SEC Proposes New ETF Rule

June 29, 2018

In a June 28, 2018 release (the "**Proposing Release**") the Securities and Exchange Commission (the "**SEC**") proposed new Rule 6c-11 (the "**Proposed Rule**") and form amendments to standardize and modernize the regulatory framework for most exchange-traded funds ("**ETFs**"). According to the Proposing Release, the SEC has issued over 300 exemptive orders allowing ETFs to operate under the Investment Company Act since 1992, and in that time the ETF market has grown significantly and now represents nearly 15% of net assets managed by investment companies. Under the Proposed Rule, ETFs that satisfy its conditions would be able to come directly to market without first obtaining an exemptive order under the Investment Company Act of 1940 (the "**Investment Company Act**"). The Proposed Rule is intended to "create a consistent, transparent, and efficient regulatory framework" for ETFs that "facilitate[s] greater competition and innovation among ETFs." Currently, for example, only certain sponsors operating under older exemptive orders can pick and choose which shares to accept from, or sell to, authorized participants during the creation and redemption process (i.e., use "custom baskets"). Most recent exemptive orders generally only allow funds to accept from, or sell to, authorized participants, a pro rata slice of the ETF's portfolio. The Proposed Rule would create a level playing field and allow all sponsors to use custom baskets.

The Proposed Rule would be available to ETFs organized as open-end funds, which constitute the majority of today's ETFs. ETFs that are (i) organized as unit investment trusts; (ii) structured as a share class of a multi-class fund; or (iii) leveraged or inverse ETFs would not be able to rely on the Proposed Rule. Additionally, the Proposed Rule would be available to both index-based and actively-managed ETFs.

Conditions for Reliance on the Proposed Rule

The Proposed Rule's conditions include, among others:

- Transparency – An ETF would be required to provide daily portfolio transparency on its website.
- Custom basket policies and procedures – If an ETF wants to use custom baskets (i.e., baskets that are not pro-rata representations of the fund's portfolio or that differ from other baskets used in transactions on the same business day), the ETF would be required to adopt written policies and procedures detailing, among other things, the "parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders." In addition, the ETF would be required to comply with certain recordkeeping requirements, including to preserve and maintain copies of all written authorized participant agreements.
- Website disclosure – An ETF would be required to disclose certain information on its website, including, among other things, portfolio holdings information, a "basket applicable to orders for the purchase or redemption of creation units," historical information about premiums and discounts, as well as bid-ask spread information.

Rescission of Certain ETF Exemptive Relief

The Proposed Rule would rescind exemptive relief previously granted to ETFs eligible to rely on the rule, as well as exemptive relief that currently permits ETFs to operate in a master-feeder structure (few ETFs utilize this structure). The Proposed Rule would grandfather existing master-feeder arrangements involving ETF feeder funds, but prevent the formation of new ones. The Proposing Release would not rescind exemptive relief that permits ETF fund of funds arrangements.

Proposed Amendments to Form N-1A and Form N-8B-2

The Proposing Release notes that several amendments to Form N-1A and Form N-8B-2 are also being proposed to provide ETF investors with additional information regarding ETFs, including with respect to costs borne by ETF investors that are not applicable to mutual fund investors (e.g., trading costs borne by investors when trading ETF shares).

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The SEC has requested public comments on the Proposed Rule and form amendments, to be received by the SEC on or before the 60th day after publication of the Proposing Release in the Federal Register. Davis Polk is preparing a more detailed discussion of the Proposed Rule.

- **See a copy of the press release announcing the Proposed Rule**
- **See a copy of the Proposing Release**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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