A PROGRAM FOR COMPLIANCE WITH THE EXCHANGE TRADED FUND RULE 6C-11

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By: Peter J. Shea, Uri S. Segelman, Alyssa B. Sherman, Trayne S. Wheeler

Compliance officers working with exchange-traded funds ("ETFs") likely know that Rule 6c-11 (the "ETF Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"), and related amendments to ETF disclosure requirements ("Disclosure Amendments") became effective December 23, 2019. December 23, 2020 marks the date by which almost all ETFs will have to comply with the ETF Rule and the Disclosure Amendments. The adopting release for the ETF Rule ("Adopting Release"),[1] moreover, provided for the automatic rescission on that compliance date of all prior exemptive orders granted by the Securities and Exchange Commission ("SEC") to ETFs that "would be permitted to operate in reliance" on the ETF Rule. This article provides compliance officers of ETFs with a step-by-step guide for assessing compliance with the ETF Rule and Disclosure Amendments.

STEP 1: INITIAL EVALUATION

As an initial matter, compliance officers should identify all ETFs subject to their compliance oversight and determine whether or not each one will rely on the ETF Rule. Only index and active ETFs that are organized as open-end funds and provide daily portfolio transparency are able to rely on the ETF Rule ("relying ETFs"). ETFs that are structured as unit investment trusts ("UIT ETFs"), ETFs that pursue leveraged and/or inverse index strategies ("Leveraged/Inverse ETFs"), ETFs that operate as a share class of a mutual fund ("Share Class ETFs"), and ETFs that do not provide full portfolio transparency ("Non-transparent ETFs") are not eligible to do so. Accordingly, existing exemptive orders for these types of ETFs will not be rescinded and, aside from complying with the Disclosure Amendments, such ETFs should continue their current compliance approaches.

STEP 2: HALT NEW MASTER-FEEDER ETF PROJECTS

The SEC, in the Adopting Release, was clear that all exemptive relief for ETFs to operate as feeder funds in a master-feeder structure is rescinded by the ETF Rule, except for ETFs that were operating as feeder ETFs prior to June 28, 2018, the ETF Rule's original proposal date. Accordingly, any plans to launch a new ETF as a feeder fund in a master-feeder structure need to be abandoned, or the fund complex will need to apply for specific master-feeder exemptive relief anew.

STEP 3: DEVELOP A POSITION ON LONG/SHORT INDEX STRATEGIES

Over the years, the SEC issued hundreds of exemptive orders that explicitly permit ETFs to provide 130/30 and other long/short index strategies.[2] The ETF Rule and the Adopting Release are completely silent on whether such strategies can be pursued by relying ETFs. ETF sponsors may take the position that 130/30 and other long/short ETFs are relying ETFs because historical SEC exemptive orders treated long/short ETFs the same as traditional ETFs (rather than as Leveraged/Inverse ETFs) and the ETF Rule imposes no other constraints on the types of investment strategies relying ETFs may pursue. In any case, long/short ETFs in the fund complex should be able to continue their operations, but the ETF compliance officers will need to determine whether they will do so as relying ETFs or as ETFs that continue to rely on their exemptive order(s).

STEP 4: REVIEW EXISTING POLICIES AND PROCEDURES

Current fund complex policies and procedures should be reviewed now to identify those that pertain to the operation of the ETFs and determine what amendments are required. Unless a fund complex has no ETFs that will be relying ETFs, some changes to the policies and procedures are likely to be necessary.

Many ETFs currently have ETF Exemptive Order Oversight Compliance Policies and Procedures. These policies and procedures may narrowly provide a compliance regime for testing compliance with the conditions of the ETF's historical exemptive order, or they may be broader. In either case, these policies and procedures will now need to provide for compliance with the terms and conditions of the ETF Rule. The remainder of this article discusses these changing compliance requirements. Most other compliance policies and procedures, including those applicable to the ETFs' fund of funds arrangements, would continue to be applicable as currently drafted.

STEP 5: CREATION/REDEMPTION BASKET POLICIES AND PROCEDURES

Although not required by historical ETF exemptive orders, the ETF Rule requires ETFs to have written policies and procedures governing the construction of baskets and the process that will be used for the acceptance of baskets.[3] These policies and procedures must cover the methodology that the ETF will use to construct baskets. For example, the methodology may detail when the ETF will use representative sampling of its portfolio to create the basket(s) and detail whether and how the ETF will update its basket(s) to reflect changes in the ETF's portfolio holdings, including (if applicable) as a result of the rebalancing or reconstitution of the ETF's underlying index. Basket policies and procedures must also describe the process that will be used for the acceptance of baskets. These are the minimum requirements for a relying ETF's basket policies and procedures.

The ETF Rule imposes heightened requirements with respect to policies and procedures for ETFs that use custom baskets.[4] The custom basket procedures must set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interest of the ETF and its shareholders. To the extent that an ETF's basket contents and weightings may deviate from the parameters for their construction in the ETF's policies and procedures or are revised during the trading day, the procedures must lay out in detail the process for making such revisions and/or deviations. In addition, they must identify the specific titles or employees of the ETF's investment adviser who will review each custom basket for compliance with the procedures' parameters. Finally, they must describe how compliance with the procedures will be tested, such as through back testing or other periodic reviews, and how the testing will assess whether the procedures' parameters have resulted and are likely to continue to result in baskets that are in the best interest of the ETF.

Well-constructed baskets can, among other things, greatly increase portfolio management efficiency, lower portfolio transaction costs, and accrue significant tax efficiencies and advantages for the ETF's shareholders. Compliance officers should work closely with the ETF's investment adviser in designing basket and custom basket compliance policies and procedures since these policies and procedures are, at heart, a function of portfolio management and not of regulatory compliance. First, a compliance officer should review the complex's current basket policies and procedures, if any, and otherwise understand the types of baskets currently used by each ETF. Then, the compliance officer will need to sit down with the ETF portfolio managers to understand the types of baskets that they would like to use, contingencies they would like to be prepared for, expected exceptions from the standard basket, the identity of those in portfolio management that will have day-to-day operational responsibility for the construction of baskets and the process for basket acceptance, and why they would like to use custom baskets, for example, for tax harvesting and portfolio management. With this information in hand, the complex's current policies and procedures can be evaluated against the needs of portfolio management and the requirements of the ETF Rule. The result should be basket and custom basket policies and procedures designed for maximum flexibility to meet the needs of each ETF with an expectation of continual involvement by ETF portfolio management in the development and ongoing implementation of each ETF's basket policies and procedures.

STEP 6: PREPARE FOR THE DISCLOSURE AMENDMENTS

Compliance officers should review the Disclosure Amendments to Forms N-1A and N-CEN.[5] As discussed above, all ETFs will need to comply with the Disclosure Amendments as of December 23, 2020, even those ETFs that do not rely on the ETF Rule. Form N-1A was substantively amended by:

- Adding the term “selling” to current narrative disclosure requirements to clarify that the fees and expenses reflected in the expense table may be higher for investors if they buy, hold, and *sell* shares of the fund (Item 3);
- Streamlined narrative disclosures relating to ETF trading costs, including bid-ask spreads (Item 6);
- Requiring ETFs that do not rely on the ETF Rule to disclose median bid-ask spread information on their websites or in their prospectus (Item 6);
- Excluding ETFs that provide premium/discount disclosures in accordance with the ETF Rule from the premium and discount disclosure requirements in Form N-1A (Items 11 and 27); and
- Eliminating disclosures relating to creation unit size and disclosures applying only to ETFs with creation unit sizes of less than 25,000 shares (Items 3, 6, 11 and 27).

Form N-CEN, which provides census-type information to the SEC on an annual basis, will now collect specific information on which ETFs are relying on the ETF Rule.

STEP 7: WEBSITE DISCLOSURES

Next, the compliance officer should review each ETF's current website disclosures to determine whether changes are required to satisfy the ETF Rule's website disclosure requirements. All website posting requirements should be addressed in the complex's written policies and procedures. Pursuant to the ETF Rule's website disclosure requirements, an ETF must disclose, on a free and publicly available website, certain specific and current information.

- The website must post, before the opening of trading on each business day, each portfolio holding (including the ticker symbol, CUSIP or other identifier, description of holding, quantity of each security/asset, and percentage weight of the holding) that will form the basis for the next net asset value (“NAV”) calculation.

- The ETF must post the previous end of trading NAV per share, market price, and premium/discount. Under the ETF Rule, premium/discount is defined as the positive or negative difference between the market price of an ETF share at the time as of which the current NAV is calculated and the ETF's current NAV per share, expressed as a percentage of the ETF's current NAV per share.
- The ETF must post the ETF's median bid-ask spread during the last (rolling) 30-calendar-day period, using national best bid and national best offer ("NBBO"). Under the ETF Rule, median bid-ask spread is computed by: (1) identifying the ETF's NBBO as of the end of each 10 second interval during each trading day of the last 30 calendar days; (2) dividing the difference between each such bid and offer by the midpoint of the NBBO; and (3) identifying the median of those values. The compliance officer needs to determine whether third-party service providers will procure the bid-ask data and who is responsible for calculating and posting the required median bid-ask spread information.
- The ETF must post (1) a table that shows the number of days that the ETF's shares traded at a premium or discount during the last calendar year and during the most recently completed calendar quarter(s), and (2) a line graph that shows the amount of the premium or discount in the ETF's shares during the last calendar year and during the most recently completed calendar quarter(s). For new ETFs, the table and graph should be provided from inception and updated daily until the first calendar quarter is completed.
- If the ETF has a premium or discount greater than 2% for seven consecutive trading days, a discussion must be had of the factors "reasonably believed to have materially contributed" to the premium or discount condition. This discussion must appear on the website for one year following the first day it was posted. The ETF complex's written policies and procedures, in addition to noting the posting requirement, should discuss the process for preparing any such disclosure, including potentially review by fund counsel before posting.

STEP 8: STOP THE IIV

Under the ETF Rule, an ETF will no longer need to publish an indicative intraday value ("IIV") of its net assets per share during the trading day. In addition, the SEC recently approved new ETF listing standards for the three most prominent ETF listing exchanges, and those standards – unlike their predecessors – do not require ETFs to publish an IIV.[6] Accordingly, as an ETF prepares to become a relying ETF, the compliance officer should confirm with the ETF's primary listing exchange that it will not be subject to an IIV publication requirement, then inform management and work with legal to terminate any IIV calculation and publication contracts. In addition, the compliance officer should have the website disclosure team delete IIV information from the ETF's website, if provided.

STEP 9: RECORDKEEPING REQUIREMENTS

The compliance officer needs to assess the adequacy of the fund complex's recordkeeping policies and procedures in light of new requirements under the ETF Rule. The ETF Rule requires an ETF to maintain two new sets records for at least five years (the first two in an easily accessible place). First, all written agreements between an authorized participant ("AP") and the ETF (or the ETF's distributor) that allow the AP to purchase and redeem creation units must be maintained. Second, the ETF will have to retain information for each basket exchanged with an AP setting forth the following: (1) ticker symbol, CUSIP, or other identifier, description of holding, quantity of each holding, and percentage weight of each holding composing the basket exchanged for creation units; (2) if applicable, an identification of the basket as a “custom basket” and a record stating that the custom basket complies with the ETF's custom basket policies and procedures; (3) cash balancing amount (if any); and (4) the identity of the AP conducting the transaction.

STEP 10: LISTING EXCHANGE COMPLIANCE

The ETF Rule requires the ETF to be listed in order to be covered by the exemption. Accordingly, the ETF's compliance officer will need to review the continued listing requirements of each ETF's primary listing exchange and implement policies and procedures to flag when the ETF may face delisting. Under such circumstances, the ETF would need to obtain relief from the SEC to permit its continued operation, and the complex's policies and procedures should address the process for obtaining such relief. Note, however, that according to the Adopting Release, circumstances such as a trading suspension, a trading halt, or a temporary non-compliance notice from the exchange would not constitute a delisting for these purposes.

STEP 11: CONFIRM CONTINUED APPLICABILITY OF FUND OF FUNDS RELIEF FOR ETFS

Rescission of prior ETF exemptive orders under the ETF Rule will not affect the relief ETFs have obtained from Section 12(d)(1) and Sections 17(a)(1) and (a)(2) under the 1940 Act permitting them to be “acquired funds” in fund of funds arrangements. The Adopting Release extends such fund of funds relief to all future ETFs that rely on the ETF Rule, provided they satisfy the conditions of recent exemptive orders that grant such relief to ETFs. Consequently, the ETF's compliance officer will need to create, if applicable, policies and procedures to ensure compliance with such fund of funds' relief conditions. Under the Adopting Release, this exemptive relief for all (including new) ETFs to be acquired funds in a fund of funds structure will last until the SEC adopts a more comprehensive fund of funds rule.

STEP 12: EMBRACE ETF COMPLIANCE AS AN ONGOING PROCESS

The new ETF Rule will make it vastly simpler and cost efficient for issuers to enter the ETF market. Accordingly, the number and type of ETFs in your fund complex may expand significantly. Under such circumstances, ETF compliance officers are likely to get important feedback on the operation of the policies and procedures developed following the above guidelines. Such feedback is valuable and normal. In our experience, a compliance program is a continual work in process, where evolving standards are reflected and good faith judgments may be made, and we stand ready to assist you with any questions or concerns you may have at this juncture or in the future.

FOOTNOTES

[1] Exchange-Traded Funds, 84 Fed. Reg. 57,162 (October 24, 2019) (to be codified at 17 C.F.R. pts. 210, 232, 239, 270 and 274) (“*Adopting Release*”).

[2] A 130/30 strategy is a form of long/short strategy where, for instance, the portfolio takes 100 long stock positions, sells 30 stock positions short, and then invests the short sale proceeds in an additional 30 long stock positions. All long/short strategies use some form of leverage.

[3] The ETF Rule defines "basket" to mean the securities, assets or other positions in exchange for which an ETF issues (or in return for which it redeems) creation unit aggregations of its shares.

[4] The ETF Rule defines "custom basket" to mean either: (A) a basket that is composed of a non-representative selection of the ETF's portfolio holdings, or (B) a representative basket that is different from the initial basket used in transactions on the same business day.

[5] If the ETF complex operates ETFs structured as UIT ETFs, then the compliance officer will need to review the Disclosure Amendments in Form N-8B-2. All ETF compliance officers should be aware that the SEC also adopted a variety of technical and conforming amendments to Form N-1A, Form N-8B-2, Form N-CSR, Form N-PORT, and Regulation S-X, which are not ETF-specific changes but will apply after December 23, 2020 to ETF filings.

[6] *See* Nasdaq Rule 5704 (Exchange Act Release No. 88,561; File No. SR-NASDAQ-2019-090 (April 3, 2020)); CBOE Rule 14.11(l) (Exchange Act Release No. 88,566; File No. SR-CboeBZX-2019-097 (April 6, 2020)); and NYSE Arca Rule 5.2-E(j)(8) (Exchange Act Release No. 88,625 File No. SR-NYSEArca-2019-18) (April 13, 2020)).

KEY CONTACTS

PETER J. SHEA
PARTNER

NEW YORK
+1.212.536.3988
PETER.SHEA@KLGATES.COM