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ETF Reg Insights

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ETF Complexes Should Prepare Now to Comply with New Rule 6c-11 to Be in a Position to Unlock Its Key Regulatory Advantages by Year-End

Key Notes:

- Immediate compliance with Rule 6c-11 will open the door for ETF complexes to use "Custom Baskets"
- Developing and implementing board-approved basket procedures should be considered a high priority
- Rule 6c-11 opens up the possibility for more innovative ETFs than possible under the current regulatory scheme

Introduction

On September 26, 2019, the Securities and Exchange Commission (SEC) adopted Rule 6c-11 (Rule) under the Investment Company Act of 1940 (1940 Act), the long-awaited "ETF Rule".[1] New Rule 6c-11 will have an immediate and most likely a favorable impact on ETF industry participants. Firms entering into the ETF business can now launch ETFs much more speedily and with greater certainty as compared to the old SEC exemptive order process. Existing ETF complexes (as well as the new entrants) can use "custom baskets," which means that they will no longer be at a competitive disadvantage to the select few ETF complexes that have used such baskets for decades.

ETF complexes and new entrants should take steps to quickly master Rule 6c-11, the features of which are described in detail below. It is advisable that firms begin designing compliance and operational procedures immediately so that they may be in place on the Rule's effective date (which will be in December 2019, on the 60th day of its publication in the *Federal Register* ("Effective Date")). After discussing the ETF Rule in detail, this alert summarizes the other related actions taken by the SEC on September 26, 2019, including new disclosure requirements, delayed compliance dates for certain conditions of the Rule and certain technical modifications to regulations that govern ETFs.

Timing

New Rule 6c-11 affects ETF complexes and new entrants differently. Firms seeking to offer ETFs that have not obtained ETF exemptive orders must wait until the Effective Date to launch their funds (assuming the funds have completed their registration process). If a firm filed an exemptive application on or before September 26, 2019, it must draft and file an APP WD with the SEC to withdraw that application. No firm may file an exemptive application with the SEC after September 26, 2019, unless the application is for an ETF that is not covered by the Rule (which is discussed below).

Firms with ETF exemptive orders have a choice. They must decide at the Effective Date whether to postpone complying with the ETF Rule to any date prior to the one-year anniversary of the Rule. ETF complexes seeking to utilize custom baskets may not want to wait to rely on the ETF Rule; ETF complexes that already have such ability may be inclined to postpone relying on the Rule. On that one-year anniversary date, all existing ETF exemptive orders will expire and thus all ETFs will have to be in compliance with the Rule.

[1] See Exchange Traded Funds, Investment Company Act Rel. No. 33646 (September 25, 2019) ("Adopting Release").

ETF Rule Conditions

ETFs seeking to rely on Rule 6c-11 on or after the Effective Date must:

1. Meet the definition of ETF including being an open-end investment company;
2. Create, implement and maintain basket (and optionally custom basket) procedures;
3. Post certain required information on the ETF's website; and
4. Comply with new ETF recordkeeping rules.

Meeting the Definition of ETF

A firm desiring to sponsor and offer ETFs must ensure that each of its funds meets the definition of "exchange-traded fund" found in paragraph (a)(1) of Rule 6c-11:

> a registered open-end management investment company (i) that issues and redeems creation units to (and from) Authorized Participants (defined below) in exchange for a basket and a cash balancing amount if any; and (ii) whose shares are listed on a national securities exchange and traded at market-determined prices.

Thus, a fund must both meet the definition of investment company in Section 3(a)(1) of the 1940 Act and not be excepted or exempted from that definition by a provision of the 1940 Act or a rule thereunder. For example, a fund that invests 80% of its assets in futures could not be an ETF relying on Rule 6c-11 because it would not meet the definition of an investment company.

In addition to being an investment company, only "open-end management investment companies;" i.e., funds that issue redeemable securities (which rules out closed-end funds and unit investment trusts) meet the definition of ETF under the Rule.[2]

Rule 6c-11's definition of ETF also requires that the shares of a fund be listed and traded on a major stock exchange (presently the Chicago Cboe BZX, Nasdaq and NYSE Arca), which means such fund must meet the applicable exchange's listing standards.

Lastly, a fund to be an ETF under the Rule must have the core feature of an ETF; i.e., the ability to issue and redeem creation units in exchange for baskets (and/or cash) in transactions with Authorized Participants. Thus, the fund must execute a participation agreement with at least one Authorized Participant.

Creating, Implementing and Maintaining Basket Procedures

A fund relying on Rule 6c-11 to operate as an ETF must 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. As discussed below, baskets are at the core of the ETF product, and the most significant aspect of Rule 6c-11 expanded what is a permissible basket.

To better understand the significance of the SEC changing the basket requirement, it is helpful to review how an ETF operates. An ETF issues shares that trade on a secondary market (i.e., one of the major stock exchanges). Only certain broker-dealers and other financial organizations ("Authorized Participants")[3] may transact directly with the ETF and their activity is said to occur on the primary market. An Authorized Participant on the primary market purchases a creation unit of ETF shares ("Creation Unit") directly from the ETF by depositing with the ETF a basket of securities and, in most cases, a cash balancing amount,[4] both of which are identified by the ETF when it opens for trading each day. In return, the Authorized Participant receives the Creation Unit consisting of the ETF's shares.[5]

The Basket is generally representative of the ETF's portfolio, and together with a cash balancing amount, it is equal in value to the aggregate net asset value ("NAV") of the ETF

[2] Unit investment trusts ("UITs") organized as ETFs will continue operating pursuant to their exemptive orders, or for new UIT ETFs will need to apply for exemptive relief, which include terms and conditions more appropriately tailored to address the unique features of a UIT.

[3] Rule 6c-11 defines an "authorized participant" to mean a member or participant of a clearing agency registered with the Commission that has a written agreement with the ETF or one of its service providers that allows the authorized participant to place orders for the purchase and redemption of creation units.

[4] Cash balancing amount is defined in paragraph (a)(1) of Rule 6c-11 to mean "an amount of cash to account for any difference between the value of the basket and the net asset value of a creation unit." Adopting Release, *supra* n.1 at 244.

[5] This required mechanism is essential to the arbitrage process that allows market makers, hedge funds and other market participants through Authorized Participants to arbitrage the difference between an ETF's NAV and share price, with the desired effect of reducing the spread between these two values.

shares in the Creation Unit. For example, XYZ S&P 500 ETF may stand ready to issue to Authorized Participants during trading hours 50,000 XYZ S&P 500 ETF shares each valued at $20 in exchange for a basket worth $1 million of a specified number of Microsoft shares, Apple shares, Amazon shares, Alphabet shares, Facebook shares and so forth to the 500th stock in the S&P 500, and a cash balancing amount. Such a basket would thus reflect a *pro rata* slice of the XYZ S&P 500 ETF's portfolio holdings.

The SEC, when adopting Rule 6c-11, recognized that "there are many circumstances … where allowing basket assets to differ from a *pro rata* representation or allowing the use of different baskets could benefit the ETF and its shareholders."[6] It went on to give the following examples:

- ETFs without basket flexibility typically are required to include a greater number of individual securities within their basket when transacting in kind, making it more difficult and costlier for authorized participants and other market participants to assemble or liquidate baskets.
- ETFs, particularly fixed-income ETFs, that do not have basket flexibility may satisfy redemption requests entirely in cash in order to avoid losing hard-to-find securities and to preserve the ETF's ability to achieve its investment objectives.[7]

Presently and up until the Effective Date of the Rule, a very select few ETF complexes have had significantly greater flexibility than other ETF complexes to substitute other securities or cash in the Basket for some (or all) of the ETF's portfolio holdings.[8] The SEC acknowledge this unfairness, noting that "these differing conditions and requirements for basket composition in our exemptive orders may have created a disadvantage for newer ETFs that are subject to our later, more stringent restrictions on baskets." [9]

Rule 6c-11 levels the ETF industry's playing field to eliminate the advantage to these ETF providers by defining "custom basket" to mean:

- A basket that is composed of a non-representative selection of the ETF's portfolio holdings; or
- A representative basket that is different from the initial basket used in transactions on the same business day.

Therefore, on the Effective Date, all ETF providers, if they so choose, will have the ability at the beginning of each trading day to substitute other securities or cash in the basket for some (or all) of the ETF's portfolio holdings provided they meet the custom basket conditions discussed below.

a. Basket Procedures

Rule 6c-11 requires an ETF to adopt and implement written policies and procedures that govern the construction of baskets[10] and the process that will be used for the acceptance of baskets. The SEC in the Adopting Release provided little detail about what should be included in basket procedures. Generally, basket procedures should consist of the basic features of compliance policies and procedures including provisions designed to comply with the rule, recordkeeping, testing and assigned responsibilities. In addition, a compliance officer may want to include some of the procedures the SEC expects to see in custom basket policies, discussed in the next section, in basket procedures even if the ETF complex does not utilize custom baskets. For example, there should be procedures governing the process that an ETF uses to construct and accept each basket.

b. Additional Procedures for Custom Baskets

Rule 6c-11 expressly permits the use of custom baskets[11] and cash in lieu of basket securities in create and redeem transactions provided its basket procedures discussed above additionally:

- 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

[6] Adopting Release, *supra* n.1 at 82-83.
[7] Adopting Release, *supra* n.1 at 83.
[8] "From 1996 to 2006, exemptive orders for open-end ETFs did not expressly limit baskets to a *pro rata* representation of the ETF's portfolio holdings." Adopting Release at 158.
[9] Adopting Release, *supra* n.1 at 83.

[10] Rule 6c-11 defines "baskets" to mean the securities, assets or other positions in exchange for which an ETF issues (or in return for which it redeems) creation units.
[11] Rule 6c-11 defines "custom baskets" to include two categories of baskets. First, a basket containing a non-representative selection of the ETF's portfolio holdings would constitute a custom basket. Second, if different baskets are used in transactions on the same business day, each basket after the initial basket would constitute a custom basket.

process for any revisions to, or deviations from, those parameters; and
- 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.

An ETF relying on the rule, must adopt policies and procedures that cover the methodology that the ETF will use to construct custom baskets. Importantly, cash baskets and cash in lieu of baskets are deemed to be "custom baskets" and must be subject to these procedures. The SEC in the Adopting Release provides helpful guidance about such policies and procedures, stating that they should:

- Set forth the circumstances under which the basket may omit positions that are not operationally feasible to transfer in kind;
- Detail when the ETF would use representative sampling of its portfolio to create its basket, and how the ETF would sample in those circumstances;
- Discuss how the ETF would replicate changes in the ETF's portfolio holdings as a result of the rebalancing or reconstitution of the ETF's underlying securities market index, if applicable;
- Contain specific parameters regarding the methodology and process that an ETF would use to construct or accept each custom basket;
- Describe the ETF's approach for testing compliance with the custom basket policies and procedures and assessing (including through back testing or other periodic reviews) whether the parameters continue to result in custom baskets that are in the best interests of the ETF and its shareholders;
- Include a process that the ETF will adhere to if it wishes to make any revisions to, or deviate from, the parameters; and
- Have reasonable controls designed to prevent inappropriate differential treatment among authorized participants.[12]

The SEC expects an ETF complex to tailor its custom basket policies and procedures to address different risks and requirements for different types of custom baskets. The SEC suggested that an ETF's custom basket policies and procedures should address the differing considerations for custom baskets depending on the direction of the trade (i.e., whether the custom basket is being used for a creation or a redemption).

[12] Adopting Release, *supra* n.1 at 87.

Posting Certain Required Information on the ETF's Website

Each business day, an ETF relying on Rule 6c-11 must disclose on its website certain information about the costs of investing in the ETF and the efficiency of the ETF's arbitrage process. Specifically, the ETF must prominently include the following on its website:

1. Before the opening of regular trading on the primary listing stock exchange of the ETF shares, the estimated cash balancing amount (if any) and the following information (as applicable) for each of the ETF's portfolio holding that will form the basis of the next calculation of its current NAV:
   - Ticker symbol;
   - CUSIP or other identifier;
   - Description of holding;
   - Quantity of each security or other asset held; and
   - Percentage weight of the holding in the portfolio;
2. The ETF's current NAV, market price, and premium or discount, each as of the end of the prior business day;
3. A table showing the number of days the ETF's shares traded at a premium or discount during the most recently completed calendar year and the most recently completed calendar quarters since that year (or the life of the ETF, if shorter);
4. A line graph showing the ETF share premiums or discounts for the most recently completed calendar year and the most recently completed calendar quarters since that year (or the life of the ETF, if shorter);
5. The ETF's median bid-ask spread, expressed as a percentage rounded to the nearest hundredth, computed by:
   - Identifying the ETF's national best bid and national best offer as of the end of each 10 second interval during each trading day of the last 30 calendar days;
   - Dividing the difference between each such bid and offer by the midpoint of the national best bid and national best offer; and
   - Identifying the median of those values.
6. If the ETF's premium or discount is greater than 2% for more than seven consecutive trading days, a statement that the ETF's premium or discount, as applicable, was greater than 2% and a discussion of the factors that are reasonably believed to have materially contributed to

the premium or discount, which must be maintained on the website for at least one year thereafter; and

7. The portfolio holdings that form the basis for the ETF's next calculation of current NAV must be the ETF's portfolio holdings as of the close of business on the prior business day.

Complying with New ETF Recordkeeping Rules

An ETF relying on Rule 6c-11 must maintain and preserve for a period of not less than 5 years, the first 2 years in an easily accessible place:

- All written agreements between an Authorized Participant and the ETF or one of its service providers that allows the Authorized Participant to place orders for the purchase or redemption of creation units; and
- For each basket exchanged with an Authorized Participant, records setting forth:
  - The ticker symbol, CUSIP or other identifier, description of holding, quantity of each holding, and percentage weight of each holding composing the basket exchanged for creation units;
  - If applicable, identification of the basket as a custom basket and a record stating that the custom basket complies with policies and procedures that the exchange-traded fund adopted pursuant to paragraph (c)(3) of this section;
  - Cash balancing amount (if any); and
  - Identity of Authorized Participant transacting with the ETF.

New ETF Disclosure Requirements

Along with adopting Rule 6c-11, the SEC amended Form N-1A, the form that governs disclosure in an ETF's prospectus and Statement of Additional Information (SAI), to provide more ETF-specific information to investors who purchase ETF shares on an exchange. These changes included:

- 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 ETF;
- Streamlined narrative disclosures relating to ETF trading costs, including bid-ask spreads;
- Requiring ETFs that do not rely on Rule 6c-11 to disclose median bid-ask spread information on their websites or in their prospectus;
- Excluding ETFs that provide premium/discount disclosures in accordance with Rule 6c-11 from the premium and discount disclosure requirements; and
- Eliminating disclosures relating to creation unit size and disclosures applying only to ETFs with creation unit sizes of less than 25,000 shares.

The SEC also made certain minor changes to Forms N-8B-2 and N-CEN under the 1940 Act. In addition, the SEC extended the compliance date for the new disclosure requirements to one year from the anniversary of the Effective Date.

Other Notable Features of the ETF Rule

Certain ETFs Are Not Eligible to Rely on Rule 6c-11

Any of the following types of ETFs may not rely on Rule 6c-11 and thus would need an exemptive order issued by the SEC prior to being offered:

- ETFs organized as UITs;
- ETFs that seek to 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;
- Multiple class ETFs including a fund that offers both a mutual fund share class and an ETF share class representing interests in the same securities portfolio; and
- Non-transparent, actively managed ETFs.

T-1 Orders

The SEC modified its original proposal that required an ETF to disclose its portfolio holdings *before the ETF starts accepting orders* on a given business day, which would have prevented certain ETFs from accepting creation and redemption orders shortly after the U.S. market closes ("T-1 orders"). Commenters to the proposed rule persuaded the SEC of the benefits of T-1 orders under certain circumstances, which allow ETFs, Authorized Participants, and other market participants to place orders for the purchase and sale of portfolio securities in foreign markets

with hours that do not overlap (or have limited overlap) with U.S. market hours when those markets are open. For example, an ETF that holds Japanese equities, for example, may permit authorized participants to submit T-1 orders (between 4:00 p.m. ET and 5:00 p.m. ET) to allow for trading in the underlying Japanese securities before the Japanese market closes (2:00 a.m. ET). To facilitate T-1 orders, the SEC modified Rule 6c-11 to require an ETF to disclose the portfolio holdings that will form the basis for the ETF's next calculation of NAV each business day *before the opening of regular trading on the primary listing exchange* of the ETF shares.

Extension of Delivery Time of Foreign Securities in Baskets

Rule 6c-11 contains an exemption from the 7-day delivery requirement in Section 22(e) of the 1940 Act to allow an ETF to delay satisfaction of a redemption request in the case of certain foreign investments for which a local market holiday or the extended delivery cycles of another jurisdiction make timely delivery unfeasible. Under the Rule, an ETF must deliver foreign investments as soon as practicable, but in no event later than 15 days after the tender to the ETF.

ETF Reorganizations

An ETF is not prohibited from selling (or redeeming) individual shares in connection with its merger into another existing fund or reorganization into a shell fund.

Master-Feeder ETFs/Fund of Funds

The SEC rescinded exemptive relief permitting ETFs to operate in a master-feeder structure, noting that very few ETFs currently utilize that structure. The SEC did grandfather certain existing master-feeder arrangements, by amending existing exemptive orders permitting such structures.

ETFs that have existing exemptive orders permitting other registered investment companies to invest in such ETFs beyond the limits of Section 12(d)(1)(A) and (B) of the 1940 Act may continue to rely on such orders. ETFs that do not have exemptive orders granting such fund of funds relief may operate in a manner consistent and in compliance with the conditions of existing fund of fund orders.

Elimination of Intraday Indicative Value

Rule 6c-11 does not require ETFs to disseminate an intraday estimate of their NAV per share as a condition for reliance on the Rule. The elimination of the so-called Intraday Indictive Value (IIV) requirement found in ETF exemptive orders will provide ETFs with modest cost savings.

Elimination of Distinction between Actively-Managed and Index ETFs

Unlike prior ETF exemptive orders, Rule 6c-11 does not distinguish between actively-managed and index ETFs. Thus, actively-managed ETFs are not subject to any conditions that do not also apply to index ETFs, and vice versa.

1940 Act Relief

Rule 6c-11 codifies certain relief from the 1940 Act presently granted in existing ETF exemptive orders. A dealer in ETF shares is exempt from Section 22(d) of the 1940 Act and Rule 22c-1(a) under the 1940 Act with regard to purchases, sales and repurchases of ETF shares at market-determined prices. A person who is an affiliated person of an ETF (or who is an affiliated person of such a person) because it holds the power to vote 5% or more of the ETF's shares or 5% or more of an investment company that is an affiliated person of the ETF is exempt from sections 17(a)(1) and 17(a)(2) of the 1940 Act with regard to the deposit and receipt of baskets. Without this relief, 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. Importantly, the SEC chose not to extend this relief to affiliates of the ETF desiring to act as authorized participants nor affiliates seeking to provide seed investments in the form of delivering an in-kind basket of securities.

1934 Act Relief

On the same day that it adopted Rule 6c-11, the SEC issued an exemptive order ("Exemptive Order") under the Securities Exchange Act of 1934 (the "1934 Act") providing relief to broker-dealers and other persons from certain

requirements with respect to ETFs relying on Rule 6c-11.[13] Specifically, the action granted relief from Section 11(d)(1) of the 1934 Act and Rules 10b-10, 15c1-5, 15c1-6, and 14e-5 thereunder because the SEC found that broker-dealers and certain other persons that engage in ETF transactions related to the create-redeem process would not raise the issues or concerns that underlie those provisions. In order for a broker-dealer to rely on the relief, a transaction must involve an ETF that satisfies certain diversification requirement and meet certain other conditions set forth in the Exemptive Order. The relief does not apply to purchases or sales of ETF shares in the secondary market.

Notably, the Exemptive Order provides and exemption from Rule 10b-10 under the 1934 Act that allows a broker-dealer that is effecting an in-kind creation or redemption transaction on behalf of a customer to confirm the transaction without providing a contemporaneous statement of the identity, price or number of shares or units (or principal amount) of each component security tendered to or delivered by the ETF, subject to certain conditions listed in the Order.

Conclusion

The industry certainly should embrace new Rule 6c-11 especially because it eliminates artificial constraints that slowed entry into the ETF business and unnecessarily limited an ETF's flexibility once operational. By adopting Rule 6c-11, the SEC shed many of the consumer-protection features originally proposed in the Rule and arguably engaged in an act of deregulation. This deregulation could spur greater innovation of ETF products that more easily fit under the Rule than the existing exemptive orders. Additionally, the SEC is now in the position to shift personnel and resources in its Division of Investment Management once devoted to approving routine ETF exemptive applications to reviewing and considering applications for innovative ETFs not covered by the Rule, most notably non-transparent, actively-managed ETFs and considering exemptive orders or interpretive positions that would allow mutual funds to convert to ETFs.

[13] See 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 for Certain Exchange Traded Funds, Securities Exchange Act Rel. No. 87110 (September 25, 2019).

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