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Efficiency at What Cost? Advantages of a Separate Board for ETFs

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Exchange-traded fund (ETF) products and sales have proliferated dramatically in the past five years and the trend promises to continue. It is no surprise then that established mutual fund companies have been eager to enter the business either through acquisition of an existing ETF sponsor or by building an ETF business organically by obtaining their own exemptive relief to sponsor and launch new ETFs. One of the principal questions that an advisor confronts upon deciding to launch ETFs is whether to establish a new board of trustees (board), separate from its mutual fund board, to oversee the ETFs. While the initial instinct may be that it is more efficient to utilize the existing mutual fund board to oversee both mutual funds and ETFs, a number of factors should be carefully considered prior to reaching that conclusion.

It is difficult to dispute that, on the surface, there are certain efficiencies in utilizing one board and extending the length of existing board meetings rather than conducting separate quarterly board meetings for the ETFs. However, management also should consider the challenges associated with using one board. There are substantial differences between the mutual fund business and the ETF business that result in the need for a great deal of education for mutual fund trustees who likely are unfamiliar with the legal and operational issues involved in sponsoring, managing and distributing an ETF. This in turn can lead to confusion and distraction from the board's oversight of business considerations, reporting, and regulatory requirements, some of which "show up" differently in the context of ETFs. In view of the increasing burdens being placed on boards, potential efficiencies of a single board should be balanced against the following considerations.

Trading Limitations

Using a combined board may result in more significant restrictions on the ability of fund complexes to select trading counterparties, as a result of Section 17 of the Investment Company Act of 1940 (the 1940 Act), which prohibits or places limits on various types of transactions between fund affiliates and the fund itself.[1]

Section 17(a) of the 1940 Act[2] generally prohibits a first- and second-tier affiliated person of a fund from engaging in principal transactions with the fund (agency trades in contrast are permitted if executed and reported to the board in accordance with established written procedures[3]). The definition of affiliated person in Section 2(a)(3) of the 1940 Act, as relevant here, includes an entity that (i) owns with the power to vote 5 percent or more of the outstanding voting securities of a fund; or (ii) controls or is under common control with a fund.[4] Under Section 2(a)(9) of the 1940 Act, control is generally defined

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as the ability to exercise a controlling influence over the management and policies of another entity.[5] While the determination of "control" depends on facts and circumstances, there is a presumption of control if an entity (directly or through a controlled company) owns more than 25 percent of the outstanding voting securities of a fund, and a converse presumption if it does not.[6]

ETFs often are funded with seed capital provided by large broker-dealers that also may act as trading partners with funds across the complex. The seeding broker-dealer becomes an affiliate of the seeded fund immediately upon seeding because it owns at the outset 100 percent of the outstanding shares of the ETF and close to that percentage for a certain period of time thereafter until there are additional creations.[7] If the seed provider becomes a first-tier affiliate of the seeded ETF, the seed provider also will become a second-tier affiliate of all the funds that are under common control with the seeded ETF. If the seed provider is also a trading counterparty for other funds in the complex, all principal transactions between the seed provider and those funds will be prohibited.

As noted above, a control relationship depends on the facts and circumstances. However, since boards have oversight responsibility for fund governance, and the responsibility to approve critical contracts and policies for the funds they oversee, it may be assumed that funds that share a board are under common control.[8] Therefore, if one board oversees both ETFs and mutual funds, all the ETFs and mutual funds overseen by the board may be deemed to be under common control and, thus, first-tier affiliates of one another, including any seeded ETF. As such, these ETFs and mutual funds would become second-tier affiliates of any broker-dealer seeding an ETF, at least until the seed provider divests itself of a substantial ownership interest. The application of Section 17 to this scenario effectively may disqualify the seed provider (and its parent company or direct subsidiary, which are in control relationships with the seed provider), from engaging in principal trades with all the mutual funds (as well as ETFs) within the complex under a common board.[9] If the seed provider acts as a regular trading counterparty to these funds, and Section 17 operates to prohibit trading, this could have significant implications for fixed income mutual funds and other funds that use derivatives,[10] especially given the limited number of bond and derivatives dealers.[11] On the other hand, if the ETFs and the mutual funds have separate boards, there is a better argument that the mutual funds and the ETFs are *not* under common control with each other, and the mutual funds may not be as vulnerable to having their trading counterparties limited due to the existence of ETF seeding arrangements.

Valuation

Valuation can present some challenging issues in the context of ETFs, particularly for passive ETFs that invest in foreign securities. The difference in the structure and operations of an ETF as compared to a mutual fund may dictate considering a different approach to fair valuation, which can be more challenging for a board that employs a robust bottoms-up approach to fair valuation commonly associated with actively managed mutual funds.

A fund's board has the statutory responsibility for valuing the fund's securities[12] and must ensure that a fund's securities are valued in such a way that (1) enables purchasing and redeeming shareholders to pay and receive fair consideration for their shares and (2) protects shareholders against dilution.[13] Actively managed mutual funds often embrace a security-by-security analysis (typically outsourced) to establishing a price at the end of the day to prevent abusive arbitrage (caused by taking advantage of securities valuation shifts during the period between the close of the relevant foreign market and the time the fund strikes its net asset value). Buying and selling mutual fund shares at a price that does not reflect the actual value of the underlying securities may adversely impact either (i) the transacting shareholder by causing her to overpay for shares purchased or to receive less than a fair price in a redemption or (ii) the remaining shareholders by diluting

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their interests as a result of the transacting shareholder paying less for shares than their actual value or receiving more than the value of shares in a redemption.

Because of the manner in which ETFs operate, ETF portfolio valuation has different practical implications than mutual fund valuation. ETF shares are purchased and sold at net asset value in large creation unit blocks (for example, 50,000 shares), exclusively by large institutions known as authorized participants. Other shareholders purchase and sell shares on the secondary market at share prices that correlate strongly with, but may deviate from, the net asset value per share. ETF creation units are often purchased and redeemed from the issuer "in-kind" instead of in cash, meaning that a creation unit of ETF shares is exchanged for a basket of portfolio securities often representing a *pro rata* share of the ETF's portfolio. Because the basket, which is established per creation unit each trading day, is designed to represent a *pro rata* share of the ETF's portfolio value, a change in value in the basket will not impact the number of shares purchased.[14] Thus, the transacting authorized participant will not be disadvantaged regardless of the valuation of the underlying portfolio securities. Similarly, because there is a set number of shares exchanged for an established *pro rata* basket, the risk of dilution to the remaining shareholders is mitigated. Thus, in these circumstances, fair valuing the underlying securities will not impact the authorized participant purchasing or redeeming the shares in-kind; nor will remaining shareholders derive significant benefit from a fair valuation mechanism (because the potential for dilution is limited).[15] Moreover, because the ETF's per share net asset value (NAV) and the secondary market prices of its shares, which are purchased and sold by retail shareholders, generally deviate from each other, a change in fair value will not necessarily result in a corresponding change in the price of the shares on the secondary market. Therefore, fair valuation is arguably not necessary to protect retail shareholders against dilution (as it is for mutual funds).[16]

Although these differences do not alter the legal obligation of the board to value the fund's portfolio, it would not be unreasonable for a board to take a different approach to fair valuation in the context of overseeing an ETF than would be necessary in the context of overseeing a mutual fund. For example, a board may determine that engaging in a fair valuation process is necessary only when there is a cash creation or redemption (in which case, unlike an in-kind transaction, the possibility of dilution is present). Alternatively, the board may determine that a costly bottoms-up, security-by-security exercise is not necessary and that a more top-down approach based on significant geographic events or significant movements in proxy country ETFs (or other instruments) may make more sense for an ETF.

While there are sound justifications for taking different approaches to fair valuation for ETFs and mutual funds, facilitating these distinctions under one board may be more challenging. The Commission Staff has stated that it "generally believes that a board could not arrive at different fair valuations for identical securities held by two or more funds that the board oversees, consistent with its good faith obligation."[17] To be sure, this is simply guidance and not a hard and fast rule. However, the Staff also has acknowledged that there is more flexibility when different funds within one complex are overseen by different boards: "We recognize that different fund boards, or funds within the same complex with different boards, when fair valuing identical securities, could reasonably arrive at prices that were not the same, consistent with the boards' obligation to fair value in good faith."[18] In conclusion, having a separate board for the ETF complex may make the application of a different and arguably more sensible approach to valuation less controversial.

Contract and Advisory Fee Approval

One of the primary responsibilities of a fund board is the approval of advisory contracts.[19] A fund's advisory agreement must be approved both at the outset and each year thereafter following a two-year initial term.[20] According to the well-known *Gartenberg*[21] standards (confirmed by the

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US Supreme Court in *Jones v. Harris Assocs.*[22]) the board must consider whether the advisory fee is fair and reasonable, based on certain delineated factors that are principally focused on the nature and quality of the services provided and the financial stability and profitability of the adviser. As part of the contract approval and renewal process, boards typically request, and advisors provide, information pertaining to the performance, advisory fees, and total expenses of competitor funds.

The competitive landscape for ETFs has evolved differently from that of mutual funds, and their respective cost structures reflect this. The costs associated with operating ETFs are different from the costs of operating mutual funds. ETFs do not charge 12b-1 fees (because distribution is externalized) and other operating expenses are lower for ETFs because individual shareholder accounts and associated services are provided outside the fund structure (by intermediaries holding the accounts of shareholders purchasing on the secondary market).[23] Moreover, unlike mutual funds, many ETFs utilize a unitary fee structure, where one fee is charged and collected by the advisor and all other expenses, including fees charged by third-party service providers, are paid out of that unitary fee. The difference in cost structure makes it difficult to draw any "apples-to-apples" comparisons with mutual funds because the ETF unitary fee may cover a more comprehensive set of services than a mutual fund advisory or management fee.[24]

Moreover, in evaluating the quality of services provided by an investment adviser to a fund, boards must be cognizant of both the operational differences between actively managed funds and (at least) index-based ETFs. Actively managed mutual funds need to buy and sell securities individually and manage daily cash flows that can be somewhat unpredictable; ETFs buy and sell portfolio securities in large baskets tied to creation unit activity and (often) to the composition of a benchmark index. Furthermore, because most ETFs are passively managed and seek to track an index, the qualitative lens through which advisory services are rendered differs between mutual funds and ETFs. The value provided by an investment advisor to a mutual fund can be measured in terms of absolute and competitive performance metrics, that is, how the fund's performance compares to its peers and a broad based-index, and depends on the skill of the advisor in selecting individual securities. ETF performance, in contrast, is measured by tracking error, or how much the performance of the ETF deviates from the performance of its underlying benchmark, which will depend largely on the basket composition process and the advisor's ability to manage transaction costs. The evaluation of an ETF's market performance is more a function of how well the index is constructed, which is often outside the advisor's control and most certainly not within the scope of the services for which advisory fees are paid.

To further complicate matters for the board, although the evaluation of the advisor's services is different between most ETFs and mutual funds, the success of an ETF may very well depend on its actual performance as compared to actively managed mutual funds. The first generation ETFs were distinguishable from actively managed mutual funds as low cost alternatives based on broad-based indices such as the S&P 500, so they could be positioned as filling a different investment niche. Now, however, as the sophistication of the so-called "smart-beta" indices has evolved to incorporate many of the same factors employed by active managers, the difference from an investor's or intermediary's perspective between ETFs and actively managed mutual funds has blurred and those ETFs are now perceived as competing directly with mutual funds. Thus, an investor is likely to look to actively managed mutual funds with similar strategies for comparisons when evaluating how an ETF actually performs.

The way the market has evolved, as well as the differences in cost structure, creates challenges when comparing and contrasting the fees and expense associated with ETFs with those of mutual funds. To be sure, there are substantive differences in the advisor's activities in managing the two structures since one may have to accommodate daily cash flows

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versus managing basket composition and index replication. Given the difference in cost structure between a mutual fund and an ETF and the operational aspects underlying portfolio management of the two vehicles, the contract approval process and fee analysis may prove to be a more straightforward exercise if there is a separate board overseeing the ETFs.[25]

Conclusion

The factors discussed above should be considered in determining whether it makes more sense to have one board overseeing both mutual funds and ETFs or to convene two separate boards. It may seem counterintuitive, but given the factors described above, as well as the distinct reporting protocols and business models of ETFs, there may be advantages to having two separate boards that, in some cases may outweigh the convenience of utilizing a single board for both ETFs and mutual funds.

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1 *See generally* Investment Company Act § 17(a), 15 U.S.C. § 80a-17(a) (prohibiting transactions with affiliated persons, promoters, or principal underwriters for registered investment companies). This could be particularly onerous for funds that invest in bonds and derivatives and need to engage in principal trades with broker-dealer counterparties.

2 Investment Company Act § 17(a), 15 U.S.C. § 80a-17(a).

3 Investment Company Act § 17(e), 15 U.S.C. § 80a-17(e). Section 17(e) prohibits a first- or second-tier affiliate of a fund from transacting with the fund on an agency basis, but Rule 17e-1 permits such trading subject to board-approved procedures and other requirements.

4 Investment Company Act §§ 2(a)(3)(a) and 2(a)(3)(c), 15 U.S.C. §§ 80a-2(a)(3)(a) and 2(a)(3)(c).

5 Investment Company Act § 2(a)(9), 15 U.S.C. § 80a-2(a)(9).

6 *Id.*

7 It is common for the seeding entity and other authorized participants to sign an irrevocable proxy to relinquish their right to vote, which will enable the entity to own five percent of the ETF's outstanding securities without being deemed an affiliate. However, at some point, depending on the facts, the percentage ownership even without the right to vote will trigger a control relationship, and an affiliation, and thus implicate Section 17. The ownership threshold at which fund complexes consider a relationship tantamount to "control" varies.

8 The Securities and Exchange Commission (Commission), however, in adopting amendments to Rule 17a-7, has stated: "The rule does not represent a Commission finding that investment companies having common officers, directors or investment advisers are always affiliated persons or affiliated persons of an affiliated person. They may or may not be, depending on the facts." Investment Company Act Release No. 11676 at n.5 (Mar. 10, 1981) (adopting amendments to Rule 17a-7). *See also* Investment Company Act Release No. 11053 (Feb. 19, 1980) (using identical language in adopting Rule 17a-8).

9 *See* § 17(a), *supra* n.2.

10 For most equity funds, which can typically trade on an agency basis, trading can continue subject to certain regulatory comments as noted above. *See* Rule 17e-1, *supra* n.3.

11 Note that if an affiliate of the seed provider (other than its parent company or direct subsidiary), and not the seed provider itself, serves as the trading counterparty, Section 17 would prohibit principal trading only between that counterparty and the seeded fund, as they would be second-tier affiliates. The remaining funds and ETFs would be third-tier affiliates of the counterparty and thus trading between those entities would be outside the scope of Section 17(a).

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[12] Investment Company Act § 2(a)(41), 15 U.S.C. § 80a-2(a)(41).

[13] See Letter to Craig S. Tyle, General Counsel, ICI, from Douglas Scheidt, Chief Counsel, SEC Division of Investment Management, 1999 SEC No-Act. LEXIS 958 (Dec. 8, 1999) (noting that "[t]hese pricing requirements are critical to ensuring that the prices at which fund shares are purchased and redeemed are fair, and do not result in dilution of shareholder interests or other harm to shareholders.").

[14] Note that this may not be true if the baskets deviate significantly from a *pro rata* slice of the funds' portfolio.

[15] Some have also argued that frequent and somewhat subjective adjustments to the valuation of portfolio securities may adversely impact the arbitrage and market making functions for ETFs.

[16] Passive ETFs seek performance that tracks the benchmark index as closely as possible. Since these indices will typically price their securities based on the close of the relevant market, any fair valuation will cause deviation from the benchmark performance. While marketing priorities should not influence or dictate valuation decisions, the board should understand the business implications of valuation decisions that are unique to ETFs.

[17] *Letter to Tyle*, *supra* n.13, at n.16.

[18] *Id*.

[19] *See* Investment Company Act § 15(a), 15 U.S.C. § 80a-15(a) (initial approval); Investment Company Act § 15(c), 15 U.S.C. § 80a-15(c) (annual approval). *See also* Lemke, Lins & Smith, "Regulation of Investment Companies" (2016) § 7.11[3] (stating that "[t]hese requirements relate primarily to advisory contracts and reflect the potential conflicts of interest between advisers and investment companies and Congress' focus on this relationship.").

[20] Investment Company Act § 15(a)(2), 15 U.S.C. § 80a-15(a)(2) (the advisory contract "[s]hall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company").

[21] Gartenberg v. Merrill Lynch Asset Management, Inc., 461 U.S. 906 (1983).

[22] 559 U.S. 335 (2010).

[23] Even though most mutual funds operate with omnibus account arrangements through broker-dealers and other intermediaries, the fund makes payment for these shareholder services to the intermediary, and thus still absorbs certain expenses associated with holding shareholder accounts.

[24] Adding to the picture is the recent fee compression observed in the ETF industry, driven by competition and the desire to create distinctions among products that are viewed as relatively commoditized. *See, e.g.*, Sarah Krouse, "BlackRock Cuts ETF Fees", *Wall Street Journal* (Oct. 5, 2016), *http://www.wsj.com/articles/blackrock-cuts-etf-fees-1475640061;* Sarah Krouse, "Schwab Reduces Fees on Five of its ETFs," *Wall Street Journal* (Oct. 7, 2016), *http://www.wsj.com/articles/schwab-reduces-fees-on-five-of-its-etfs-1475844106.* ETFs started as funds based on broad-based, easy to replicate indices and thus charged relatively low advisory fees (which have since gotten much lower due to scale and "fee-wars"), much lower than the typical actively managed mutual fund. As ETFs have evolved to be based on more sophisticated indices based on proprietary quantitative metrics and in some cases asset classes more difficult to trade and manage than listed equities, license fees and other costs have increased, justifying somewhat higher fees than the original wave of more commoditized ETFs. Nonetheless, competitive pressures have kept fees, and in some instances profitability, of ETFs generally lower than those associated with mutual funds.

[25] This article is written generally from the advisor's perspective; from the board's perspective, it must be acknowledged that conflicts of interest that arise might be easier to govern with a consolidated board, such as the allocation of resources between the ETF and mutual fund complexes, the potential for disintermediation of assets from mutual funds when similar ETFs are launched, and trading conflicts that arise from seeding arrangements as described above.

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