

Chapman Client Alert

June 29, 2018

Current Issues Relevant to Our Clients

Securities and Exchange Commission Proposes Long-Awaited “ETF Rule”

On June 28, 2018, the Securities and Exchange Commission (“SEC”) proposed Rule 6c-11 under the Investment Company Act of 1940 (the “1940 Act”) and amendments to Form N-1A and Form N-8B-2 that overhaul the patchwork regulatory framework that currently governs the \$3.4 trillion ETF industry. The proposed rule and rule amendments (collectively, the “ETF Rule”) would substantially replace the current regime under which each ETF sponsor is required to obtain, and subsequently rely upon and comply with, its own individual exemptive relief from certain provisions of the 1940 Act in order to offer and operate an ETF. If adopted, the ETF Rule would allow prospective market entrants to more quickly and cheaply enter the ETF market as they would no longer be required to undergo the four to nine month process of obtaining exemptive relief.

For existing sponsors, the ETF Rule would standardize the requirements imposed on issuers and democratize certain advantages that had accrued to issuers based upon the terms of their individual relief. Perhaps most notably, the ETF Rule would amend the requirements regarding the composition of an ETF’s creation basket¹ that would allow all ETF issuers relying on the ETF Rule to deviate from the typical exemptive relief mandate of pro rata creation baskets. Under the current regulatory regime, only certain issuers with older exemptive relief were permitted to avail themselves of the flexibility to create “custom baskets.”

The ETF Rule also expands disclosure requirements on ETFs. The rule requires that an ETF sponsor provide additional disclosures on its website, including daily portfolio transparency, historical information regarding share premiums and discounts and bid-ask spreads.

The full text proposing the ETF Rule is available [here](#). The SEC staff also released a fact sheet that is available [here](#).

Proposed Rule 6c-11

Proposed Rule 6c-11 provides qualifying sponsors exemptions from certain provisions of the 1940 Act that are necessary for ETFs to operate. These exemptions are generally consistent with the relief granted pursuant to existing ETF exemptive orders. The rule would permit an ETF that meets the conditions

of the rule to: (i) redeem shares only in creation unit aggregations; (ii) permit ETFs to be purchased and sold at market prices rather than at net asset value per shares; (iii) engage in in-kind transactions with certain affiliates and (iv) in certain circumstances, pay authorized participants the proceeds from the redemption of shares later than seven days after the redemption. The rule would also do away with any distinction under the 1940 Act between an ETF that seeks to track an index and one that is actively managed.

Certain types of ETFs will not be able to rely on the ETF Rule. The first are “leveraged ETFs,” which are ETFs that seek to provide returns that 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. Citing concerns about the negative effects of daily compounding and the appropriateness of leveraged funds for retail investors holding such funds, the SEC proposes not to include leveraged funds within the scope of the rule.

In addition, the ETF Rule will not be available for ETFs structured as unit investment trusts rather than open-end funds, those that utilize master-feeder arrangements and those ETFs that operate as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio.

The ETF Rule would grandfather in existing ETFs utilizing these arrangements but require any other sponsor seeking to utilize them to seek exemptive relief. Issuers seeking to operate ETFs that are leveraged, unit investment trusts, master-feeders or multi-class, or that have other non-standard features (e.g., proposals relating to non-transparent ETFs) would still be required to seek specific exemptive relief from the SEC.

Systemic Changes

ETFs are investment products that were not contemplated by the foundational securities laws adopted in the aftermath of the Great Depression. As such, in order to operate, an ETF issuer must receive exemptive relief from the SEC from certain provisions of the 1940 Act. Since the first ETF was launched in 1992, the SEC has issued more than 300 such orders. While

the exemptive orders for most ETF issuers impose generally similar requirements, certain issuers, especially the early entrants to the ETF market receiving the initial orders, had different and less onerous restrictions with which they were required to comply.

The ETF Rule proposes doing away with this regime nearly entirely by rescinding exemptive relief previously granted to ETFs that would be able to rely on the rule. The proposed rescissions would specifically be limited to the formation and operation of an ETF and would not rescind the relief from Section 12(d)(1) of the 1940 Act and Sections 17(a)(1) and 17(a)(2) of the 1940 Act related to fund of funds arrangements involving ETFs. Crucially, the rule would also not rescind existing exemptive relief of ETFs that fall outside the scope of the rule such as leveraged ETFs, UIT ETFs, ETFs utilizing master-feeder arrangements and ETFs that are issued as a separate share class.

Custom Baskets

Perhaps the most notable change in the ETF Rule is that, subject to compliance with the provisions of the rule, ETF sponsors may deviate from the requirement that a fund's creation basket correspond pro rata to the fund's portfolio. In

order to rely on the rule to utilize custom baskets, an ETF must adopt and implement written policies and procedures governing the construction of baskets and the process that would be used for the acceptance of custom baskets to ensure that such process is operated in the best interest of fund shareholders. The rule also requires an ETF to disclose prominently on its website, on each business day, information regarding the published basket that will apply to orders for the purchase or redemption of creation units for such day.

What's Next?

The long-awaited rule proposal is a first step in standardizing the regulatory regime for ETFs, an increasingly important investment vehicle and trading tool. Comments on the rule are due sixty days from the date of its publication in the Federal Register. Chapman and Cutler will provide more detailed analysis of the ETF Rule and the comment process in the coming weeks.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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- 1 An ETF's creation basket is the specified list of securities and/or cash that is deposited or withdrawn, as applicable, when an authorized purchaser creates or redeems shares in creation units directly with the ETF in the primary market.

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