

SEC Adopts Rule to Modernize Regulation of Exchange-Traded Funds

by Ellen J. Bickal

Summary

On Sept. 26, 2019, the Securities and Exchange Commission (SEC) announced that it voted to adopt a new rule and form amendments designed to modernize the regulation of exchange-traded funds (ETFs). In addition, the SEC indicated that it will issue an exemptive order that further harmonizes related relief for broker-dealers.

ETFs shares trade on an exchange like a stock or closed-end fund, but they also allow identified large institutions (Authorized Participants) to transact directly with the fund. Presently, pursuant to more than 300 SEC issued exemptive orders, ETFs are permitted to operate under the Investment Company Act of 1940 (the “1940 Act”). It is estimated that there are approximately 2,000 ETFs with currently over \$3.3 trillion in total net assets.

The SEC described its goals as establishing a clear and consistent framework for most ETFs operating today, and facilitating greater competition and innovation in the ETF marketplace, providing investors with more choices. Pursuant to Rule 6c-11 (the “Rule”), new ETFs will be able to come to market more quickly without the time or expense of applying for individual exemptive relief. All ETFs relying on the Rule and related exemptive order will have to comply with the conditions set forth in the Rule, generally designed to protect investors. These include conditions relating to transparency and disclosure.

Details

Rule 6c-11

The Rule will permit ETFs that satisfy certain conditions to operate within the scope of the 1940 Act without obtaining an exemptive order, replacing the conditions set forth in

Related People

- Ellen J. Bickal

Related Capabilities

- Investment Management
- Investment Funds
- Securities & Financial Services Litigation & Enforcement

individualized exemptive orders. ETFs must be organized as open-end funds (the structure used by most ETFs) in order to rely on the Rule. ETFs organized as UITs, leveraged or inverse ETFs, ETFs structured as a share class of a multi-class fund, and non-transparent ETFs will not be able to rely on the Rule. The Rule conditions include the following:

- Transparency. An ETF will be required to provide daily portfolio transparency on its website.
- Policies and procedures relating to custom baskets. An ETF may use baskets that do not reflect a pro-rata representation of the ETF's portfolio or that differ from the initial basket used in transactions on the same business day (custom baskets) if it adopts written policies and procedures setting forth detailed parameters (and recordkeeping requirements) for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders.
- Website disclosure. An ETF will be required to disclose historical information regarding premiums and discounts and bid-ask spread information on its website, highlighting for investors, the costs of investing and the efficiency of an ETF's arbitrage process.

Rescission of Existing ETF Exemptive Relief

One year after the effective date of Rule 6c-11, the SEC will rescind exemptive relief previously granted to ETFs now eligible to operate in reliance on the Rule. The SEC indicated that it will also rescind exemptive relief permitting ETFs to operate in a master-feeder structure, grandfathering certain existing master-feeder arrangements, by amending relevant exemptive orders. The SEC is not rescinding exemptive relief that permits ETF fund of funds arrangements. Additionally, the SEC will permit ETFs relying on Rule 6c-11, that do not already have their own exemptive relief, to enter into fund of funds arrangements as set forth in recent ETF exemptive orders, provided they satisfy the terms and conditions in those orders. The SEC is also issuing an exemptive order that harmonizes certain relief under the Securities Exchange Act of 1934 (the "Exchange Act") relevant to ETFs. More specifically, the order will afford exemptive relief to broker-dealers from certain requirements under the Exchange Act with respect to ETFs relying on Rule 6c-11.

Form Amendments

ETFs structured as open-end funds must use Form N-1A to register under the 1940 Act and to offer their securities under the Securities Act of 1933. Amendments to Form N-1A will provide ETF-specific information to investors who purchase ETF shares on an exchange. The SEC is also adopting amendments requiring that ETFs organized as UITs provide the same information to investors on Form N-8B-2, which UITs use to register units.

Timeline

The rule, form amendments, and related exemptive relief will be published on the SEC website and in the Federal Register becoming effective 60 days after publication in the

Federal Register. There will be a one-year transition period for compliance with the form amendments and with respect to rescission of exemptive relief.