PRECIDIAN AND ACTIVESHARES ETFS: THE DAWN OF A NEW ERA FOR ACTIVE MANAGEMENT

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U.S. Investment Management Alert

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On Monday, April 8, 2019, the U.S. Securities and Exchange Commission ("Commission" or "SEC") signaled the dawn of a new era for traditional active management and exchange-traded fund ("ETF") regulation by noticing its intent to grant exemptive relief ("Relief") to Precidian Funds LLC ("Adviser") and its related open-end investment companies (each a "Trust" and collectively, "Trusts" and together with the Adviser, "Precidian") to permit them to operate actively managed ETFs that — unlike all existing actively managed ETFs currently available in the United States — do not provide daily portfolio transparency. [1] The Relief would require the Trusts to comply with many of the same conditions as existing actively managed ETFs do and with a handful of new conditions that are designed to ensure that the arbitrage mechanism of the Trusts can operate efficiently and that potential investors in the Trusts' shares ("ActiveShares") appreciate the differences between ActiveShares ETFs and existing actively managed ETFs, including certain additional risks of ActiveShares. This article summarizes the ActiveShares ETF structure, the novel regulatory issues presented by it, and the SEC's approach to addressing those issues, which may become familiar as the SEC processes the other pending applications of active managers who, like Precidian, have long been pursuing SEC exemptive relief for the operation of actively managed ETFs that do not provide daily portfolio transparency (collectively, "Novel Active ETFs"). [2]

BACKGROUND

ETFs have features of both open-end and closed-end funds. Like open-end funds, they register an unlimited number of shares on Form N-1A and continuously sell and redeem such shares at NAV. Like closed-end funds, however, their shares also trade on an exchange. These hybrid features of the ETF structure do not allow ETFs to fit into the regulatory scheme established by the Investment Company Act of 1940 ("1940 Act") for open-end or closed-end funds. Accordingly, ETFs must obtain SEC exemptive relief to exist, and the SEC routinely grants such relief pursuant to exemptive applications. [3]

According to the Commission, to grant such relief, it "relies on [a] close tie between what retail investors pay" when transacting for ETF shares (i.e., market price) and "what Authorized Participants pay" (i.e., NAV) when transacting for ETF shares to conclude that the ETF treats all shareholders equitably. [4] In other words, the Commission relies on the presence of an efficient arbitrage mechanism in the ETF structure. [5]

Since 2008, the Commission has concluded that daily portfolio transparency supports an efficient arbitrage mechanism and has approved multiple exemptive applications for fully transparent actively managed ETFs. [6] In ActiveShares ETFs, the SEC seems to have identified an "alternative arbitrage mechanism" that it believes "can also work in an efficient manner to maintain an ActiveShares ETF's secondary market prices close to its NAV." [7]

THE ACTIVESHARES ARBITRAGE MECHANISM

The ActiveShares ETF arbitrage mechanism depends primarily on (1) the publication, updated every second of the trading day, of a real-time value of the ETF portfolio, a so-called "verified intraday indicative value" ("VIIV"); and (2) the concomitant ability of Authorized Participants contemporaneously to purchase and sell both creation units of ActiveShares and the ActiveShares ETF's portfolio securities.

Authorized Participants would purchase and sell creation units of ActiveShares and would purchase and sell the ETF's portfolio securities (in connection with such transactions and in connection with other arbitrage transactions) through an unaffiliated agent (the "AP Representative"). The Authorized Participant would send (receive) cash to (from) its AP Representative in connection with a creation (redemption). The ActiveShares ETF would provide the AP Representative each trading day with a basket, representing a pro rata slice of the portfolio, for creating and redeeming with the ETF. Accordingly, to complete an Authorized Participant's desired transaction, the AP Representative would convert the cash (basket securities) into the basket securities (cash) required by the ETF for the creation (redemption). The AP Representative would be contractually required to use the information about the basket securities only to execute Authorized Participant transactions and would be contractually restricted from disclosing such information, even to the Authorized Participant.

The AP Representative's confidentiality obligation and obligation not to misuse material nonpublic information, including for trading, is reinforced in two ways, according to the Notice. First, each AP Representative as a registered broker would necessarily have policies and procedures that prohibit the use of material nonpublic information, including for insider trading. [8] Second, pursuant to a condition of the Relief, each ActiveShares ETF and each person acting on behalf of such ETF would comply with and be subject to the requirements of Regulation Fair Disclosure ("Regulation FD") as if it applied to them. [9] As a result, the Notice suggests, in relying on the Relief, Precidian would be required to ensure that AP Representatives take their confidentiality obligations with respect to the basket securities seriously or potentially violate Regulation FD themselves. [10]

For the VIIV, an ActiveShares ETF's portfolio securities would be valued every second at the mid-point of the current national best bid and best offer ("NBBO") pursuant to precise and uniform parameters overseen and enforced by the Adviser. [11] As proposed, each ActiveShares ETF would employ two independent calculation engines and a pricing verification agent, who would continuously compare the engines' real-time prices and resolve any discrepancies pursuant to policies and procedures approved by the Trust's board.

The likelihood for pricing discrepancies, however, would be minimized by certain investment limitations with which all ActiveShares ETFs would comply. [12] Most importantly, every portfolio holding would be required to have a "readily available market price" or be fully disclosed as a portfolio holding of the ETF. [13] In addition, all portfolio holdings of the ActiveShares ETFs would be required to trade on a U.S. exchange contemporaneously with trading in ActiveShares themselves. [14]

In the Notice, the Commission acknowledges that the publication of the VIIV could allow for reverse engineering of an ActiveShares ETF's portfolio, depending on the universe from which the portfolio is drawn. Concerns about front running and free riding, which are byproducts of reverse engineering, have long existed with respect to actively managed ETFs. Such issues were identified as hurdles for actively managed ETF structures in the Commission's 2001 ETF Concept Release. Here, however, the Commission notes that Precidian deems the reverse engineering "highly unlikely" and dismisses reverse engineering concerns without significant analysis in light of the Adviser's implicit incentive to protect the ETFs against predatory trading practices. [15]

ACTIVESHARES' DISCLOSURES

The disclosures required of ActiveShares ETFs by the Relief implicitly acknowledge that the Relief would allow for a new ETF structure whose market experience may differ from what the sponsor and SEC expect. Accordingly, when relying on the Relief, Precidian would be required to disclose the different and potentially riskier nature of ActiveShares ETFs as compared to traditional ETFs. Such disclosure would be required, most significantly, on such an ETF's website and in its marketing materials, as well as in a legend "in a prominent location on the outside cover page" of each ActiveShares ETF prospectus. [16] The legend would highlight the different risks of ActiveShares ETFs as compared to traditional ETFs, such as larger premiums and discounts (between market price and NAV) and wider bid-ask spreads. [17] Each ActiveShares ETF would also be required to disclose on its website its median bid-ask spread for the most recent fiscal year based on NBBO as of the time that the ETF calculates its NAV. [18]

In addition, the Relief would require Precidian to take remedial actions if ActiveShares do not function as anticipated. In this regard, for the first three years, the Relief would require the Trusts' board(s) of trustees ("Board") to consider whether shareholders are being harmed and, if so, what action(s) may be appropriate. In addition, during the same three-year period, the Board would be required to meet "promptly" if, for 30 or more days in any quarter or 15 days in a row, an ETF's ActiveShares trade at a market price that reflects a premium *or* discount to NAV of more than 1 percent or have a bid-ask spread of more than 1 percent.

Finally, the Relief would require the ActiveShares ETFs to provide the Commission staff with "periodic reports… containing such information as the Commission staff may request." [19] Because such a condition is not typically found in an exemptive order, it may be read (as suggested here) as an implicit acknowledgement that even the Commission cannot know what it does not know, while allowing for innovation within the laboratory provided by section 6(c) of the 1940 Act.

ANALYSIS AND OBSERVATIONS

First, the ActiveShares ETF structure is an important step forward for offering traditional actively managed strategies as ETFs. While Precidian has sought a patent for the structure, it is available for licensing by active managers from Precidian. With such a license, managers may operate ActiveShares ETFs as series of the Trusts. Or, they may seek "fast track" exemptive relief from the SEC by incorporating by reference the terms and conditions of the Relief in their own exemptive application. Then, upon obtaining an SEC exemptive order, they may manage ETFs as series of their own open-end registered investment companies that employ the ActiveShares ETF structure. [20]

Second, in considering whether to adopt the ActiveShares ETF structure, managers should consider that the structure will not work for all active strategies due to the requirement that all of an ActiveShares ETF's portfolio holdings must trade on a U.S. exchange contemporaneously with trading in the ActiveShares themselves. Thus, active managers that specialize in foreign investments or invest, even insignificantly, in foreign markets may not benefit from the ActiveShares ETF structure, unless such strategies can be implemented with American depositary receipts. Similarly, strategies that invest in instruments that require fair valuation cannot be offered as ActiveShares ETFs due to the requirement that all ActiveShares ETF portfolio holdings have a "readily available market price." [21]

Third, the tax efficiencies of the ActiveShares ETF structure may be somewhat limited due to the requirement that ActiveShares ETFs transact in baskets that represent pro rata slices of their portfolios. Given the Commission's recent proposal of the ETF rule, which would allow for non-pro rata baskets based on, among other things, a recognition of the tax efficiencies and benefits that can flow from non-pro rata baskets, [22] the requirement here for pro rata baskets is somewhat surprising. In addition, it signals that when reviewing applications for Novel ETF Relief, the Commission is likely to give little weight to arguments in favor of a new structure based on its potential tax efficiencies. Rather, the Notice leaves no doubt that the Commission's primary regulatory concern about Novel Active ETFs is the efficiency of the arbitrage mechanism.

Finally, a review of the ETF Concept Release on actively managed ETFs and the 100-plus actively managed ETF exemptive applications that followed during the last decade reveals that the Commission once harbored serious regulatory concerns about the potential for "front running" and "free riding" of actively managed ETFs — concerns that, again, are not disassociated with reverse engineering but rather byproducts thereof. Yet in the Notice the Commission dispenses with such regulatory concerns in a paragraph and a footnote. In so doing, the Commission signals an openness to innovation that should portend well for Novel Active ETFs generally.

NOTES

[1] Investment Company Act Release No. 33440 (Apr. 8, 2019) ("Notice"). The Relief would pertain not only to Precidian but also to other (future) open-end management investment companies, including series thereof, advised by the Adviser or an entity in the Adviser's control group. Notice at n.15. Precidian first filed an application for exemptive relief to permit Novel Active ETFs almost seven years ago. *See* Precidian ETFs Trust, et al., File No. 812-14116 (July 23, 2013). The Commission issued a preliminary notice of its intent to deny that application based on concerns about the effectiveness of the proposed arbitrage mechanism. *See* Precidian ETFs Trust, Investment Company Act Release No. 31300 (Oct. 21, 2014). *See also SEC Issues Preliminary Denial Notices for Two Nontransparent Actively Managed ETF Applications*, Exchange-Traded Funds Alert (Nov. 6, 2014). At the same time, the Commission approved exemptive relief for a new type of exchange-traded vehicle, namely exchange-traded managed funds, which do not trade intraday at market prices that diverge from net asset value ("NAV") and therefore do not require an arbitrage mechanism. See Investment Company Act Release Nos. 31333 (Nov. 6, 2014) (notice) and 31361 (Dec. 2, 2014) (order).

[2] *See, e.g.*, T. Rowe Price Associates, Inc. et al. (File No. 812-14214) (Sept. 23, 2013, as amended on Mar. 14, 2014, Feb. 23, 2018, and June 18, 2018); Fidelity Beach Street Trust et al. (File No. 812-14364) (Sept. 26, 2014, as amended on Jan. 26, 2018, May 18, 2018, and Aug. 8, 2018); Blue Tractor ETF Trust et al. (File No. 812-14625) (Mar. 14, 2016, as amended on Sept. 28, 2016, Feb. 1, 2017, July 31, 2017, Jan. 17, 2018, Apr. 11, 2018, and May 23, 2018); Natixis Advisors, L.P., et al. (File No. 812-14870) (Jan. 22, 2018, as amended on June 15, 2018, and Nov. 9, 2018).

[3] The SEC has proposed a rule that, if adopted, would permit index-based and actively managed ETFs that provide daily portfolio transparency to exist without particularized exemptive relief from the SEC. "Exchange-Traded Funds," Investment Company Act Release No. 33140 (June 28, 2018) ("ETF Rule Proposal") https://www.sec.gov/rules/proposed/2018/33-10515.pdf (proposing rule 6c-11 to provide all necessary exemptive

relief for any future ETF that provides full portfolio transparency). Until the rule is adopted, application must be made pursuant to rules 0-2 and 0-5 of the 1940 Act.

[4] Notice at ¶ 12. "Authorized Participants" are the institutional investors who enter into an agreement with each Trust to transact directly with the Trust for blocks of ActiveShares ("creation units") at NAV.

[5] Notice at ¶ 12 ("It is the exercise of . . . arbitrage opportunities that keeps the market price of ETF shares at or close to the NAV per share of the ETF. This close tie between market price and NAV per share of the ETF is the foundation for why the prices at which retail investors buy and sell ETF shares are similar to the prices at which Authorized Participants are able to buy and redeem shares directly from the ETF at NAV.")

[6] *Compare* SEC Concept Release: Actively Managed Exchange-Traded Funds, Investment Company Act Release No. 25258 (Nov. 8, 2001) ("ETF Concept Release") (seeking comment on the role of transparency in the arbitrage mechanism) *with* ETF Rule Proposal, *supra* note 3.

[7] Notice at ¶ 26.

[8] *See* 15 U.S.C. § 78o(g).

[9] Notice at Condition A.8. Technically, Regulation FD does not apply to open-end management investment companies but is applied to Precidian by this condition of the Relief; and under the condition, Precidian could not claim the exemption from compliance provided by rule 100(b)(2)(iii) of Regulation FD (for communications made in connection with an offering registered under the Securities Act of 1933).

[10] Notice at n.36 and surrounding text.

[11] Notice at Condition A.5.

[12] Notice at nn.23–25 and surrounding text.

[13] ActiveShares ETFs will not purchase illiquid investments (as defined by rule 22e-4 under the 1940 Act), borrow for investment purposes, or hold short positions.

[14] Each ActiveShares ETF may only invest in ETFs, exchange-traded notes, common stocks, preferred stocks, American depositary receipts, real estate investment trusts, commodity pools, metals trusts, currency trusts, futures contracts (whose reference assets the ActiveShares ETF could invest in directly), cash, and cash equivalents.

[15] Notice at ¶ 34 and n.51.

[16] Notice at Condition A.3.

[17] Notice at ¶ 17.

[18] Notice at Condition A.2. The Commission's focus on ETF bid-ask spreads is familiar due to such disclosure being contemplated by the proposed ETF rule. *See* ETF Rule Proposal, *supra* note 3, at 111-12, 158-60.

[19] Notice at Condition A.7.

[20] *See* Notice at n.41 (describing streamlined SEC exemptive order process for Precidian licensees).

[21] *See* 15 U.S.C. § 80a-2(a)(41) (contrasting securities with a "readily available market price" to those requiring fair value). *See also* Precidian ETFs Trust, et al. (File No. 812-14405) (Dec. 22, 2014, as amended on Aug. 11,

2015, Sept. 21, 2015, May 3, 2017, Oct. 2, 2017, Dec. 4, 2017, May 30, 2018 and Apr. 4, 2019) (deleting text in the final version of the application, which was included in prior versions, that would have allowed ActiveShares ETFs' portfolio holdings to require fair valuation).

[22] *See* ETF Rule Proposal, *supra* note 3, at 49.

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