⁰

Persons seeking to rely on the granted exemptions must be engaged in a transaction with an ETF that relies on the Adopted Rule. With respect to each exemption other than an exemption from rule 14e-5, the Commission requires that the ETF meet the diversification requirements applicable to regulated investment companies under section 851 of the Internal Revenue Code.²¹

Specific conditions for each exemption are discussed in brief below:

1. **Rule 10b-10.** Rule 10b-10 requires a broker-dealer to send confirmation statements to customers following a transaction. Under the exemption, these statements need not include the identity, price, and number of shares or units within a transaction involving an ETF.²²
2. **Rules 15c1-5, and 15c1-6.** Rules 15c1-5, and 15c1-6 both require the disclosure of relationships between a broker-dealer and security issuers, and of interests that the broker-dealer may have in distribution of a security. In order to be exempted from this requirement, broker-dealers must provide the information to which a customer is entitled under Rules 15c1-5 or 15c1-6 upon request, and to fulfil such requests in a timely manner.²³
3. **Section 11(d)(1).** Section 11(d)(1) prohibits broker-dealers from extending or maintaining credit to or for a customer on any security which was part of an issue in which the broker dealer participated. For purposes of the exemption, the Commission distinguishes between registered broker-dealers that have entered into contractual arrangements with ETFs that allow them to place orders for the purchase or redemption of creation units, known as "Broker-Dealer APs," and broker-dealers who effect ETF securities transactions solely on the secondary market, known as "Non-AP Broker-Dealers." Both groups of broker-dealers are prohibited from directly or indirectly accepting compensation, payment, or economic incentives from ETF share issuers to sell ETF shares. In addition, Broker-Dealer APs must wait thirty days from the date ETF shares begin trading before extending or maintaining credit to or for a customer on such shares.²⁴
4. **Rule 14e-5.** Rule 14e-5 prohibits dealer-managers of a tender offer from purchasing securities relating to that tender offer. The SEC has relaxed²⁵ this prohibition in the context of transactions involving ETFs so long as broker-dealers acting as dealer-managers of a tender-offer do not themselves purchase securities for the purpose of facilitating a tender-offer.

The SEC's exemption order 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

Vadim Avdeychik
1.212.318.6054

vadimavdeychik@paulhastings.com

Gary D. Rawitz
1.212.318.6877

garyrawitz@paulhastings.com

Arthur L. Zwickel
1.213.683.6161

artzwickel@paulhastings.com

Bill Belitsky
1.212.318.6097

billbelitsky@paulhastings.com

Justin R. Capozzi
1.212.318.6015

justincapozzi@paulhastings.com

New York

Ira Kustin
1.212.318.6094

irakustin@paulhastings.com

Runjhun Kudaisya
1.212.318.6747

runjhunkudaisya@paulhastings.com

San Francisco

David A. Hearth
1.415.856.7007

davidhearth@paulhastings.com

Michael R. Rosella
1.212.318.6800

mikerosella@paulhastings.com

Jacqueline A. May
1.212.318.6282

jaquelinemay@paulhastings.com

¹ Rule 6c-11 will 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, and ETFs structured as a share class of a multi-class fund are excluded from the rule. See SEC Release No. 33-10695, at 18, and 121-22. In addition, ETFs that seek to provide leveraged or inverse investment over a predetermined period of time will not be able to rely on the rule. *Id.* at 31.

² *Id.*, footnote 2, (“This figure is based on data obtained from Bloomberg. As of December 2018, there were 2,000 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 5-6; see also *id.* footnote 6, (“[s]ince 2000, our ETF exemptive orders have provided relief for future ETFs.”).

⁴ SEC Release No. 33-10695, at 22.

⁵ *Id.* at 68.

⁶ *Id.* at 79.

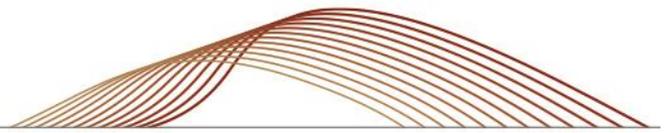
⁷ *Id.* at 86.

⁸ While the proposed rule would have required an ETF to disclose median bid-ask spreads for the ETF’s most recent fiscal year on both its website and prospectus, the Adopted Rule requires publication of the spread online over the most recent 30-day period. The modification was made to make disclosure more cost-effective, while maintaining utility for investors. Finally, the national best bid and national best offer (“NBBO”) must be used in calculating the spread.

⁹ *Id.* at 97; The Adopting Release notes that the addition of the requirement to disclose a premium or discount greater than 2% for more than seven consecutive trading days would promote transparency regarding the significance and/or persistency of deviations between market price and NAV per share, and thus may permit investors to make more informed investment decisions. Moreover, this information also may provide the market (and the Commission) with information regarding the efficiency of an ETF’s arbitrage mechanism.

Paul Hastings LLP

Stay Current is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2019 Paul Hastings LLP.



¹⁰ *Id.* at 118.

¹¹ *Id.* at 73.

¹² *Id.* at 76-77.

¹³ *Id.* at 95.

¹⁴ *Id.* at 129.

¹⁵ *Id.* at 131.

¹⁶ *Id.* at 128.

¹⁷ *Id.* at 132; The Commission is, however, considering rescission of fund of fund exemption orders in connection with proposed new rule 12d1-4. The proposed rule would streamline and enhance the regulatory framework applicable to fund of funds arrangements.

¹⁸ *Id.* at 133.

¹⁹ *Id.* at 145.

²⁰ SEC Release No. 34-87110, at 6.

²¹ *Id.* at 9

²² *Id.* at 11. The SEC also requires that such confirmation statements include a statement that omitted identity, price, and number information may be provided upon request.

²³ *Id.* at 14.

²⁴ *Id.* at 14-17.

²⁵ *Id.* at 17-20. The SEC specifies that “[t]he conditional exemption will allow . . . persons (i) to redeem ETF shares in creation unit sizes for a redemption basket that may include a [security related to a tender offer], (ii) to engage in secondary market transactions with respect to the ETF shares after the first public announcement of the tender offer and during such tender offer given that such transactions could include, or be deemed to include, purchases of, or arrangements to purchase, [securities related to a tender offer], and (iii) make purchases of, or arrangements to purchase, [securities related to a tender offer] in the secondary market for the purpose of transferring such securities to purchase one or more creation units of ETF shares.”