SEC NEW ETF RULE IS EFFECTIVE: WHAT ETFS SHOULD KNOW

OVERVIEW

In September of 2019, the SEC adopted a new rule (Rule 6c-11 or 'the Rule') and related form amendments in an effort to modernize an antiquated regulatory framework for exchange-traded funds (ETFs) . Specifically, ETFs satisfying certain conditions may now operate under the Investment Company Act of 1940 (the Company Act) to directly offer their funds in the marketplace without having to obtain an exemptive order . Previously, ETFs were forced to rely on individualized exemptive orders to enter the market, which was cumbersome, costly, and potentially anticompetitive.

The Rule was published in the Federal Register on October 24, 2019 and became effective as of December 23, 2019. The compliance date for ETFs relying on the Rule's conditions is December 23, 2020.

Capco believes the new rules will level the playing field among many ETFs, while also protecting the investing public by requiring new disclosures regarding ETFs traded on the secondary market.

WHAT ARE THE CONDITIONS FOR ETFS RELYING ON RULE 6C-11?

The Rule will exempt ETFs organized as open-ended funds from the Company Act and related rule-making.

These exemptions will allow:

- Redemption of shares only in 'creation unit' aggregations
- The purchase and sale of ETFs at market price rather than at Net Asset Value (NAV)
- In-kind transactions with some affiliates
- Payment of authorized participants the proceeds from share redemption in more than seven days

In exchange for these exemptions, the Rule requires certain conditions to be met in order to support the primary concerns of investor protection and an efficient marketplace and is based upon the existing body of exemptive relief from the SEC.

EXAMPLES OF THE CONDITIONS INCLUDE:

1. **Transparency**: ETFs must provide daily portfolio information on their websites before the opening of trading on the primary listing exchange of the ETF shares, including:
   - The ticker symbol
   - CUSIP or another relevant identifier
   - A description of the holding
   - The quantity of each security and/or asset
   - The percentage weight of each holding that will drive the next NAV calculation

2. **Policies and Procedures**: ETFs relying on 'custom baskets' under the Rule must adopt written policies and procedures outlining the detailed conditions for constructing and accepting custom baskets that are in the best interests of investors, including revisions to, or deviations from, those conditions; and must specify the titles or roles of employees of the ETFs investment adviser who are required to review each custom basket for compliance.

   In addition, the new Rule imposes recordkeeping requirements, including an express requirement that states that ETFs relying on rule 6c-11 preserve and maintain copies of all written agreements between an authorized participant and the ETF (or one of the ETFs service providers) that allow the authorized participant to purchase or redeem creation units.

3. **Disclosures**: The Rule also requires an ETF to disclose, on its website, specific data points, including those relating to historical premiums, discounts and bid-ask spreads, with the intent of keeping investors informed about the possible costs associated with ETF investing. More specifically[6]:

- NAV per share, market price, and premium or discount, each as of the end of the prior business day
- A table and chart depicting the number of days that an ETFs shares traded at a discount or premium over the trailing calendar year and calendar quarters
- An explanation of factors causing an ETFs premium or discount to trade greater than 2 percent over the previous seven trading days, if applicable
- The median bid-ask spread during the last 30 calendar days

SO WHAT?

- ETFs will now be able to come to market much more quickly and should allow for some significant cost savings in doing so (as these ETFs will now be able to operate under the Company Act, and not through an exemptive relief process)
- The SEC should see a more orderly exemptive process, which will allow them to deploy its resources better and focus on more innovative methods for exemptive relief
- In addition, ETF investors should see a more fulsome and competitive ETF marketplace, as more ETFs will be encouraged to enter and will be required to provide greater investor transparency
- Firms sponsoring their own mutual fund complexes may now look to convert these products into ETFs and immediately become viable ETF producers with streamlined regulatory intervention. With the possibility of considerable tax advantages from in-kind redemptions versus the sale of securities, we expect the ETF market to continue to grow as a result of this rule – including increased participation from the insurance space and fixed income ETFs.

WHAT'S NEXT?

In addition to the Rule, SEC proposed related amendments to Form N1A (or, the form used by ETFs which are structured as open-ended funds to register under the Company Act and to offer their securities to the public). By December 2020, ETFs must conform to registration and disclosure requirements .

ETFs should begin identifying which of their products will rely on the Rule and begin to develop a compliance roadmap for December 2020.

These requirements can include:

- Drafting and/or amending policies and procedures, including those relating to the use of custom baskets and recordkeeping; and considering whether ETFs require different policies and procedures from traditional mutual fund complexes
- Implementing IT requirements relating to providing daily portfolio information to ETF shareholders
- Tuning/calibrating systems of record
- Completing or amending registration requirements with the SEC and drafting associated disclosures

HOW CAN CAPCO HELP?

With the compliance date of December 23, 2020, ETF providers have less than a year to be compliant - immediate steps should be taken to assess the impact of the Rule on your suite of ETF products. Developing a strategy for ETF Products would be highly advised.

Partnering with a trusted advisor is crucial to navigating this new regulatory change. Providers can realize operational efficiencies by aligning compliance programs and processes across the Rule and other regulations, for example, enhancing existing reporting platforms for daily portfolio information and related recordkeeping.

Capco has a well-established FRC Reg Change Management offering that has been successfully leveraged at numerous clients. Tailored to each individual institution's needs, Capco can land onsite and use its various accelerators to assess, strategize, design the target operating model, implement, reach regulatory compliance and once stabilized, transition the program into a BAU state.

The core capabilities within the FRC offering include: TOM Design; Regulatory Change Program Management; Modern Delivery; Modern Risk Management and Managed Services.

Capco combines subject matter expertise with innovative design and modern delivery principles to bring clients effective and efficient solutions that can turn compliance into a competitive advantage

REFERENCES

[1] Generally, ETFs do not possess the same characteristics as the types of entities initially contemplat-ed by the Company Act; and as a result, these ETFs historically required exemptions from certain requirements in order to operate.

[2] Rule 6c-11 is available to ETFs that are structured as 'open-ended funds' (the large majority of ETFs currently offered in the market). However, the Rule is not available to Unit Investment Trusts, leveraged ETFs or ETFs structured as a share class of a multi-class fund or funds, to name a few.

[3] A 'creation unit' refers to a block of new shares sold by an ETF issuer to a broker-dealer for sale to the public. Unlike mutual fund shares, retail investors can only purchase and sell ETF shares in market transactions. Also, unlike mutual funds, ETFs do not sell individual shares directly to, or redeem their individual shares directly from retail investors. Instead, ETF sponsors enter into contractual relationships with one or more financial institutions known as 'authorized participants.' Authorized participants typically are large broker-dealers. Only authorized participants are permitted to purchase and redeem shares directly from the ETF, and they can do so only in large aggregations or blocks (e.g., 50,000 ETF shares) of creation units.
See, https://www.investor.gov/introduction-investing/basics/investment-products/exchange-traded-funds-etfs.

[4] See, "Exchange-Traded Funds," SEC Release Nos. 33-10695 & IC-33646 (Sept. 25, 2019). (https://www.sec.gov/rules/final/2019/33-10695.pdf) ('Adopting Release') at page 15.

[5] 'Custom basket' refers to baskets that do not reflect a pro-rata representation of the fund's portfolio or that differ from the initial basket used in transactions on the same business day. SEC exemptive orders regarding 'customer baskets' over the last 15 or so years require that an ETFs basket generally correspond, pro-rata, to its portfolio holdings, while identifying certain limited circumstances under which an ETF may use a non-pro-rata basket. However, the SEC recognized in the Rule's adopting release that, "there are many circumstances, in addition to the specific circumstances enumerated in our orders, 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." See, 'Exchange-Traded Funds,' SEC Release Nos. 33-10695 & IC-33646 (September 25, 2019). (https://www.sec.gov/rules/final/2019/33-10695.pdf) ('Adopting Release') on pages 82-83

[6] See, 'Exchange-Traded Funds,' SEC Release Nos. 33-10695 & IC-33646 (Sept. 25, 2019). (https://www.sec.gov/rules/final/2019/33-10695.pdf) ('Adopting Release') at page 97.

[7] Existing ETFs that plan to rely on the Rule can decide to comply with the Rule any time after the effective date of December 23, 2019.

[8] ETFs that are not able to rely on the Rule, should continue to rely on the conditions of their pre-existing exempted relief, but may be required by the SEC to adhere to disclosure requirements required by the new Rule.