

ETF Rule

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- ▶ Focuses on investment company and investment adviser regulatory issues, and related issues affecting the investment management activities of financial institutions
- ▶ Assists clients with the formation and registration of investment companies and investment advisers, and provides advice about regulatory compliance and securities law issues
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- ▶ Primarily involved in areas of corporate governance, legal administration and registration of investment companies under the Investment Company Act of 1940, including mutual funds, closed-end investment companies and exchange traded funds
- ▶ Has as counseled clients on a number of issues including the registration and listing requirements for closed-end funds and ETFs.



Agenda

- ▶ What is an ETF?
- ▶ Arbitrage Mechanism
- ▶ Advantages of ETFs
- ▶ Regulatory Background
- ▶ ETF Market Today
- ▶ Scope of the Rule
- ▶ Relief Granted
- ▶ Conditions for Reliance on the Rule
- ▶ Questions and Discussion



What is an ETF?

- ▶ ETF = **Exchange Traded Fund**
 - Basket of stocks or other securities, like mutual funds
 - Intraday trading on exchanges, like individual stocks

- ▶ Trades at a **market price** determined by supply/demand
 - Uses arbitrage mechanism to ensure market price tracks net asset value
 - Authorized Participants (APs) buy and sell creation units from the ETF's distributor

Arbitrage Mechanism

- ▶ ETF issued in creation units (e.g., 100k shares) to APs (i.e., large broker dealers)
- ▶ **If ETF shares selling at a premium to the intrinsic value of the portfolio (i.e., market price > NAV) → AP will buy portfolio securities, and exchange the portfolio securities for newly issued ETF shares to sell for profit.**
- ▶ **If ETF shares selling at a discount to the intrinsic value of the portfolio (i.e., market price < NAV) → AP will buy ETF shares on the market, redeem ETF shares in-kind for portfolio securities and sell portfolio securities for profit.**
- ▶ This mechanism closes spread between market price & NAV
- ▶ Discounts or premiums in ETF price are not expected to be large or to last long because of these arbitrage opportunities

Advantages of ETFs

▶ Transparency

- ETFs generally disclose positions daily and provide an “indicative intraday value” every 15 seconds during trading
- Mutual funds only required to disclose portfolio quarterly

▶ Tax efficiency

- ETFs do not have to sell securities to meet redemptions, shareholders simply sell on exchange
- APs may redeem in kind
- → Fewer capital gains for shareholders

Regulatory Background (1/2)

- ▶ Before the Rule, ETFs required individualized exemptive relief from the SEC
 - Exemptive relief is relief granted by the SEC to individual industry participants from certain requirements of the 1940 Act
 - Exemptive relief may only be relied upon only by the party that applied for and obtained such relief

- ▶ Without exemptive relief, ETFs would run afoul of certain provisions of the 1940 Act
 - Affiliated Transactions
 - Issue shares only in large aggregated creation units
 - Secondary market transactions to occur at negotiated market prices

Regulatory Background (2/2)

- ▶ Rule first proposed in 2008
 - ETFs had only 7% AUM compared to AUM of mutual funds
 - ETF market has matured and coalesced substantially since 2008
- ▶ Since the 2008 proposal, ETF asset growth has outpaced growth in mutual fund assets
 - From 2008 through 2017, ETF assets grew from approximately \$530 billion to \$3.4 trillion
- ▶ Process of obtaining relief is slow, uncertain and, at times, led to inconsistencies across ETF products, especially as the market evolved

ETF Market Today

- ▶ As of September 2019:
 - > 300 exemptive orders issued since 1992
 - > 2,000 ETFs
 - ~ \$3.4 trillion AUM*
 - ETFs have about 15% AUM compared to AUM of mutual funds
- ▶ The Rule will streamline registration process bringing new funds on from in as little as 75 days from filing with the SEC.
- ▶ The Rule will standardize a large swath of registered funds known as “ETFs” – but not all

Scope of the Rule (1/2)

Applies to “ETFs” as defined in the Rule:

- ▶ Open-end management investment company,
- ▶ Issues (and redeems) creation units to (and from) authorized participants in exchange for a basket and a cash balancing amount (if any), and
- ▶ Issues shares that are listed on a national securities exchange and traded at market-determined prices



Scope of Rule (2/2)

Rule **not** applicable to other products that trade like ETFs *or that are called ETFs*:

- ▶ Leveraged/Inverse ETFs
- ▶ UITs
- ▶ ETFs structured as a class of a mutual fund (e.g., many Vanguard ETFs)
- ▶ Master Limited Partnerships
- ▶ Grantor Trusts
- ▶ Opaque active funds

The Rule, while a major and welcomed regulatory development, is somewhat narrow.

Relief Granted (1/2)

- ▶ The Rule codifies relief customarily granted in exemptive orders
- ▶ **Redeemable Securities** – Shares of ETFs are “redeemable securities”
 - Redeemable securities are defining feature of open-end funds
 - Previous exemptive orders provided exemptions from the definition of “redeemable security” for ETFs, because ETF shares only redeemable in creation units by APs
 - Notwithstanding, Rule clarifies that shares of ETFs *are* redeemable securities
 - Applies to shares of funds that cannot rely on the Rule generally too for purposes of certain Exchange Act rules in connection with secondary market transactions and creation/redemption process

Relief Granted (2/2)

- ▶ **Market Prices** – Allows for trading of shares at current market price (rather than NAV)
- ▶ **Affiliated Transactions** – Allows for certain affiliates of ETFs to engage in creation/redemption transactions if affiliated solely by reason of holding >5% of such ETF or an affiliate of such ETF
- ▶ **Redemption Proceeds** – Permits delay in satisfying redemptions where local foreign market holidays or cycles make delivery unfeasible



Conditions for Reliance (1/2)

- ▶ **Listed** – Listing on national securities exchange
- ▶ **Portfolio Holdings** – Disclosure of portfolio holdings on a daily basis
- ▶ **Website Disclosure**
 - NAV per share
 - Discount/premium to NAV information
 - Bid-ask spreads over last 30 days



Conditions for Reliance (2/2)

- ▶ **Custom Baskets** – Fund accepting “custom baskets” must adopt policies governing construction of custom baskets and acceptance thereof from APs
- ▶ Exemptive relief generally required *pro rata* in kind redemption baskets
 - Rule permits ETFs to accept non-*pro rata* baskets, increasing flexibility for ETFs
- ▶ Policies must:
 - Set forth detailed parameters for construction and acceptance
 - Specify the titles or roles of employees of adviser responsible for reviewing custom baskets

Questions & Answers

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