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New SEC Rule Aims to Streamline ETF Regulation

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On Sept. 25, 2019, the SEC adopted Rule 6c-11 under the Investment Company Act of 1940, as amended ("1940 Act"). The new rule allows sponsors of exchange-traded funds ("ETFs") to launch and operate ETFs without first obtaining individual exemptive orders from the SEC. Subject to satisfying certain conditions, the rule provides for blanket exemptive relief from sections of the 1940 Act and other securities laws for many, though not all, ETFs that are structured as open-end investment companies. The adoption of the rule will streamline the process for establishing new ETFs and will level the playing field among ETFs subject to the rule by establishing consistent conditions that must be met by such ETFs. While certain types of ETFs, including those structured as unit investment trusts ("UITs") or operating as inverse or leveraged ETFs, will still require exemptive relief, the new rule provides the opportunity for many new ETFs to launch more quickly and less expensively than in the past.

Overview of the Rule

ETFs are exchange-traded investment products that issue shares traded by investors on the secondary market. An ETF's shares are also transacted in large blocks called "creation units" between the ETF and market participants called "authorized participants," in exchange for "baskets" of securities that underlie the ETF's portfolio. Because ETFs have characteristics of both open-end mutual funds and closed-end funds, and do not fall neatly into the regulatory scheme of the 1940 Act, they have historically required exemptions from certain 1940 Act (and other securities laws) requirements in order to operate.

The new rule provides that an ETF structured as an open-end investment company (as opposed to a UIT) may avoid the onerous process of obtaining exemptive relief if the ETF meets certain criteria and conditions. Among other things, the rule will classify ETFs that rely on the rule as issuing redeemable securities, which will also make those ETFs eligible to rely on certain exceptions from Regulation M and the Securities Exchange Act of 1934. The rule also provides exemptions from i) Section 22(d) and Rule 22c-1 of the 1940 Act, enabling ETFs to sell shares at prices other than at net asset value; (ii) Sections 17(a)(1) and (a)(2) as they relate to depositing and receiving baskets by affiliated persons of the ETF (including those holding more than 25% of the ETF's shares); and (iii) Section 22(e) to permit delays in meeting redemption requests in connection with foreign investments held by the ETF. The rule applies equally to ETFs that are index-based and actively managed, and as such, eliminates the historical differences that had emerged in the exemptive relief granted to these types of ETFs.

Alongside the adoption of the rule, the SEC rescinded (effective one year after the effective date of the rule) certain exemptive relief that had been previously granted to ETFs. However, as noted above, the rule does not apply to UIT ETFs, inverse or leveraged ETFs, share class ETFs or non-transparent ETFs, and exemptive relief relating to these types of ETFs was not rescinded. The SEC also adopted amendments to

Form N-1A and other forms to require, among other things, additional narrative disclosure by ETFs in their prospectuses, including relating to bid-ask spreads.

Requirements to Comply with the Rule
Several conditions must be met to rely on the rule. First, the ETF must disclose its portfolio holdings on a website each business day, along with certain other required information, including the ETF's median bid-ask spread over the last thirty calendar days. Second, the ETF must adopt and implement policies and procedures governing the construction of the basket of securities that is representative of the ETF's portfolio, as well as the process for acceptance of baskets from authorized participants. Additional policies are required for those ETFs that utilize custom baskets (i.e., baskets that do not represent a strictly pro rata portion of the ETF's portfolio). Lastly, the rule imposes certain recordkeeping requirements, including relating to basket information. The rule does not impose any additional conditions on so called "self-indexed ETFs," which are based on the index of an affiliate.

Potential Benefits of the Rule
Adoption of the new rule is expected to have a number of benefits for both ETF sponsors and investors. First, by eliminating the need to obtain exemptive relief, the rule will decrease the time and cost involved in launching new ETFs or ETF platforms, which has been a significant barrier to entry in the industry. Greater access to the ETF market for new sponsors may increase competition among ETFs and ETF platforms and correspondingly reduce fees across the sector, benefiting investors. Prospective ETF sponsors will also now be able to more easily launch ETF platforms comprised of multiple ETFs with different strategies that are part of a single series trust vehicle. The resulting economies of scale should allow sponsors to offer investors smaller and more narrowly tailored ETFs. The rule also levels the playing field among existing ETFs, so that those with more recent exemptive relief no longer have a potential advantage compared to those ETFs with older versions of such relief. Creating uniform and consistent requirements for ETFs will also promote efficiency in the industry, including for service providers assisting ETFs with meeting the relevant requirements, and should simplify regulatory requirements for complexes with multiple ETFs that may have been subject to different exemptive order requirements. Lastly, by reducing the need for SEC review of exemptive order applications, the rule may help to spur innovation in the industry by enabling the SEC to focus on review of exemptive order applications for more complex or cutting edge ETFs that may still require exemptive relief.

Practical Implications for Investment Managers
For potential new sponsors of ETFs, the new rule means that new ETFs and ETF platforms can be launched much more quickly than in the past, without the many months delay of obtaining exemptive relief if an existing series trust vehicle is not used. In particular, while new ETF sponsors have had access to third-party ETF series trust vehicles with existing exemptive relief for some time, using such third-party platforms necessarily reduces the economics for the new ETF sponsor. The process will now also be considerably less expensive. On the whole, the rule provides a clear and simplified framework for complying with the exemptive conditions, though additional transparency and disclosure will be required. Sponsors of more innovative ETFs, including leveraged ETFs, will still need to go through the exemptive order process. Investment managers of other investment products, including mutual funds, must also consider the potential impact of the rule on their own products and investors. With greater ease for new ETF sponsors to enter the market, ETFs could potentially become even more popular and less expensive, which may draw investors away from other investment options.

Conclusion

The adoption of the new rule, which has been widely anticipated in the ETF industry, is expected to benefit both ETF sponsors and investors by increasing the efficiency and cost-effectiveness with which the majority of ETFs can now be launched. It seems likely that the rule will herald the further expansion of the ETF industry and result in a more even playing field among market participants.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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