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The SEC Issues its Long-Awaited ETF Rule (Part 1) - What Made the Cut

On September 26, 2019, the U.S. Securities and Exchange Commission ("SEC") unanimously [approved a long-awaited rule](#) regulating exchange-traded funds ("ETFs"). Previously, ETFs were required to obtain exemptive orders from the SEC, a time consuming and expensive process. New Rule 6c-11 under the Investment Company Act of 1940 (the "ETF Rule") streamlines the process for launching some ETFs and standardizes the compliance requirements for existing ETFs. The ETF Rule goes into effect sixty days after it appears in the Federal Register, which has yet to occur as of this post. One year following its effective date, the SEC will rescind the exemptive orders for any existing ETF that falls within the scope of the ETF Rule.

The New ETF Rule

Scope and Relief Provided

The ETF Rule is available to ETFs that are organized as open-end funds, whether they use index-based or actively managed investment strategies, but not to ETFs formed as unit investment trusts ("UITs"). It is not available for leveraged ETFs that seek to provide investment returns over a predetermined period of time that: (a) correspond to the performance of a market index by a specified multiple or (b) have an inverse relationship to the performance of a market index. Qualifying ETFs will no longer need to obtain an exemptive order to:

1. Issue (and redeem) their shares only in creation unit aggregations to (and from) authorized participants in exchange for a basket of securities and a cash balancing amount (if any);
2. Permit ETF shares to be purchased and sold at market prices rather than at net asset value per share ("NAV");
3. Engage in in-kind transactions with certain affiliates with regard to the deposit and receipt of baskets; and
4. Pay authorized participants the proceeds from the redemption of shares in more than seven days in certain limited circumstances.

Conditions for Reliance on Rule 6c-11

Consistent with [the SEC's 2018 proposal](#), the ETF Rule contains the following five core conditions that ETFs must meet to rely on the rule instead of seeking exemptive relief:

1. Issuance and Redemption of Shares. The ETF must issue and redeem its shares in the form of "creation units" to and from "authorized participants" in exchange for baskets of securities (and any cash balance).
2. Listing on a National Securities Exchange. The ETF's shares must be listed on a national securities exchange and must trade at market-determined prices.
3. Portfolio Holdings. The ETF must disclose on its website daily the "portfolio holdings" that will form the basis for the next calculation of the NAV. Accordingly, Rule 6c-11 requires that any changes in an ETF's holdings of portfolio securities be reflected on a T+1 basis.
4. Baskets. The ETF must adopt and implement written policies and procedures governing the construction of baskets and the process for accepting baskets. In addition, the ETF Rule allows an ETF to use "custom baskets" according to a written policy. Permitting custom baskets instead of requiring pro rata baskets can make ETFs more efficient from an arbitrage or tax perspective; in addition, some ETFs could satisfy redemption orders in cash, instead of having to deliver securities that might be hard to replace.
5. Website Disclosure. The ETF must disclose on its website, which must be publicly available and free, (i) before the opening of trading, the composition of the portfolio required for a creation unit, plus any cash

balancing amount; (ii) the ETF's NAV, market price, and premium or discount of the market price from the NAV, each as of the end of the prior business day; (iii) detailed information about the ETF's bid-ask spreads; (iv) historical information regarding premiums and discounts; and (v) specific disclosures when an ETF's premium or discount was greater than 2% for more than seven consecutive trading days.

Other Items Included in the SEC's Adoption of the ETF Rule

In connection with adopting the new ETF Rule, the SEC also approved changes to Forms N-1A, N-8B-2, N-CSR, and N-PORT. One of these changes requires an ETF that does not rely on Rule 6c-11 to provide median bid-ask spread information either on its website or in its prospectus. In addition, the SEC clarified in the adopting release that non-transparent ETFs cannot rely on Rule 6c-11 because they do not provide daily portfolio transparency.

Items Excluded in the SEC's Adoption of the ETF Rule

Please check back here for our continued coverage of the ETF Rule, including a discussion of the items the SEC declined to include in the final rule.

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