SEC Adopts New ETF Rule

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On September 26, 2019, the Securities and Exchange Commission ("**SEC**") announced that it had unanimously adopted Rule 6c-11 (the "**Final Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") and related form amendments to standardize and modernize the regulatory framework for most exchange-traded funds ("**ETFs**"), as detailed in an accompanying release (the "**Adopting Release**").

According to the Adopting 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 approximately 16% of net assets managed by investment companies. Under the Final Rule, ETFs that satisfy its conditions will be able to come directly to market without first obtaining an exemptive order under the Investment Company Act. The Final Rule is intended to "establish 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 securities 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 Final Rule will create a level playing field and allow, among other things, all sponsors to use custom baskets.

The Final Rule was adopted in largely the same form as the rule proposed on June 28, 2018 (the "**Proposed Rule**"), with "several modifications that are designed to reduce the operational challenges that commenters identified, while maintaining protections for investors and providing investors with useful information regarding ETFs." The Adopting Release states that the Final Rule and form amendments will be effective 60 days after publication in the Federal Register, with a one-year transition period for compliance with the form amendments. In addition to the Final Rule's adoption, the SEC also granted an order for conditional exemptive relief from Section 11(d)(1) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and rules 10b-10, 15c1-5, 15c1-6 and 14e-5 thereunder.

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Scope of the Final Rule

The Final Rule is available only to transparent ETFs organized as open-end funds that are index-based or actively managed, which constitute the vast majority of today's ETFs.

According to the Adopting Release, the Final Rule defines an ETF as a "registered open-end management investment company that: (i) issues and redeems creation units to and from authorized participants in exchange for a basket and cash balancing amount (if any), and (ii) issues shares that are listed on a national securities exchange and traded at market-determined prices." Under the Final Rule, an ETF that is delisted or suspended from its listing exchange is not eligible to rely on the Final Rule.

Due to commenters' concerns, in discussing the definition of "authorized participant," the Adopting Release states that "an authorized participant that purchases ETF shares from the ETF's principal underwriter is not a principal underwriter as defined in section 2(a)(29) of the [Investment Company] Act solely because it buys and sells ETF shares in creation units."

The Adopting Release states that ETFs that are (i) organized as unit investment trusts ("**UIT ETFs**"); (ii) structured as a share class of a multi-class fund; or (iii) leveraged/inverse ETFs (i.e., ETFs that seek directly or indirectly to provide returns at a multiple of a specific index over a fixed period of time, or, which seek to provide returns that "have an inverse relationship to the performance of a specific index over a fixed period of time") cannot rely on the Final Rule. The Adopting Release notes that because the "unique features" of these types of ETFs raise different considerations, the SEC believes these types of ETFs should "continue operating pursuant to their exemptive orders, which include terms and conditions more appropriately tailored to address" their specific features. The Adopting Release also notes that the Final Rule does not apply to actively managed ETFs that "operate without being subject to the daily portfolio transparency condition included in other actively managed ETF orders" ("**Non-Transparent ETFs**").

Under the Final Rule, the SEC is rescinding exemptive relief that it previously issued to ETFs that fall within the scope of the Final Rule and retaining the exemptive relief granted to ETFs outside the scope of the Final Rule. The Adopting Release notes that the SEC is also retaining the exemptive relief currently granted to ETFs that allows them to enter into fund of funds arrangements.

Elimination of the Distinction between Index-Based and Actively Managed ETFs

The Adopting Release notes that eliminating the regulatory distinction between index-based and actively managed ETFs will "provide a level playing field among those market participants."

Consistent with the Proposed Rule, the Final Rule does not distinguish between index-based and actively managed ETFs, because the SEC believes that index-based and actively managed ETFs that comply with the Final Rule's conditions "function similarly with respect to operational matters, despite different investment objectives or strategies" and "do not present significantly different concerns under the provisions of the [Investment Company] Act from which the [Final Rule] grants relief."

Exemptive Relief under the Final Rule

The Final Rule provides ETFs within its scope with exemptions from certain provisions of the Investment Company Act, which are "consistent with the relief [the SEC has] given to ETFs under [its] exemptive orders." As discussed below, the Final Rule will allow ETFs that satisfy its conditions to: (i) redeem shares only in creation unit aggregations; (ii) permit ETF shares to be purchased and sold at market prices rather than at net asset value ("**NAV**") per share; (iii) engage in in-kind transactions with certain affiliates; and (iv) in limited circumstances, pay authorized participants the proceeds from the redemption of shares in more than seven days.

In response to concerns raised by commenters, the Adopting Release clarifies that on the day of consummation of a merger, reorganization, conversion or liquidation of an ETF, the ETF "may sell or redeem individual shares and is not limited to transacting with authorized participants" because allowing "ETFs to conduct redemptions with investors other than authorized participants in these circumstances is operationally necessary to facilitate these transactions and will allow an ETF to compensate individual shareholders exiting the reorganized, merged, converted or liquidated ETF."

- Treatment of ETF Shares as Redeemable Securities – According to the Adopting Release, under the Final Rule, an ETF is considered to issue a "redeemable security" within the meaning of section 2(a)(32) of the Investment Company Act and any ETF operating in compliance with the Final Rule will meet the definition of an open-end company. ETFs relying on the Final Rule will be subject to the Investment Company Act requirements and SEC rules that apply to all open-end funds. The Adopting Release notes that only authorized participants may redeem ETF shares and only when shares are aggregated into creation units, except in limited circumstances. As exceptions, according to the Adopting Release, the Final Rule will allow an ETF to sell or redeem individual shares on the day of consummation of a merger, reorganization, conversion or liquidation. The Adopting Release also states that creations may be suspended "only for a limited time and only due to extraordinary circumstances, such as when the markets on which the ETF's portfolio holdings are traded are closed for a limited period of time." In addition, the Adopting Release also clarifies that shares of all investment company ETFs, including those that are ineligible to rely on the Final Rule, will qualify as "redeemable securities" in rules 101(c)(4) and 102(d)(4) of Regulation M and rule 10b-17(c) under the Exchange Act "in connection with secondary market transactions in ETF shares and the creation or redemption of creation units and the exemption in rule 11d1-2 under the Exchange Act for securities issued by a registered open-end investment company or unit investment trust."
- Trading of ETF Shares at Market Determined Prices – According to the Adopting Release and consistent with the Proposed Rule, under the Final Rule a dealer in ETF shares will be exempt from section 22(d) of the Investment Company Act, which prohibits investment companies, their principal underwriters and dealers from selling a redeemable security to the public except at a current public offering price described in the prospectus, and from rule 22c-1, which requires that a dealer selling, redeeming or repurchasing a redeemable security do so only at a price based on its NAV. The Adopting Release notes that section 22(d) of the Investment Company Act and rule 22c-1 thereunder were designed to, among other things, "(i) prevent dilution caused by certain riskless trading practices of principal underwriters and dealers; (ii) prevent unjust discrimination or preferential treatment among investors purchasing

and redeeming fund shares; and (iii) preserve an orderly distribution of investment company shares." Consistent with existing exemptive orders, the Final Rule will exempt a covered ETF from these provisions with regard to purchases, sales and repurchases of ETF shares at market-determined prices. The Adopting Release states that the concerns noted above are addressed by the Final Rule's conditions along with a properly functioning arbitrage mechanism.

Despite requests from commenters, the SEC declined to expand relief to cover additional types of affiliated relationships, such as exempting broker-dealers that are affiliated with an ETF's adviser. In declining to do so, the SEC noted that expanding the scope of affiliated persons would constitute novel section 17(a) relief.

- Affiliated Transactions – Section 17(a) of the Investment Company Act prohibits "an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security or other property to or purchasing any security from the company." According to the Adopting Release, under the Final Rule, affiliates of an ETF will be exempt from sections 17(a)(1) and (a)(2) of the Investment Company Act and will be allowed to enter into in-kind creation and redemption transactions with an ETF if they are affiliated with the ETF solely because the affiliate or its affiliates hold the power to vote 5% or more of the shares of the ETF or any investment company affiliate of the ETF. The Adopting Release notes that this relief is "appropriate to facilitate the efficient functioning of the arbitrage mechanism." The Adopting Release also clarified that the section 17 relief will apply to shareholders who hold more than 25% of an ETF's shares or 25% of any investment company that is an affiliated person of the ETF, as this is consistent with the terms of existing exemptive orders.
- Additional Time for Delivering Redemption Proceeds – According to the Adopting Release, the Final Rule will provide an exemption from section 22(e) of the Investment Company Act to permit an ETF to delay satisfaction of a redemption request for more than seven days if "a local market holiday, or series of consecutive holidays, the extended delivery cycles for transferring foreign investments to redeeming authorized participants, or the combination thereof prevents, timely delivery of the foreign investment included in the ETF's basket." The ETF will be required to deliver foreign investments as soon as practicable, but no later than 15 days after the tender to the ETF. While the Proposed Rule stipulated that the exemption from section 22(e) would expire ten years from the effective date of the Proposed Rule (unless the SEC took action before then), due to commenters' concerns, the Final Rule eliminates the ten-year sunset provision. In addition, in response to commenters' concerns, the Final Rule removes the "no established U.S. public trading market" portion of the proposed definition of foreign investment and defines a foreign investment as "any security, asset or other position of the ETF issued by a foreign issuer (as defined by rule 3b-4 under the Exchange Act), and that is traded on a trading market outside the U.S." The Adopting Release also confirms that the relief from section 22(e) will apply even if a foreign investment has a U.S.-traded equivalent security.

Conditions for Reliance on the Final Rule

The Final Rule's conditions include, among others:

- Issuance and Redemption of Shares – According to the Adopting Release, the definition of an ETF under the Final Rule will, as proposed, "require that an ETF issue (and redeem) creation units to (and from) authorized participants in exchange for baskets and a cash balancing amount (if any)." The Adopting Release notes that the definition is designed to "preserve the existing ETF structure, reflected in our exemptive orders."
- Listing on a National Securities Exchange – The Adopting Release states that, as proposed, the Final Rule will define an ETF, in part, to mean "a fund that issues shares that are listed on a national securities exchange and traded at market-determined prices." According to the Adopting Release, exchange-listing: (i) "is one of the fundamental characteristics that distinguishes ETFs from other types of open-end funds (and [unit investment trusts])"; and (ii) "provides an organized and ongoing trading market for the ETF shares at market-determined prices, and therefore is important to a functioning arbitrage mechanism."
- Portfolio Transparency – According to the Adopting Release, under the Final Rule, an ETF will be required to disclose prominently on its publicly available website the portfolio holdings that will form the basis for each calculation of NAV per share, and any cash balancing amount (if any). The Proposed Rule would have required this disclosure to be posted each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before an ETF started accepting creation and redemption orders. However, according to the Adopting Release, the Final Rule does not include this requirement and instead "will require an ETF to disclose the portfolio holdings that will form the basis for the ETF's next calculation of NAV per share each business day before the opening of regular trading on the primary listing exchange of the exchange-traded fund shares," which "will accommodate T-1 orders, as requested by commenters." As proposed, the Final Rule requires the "portfolio holdings that form the basis for the ETF's NAV calculation to be the ETF's portfolio holdings as of the close of business on the prior business day." In addition, the Proposed Rule would have required that this information be presented in the manner prescribed within Article 12 of Regulation S-X. The Final Rule does not require that portfolio holdings include the details and format stipulated by Regulation S-X; instead, the Final Rule will require an ETF to disclose for each portfolio holding on a daily basis, the: "(1) ticker symbol; (2) CUSIP or other identifier; (3) description of holding; (4) quantity of each security or other asset held; and (5) percentage weight of the holding in the portfolio supply." The Adopting Release provides certain examples of the description of holding requirement, noting that "ETFs holding debt securities should include the security's name, maturity date, coupon rate, and effective date, where

The Adopting Release clarifies that "an ETF is considered no longer listed on an exchange as of the effective date of the removal of the ETF's shares from listing pursuant to rule 12d2-2 under the Exchange Act." The Adopting Release further clarifies that "[c]ircumstances such as a trading suspension, trading halt, or a temporary non-compliance notice from the exchange therefore would not constitute a 'delisting' for purposes of [the Final Rule]."

The Adopting Release states that the term "portfolio holdings" means "an ETF's securities, assets, or other positions," meaning that an ETF will be required to disclose its cash holdings, "as well as holdings that are not securities or assets, including short positions or written options."

applicable, to assist investors in identifying the specific security held."

- Basket Policies and Procedures – According to the Adopting Release, the Final Rule will require each ETF relying on the Final Rule to adopt and implement written policies and procedures that will form part of the ETF's Rule 38a-1 compliance program, and that will govern the construction of baskets and the process used for accepting baskets. The Adopting Release also notes that the policies and procedures should detail the methodology that the ETF will use to construct baskets, including the circumstances under which "the basket may omit positions that are not operationally feasible to transfer in-kind," "when and how the ETF will use representative samplings of its portfolio to create its basket," as well as "how the ETF will replicate changes in [its] portfolio holdings as a result of the rebalancing or reconstitution of the ETF's underlying securities market index, if applicable."

The Final Rule contemplates two types of custom baskets: (i) baskets that are not pro rata representations of the fund's portfolio (which includes baskets that do not reflect "a representative sampling of the ETF's portfolio holdings" or "changes due to a rebalancing or reconstitution of the ETF's securities market index, if applicable"); and (ii) baskets that differ from other baskets used in transactions on the same business day.

- Custom Basket Policies and Procedures – According to the Adopting Release, the Final Rule will allow ETFs "the flexibility to use baskets that differ from a pro rata representation of the ETF's portfolio if certain conditions are met." Under the Final Rule, an ETF using custom baskets will be required to adopt written policies and procedures: (i) detailing the "parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for any revisions to, or deviations from, those parameters" and (ii) specifying the "titles or roles of employees of the ETF's investment adviser who are required to review each custom basket for compliance with those parameters." According to the Adopting Release, these policies and procedures should detail the methodology that the ETF uses to construct baskets and should describe the ETF's "approach for testing compliance with the custom basket policies and procedures," which should also include determining whether the parameters continue to provide custom baskets that are "in the best interest of the ETF and its shareholders." The Adopting Release confirms that the best interest standard "is not intended to apply to each ETF shareholder individually, but rather to the ETF's shareholders generally." The Adopting Release further states that these "heightened process requirements" for ETFs using custom baskets are intended to "protect the ETF and its shareholders from the risks that custom baskets may present." Additionally, the Adopting Release notes that "the ETF's board of directors' oversight of the ETF's compliance policies and procedures, as well as their general oversight of the ETF, would provide an additional layer of protection for an ETF's use of custom baskets."

- Intraday Indicative Value – According to the Adopting Release, the Final Rule will not require ETFs to disseminate an intraday indicative value, as required by certain exchange listing standards, in part because “market participants typically calculate their own intraday value of an ETF’s portfolio with proprietary algorithms that use an ETF’s daily portfolio disclosure and available pricing information about the assets held in the ETF’s portfolio.” Additionally, the Adopting Release states that the Final Rule includes a daily disclosure of portfolio holdings requirement, which will “provide market participants with the relevant data to input into their internal algorithms and thus allow them to determine if arbitrage opportunities exist.” Further, commenters noted that “even if [the Final Rule] were to omit an [intraday indicative value] requirement, existing relief under the Exchange Act and certain exchange listing requirements would require ETFs to continue disseminating IIV.” Commenters also encouraged the SEC “to work with the exchanges to remove these listing requirements.”

The Final Rule amends the definition of market price to mean (a) “the official closing price of an ETF share; or (b) if it more accurately reflects the market value of an ETF share at the time as of which the ETF calculates current NAV per share, the price that is the midpoint of the national best bid and national best offer, calculated as of the time NAV per share is calculated.”

- Website Disclosure – Although the Proposed Rule would have required an ETF to disclose certain information on its website, including the portfolio holdings information discussed above as well as information regarding a published basket “applicable to orders for the purchase or redemption of creation units” to be posted at the beginning of each business day, the Final Rule does not include this requirement. According to the Adopting Release, the Final Rule will require website disclosure of: (i) the ETF’s NAV per share, market price and premium or discount, each as of the end of the prior business day; (ii) historical information regarding the median bid-ask spreads over the most recent 30 days (rather than the most recent fiscal year as proposed under the Proposed Rule, which also would have required a corresponding prospectus disclosure as well); and (iii) historical information, in a table and line graph, illustrating the extent and frequency of the ETF’s premiums and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year. In response to commenters’ concerns that bid-ask spread disclosure may vary among firms, the Final Rule provides a formula for calculating the median bid-ask spread information by reference to the ETF’s national best bid and national best offer as of that time. The Final Rule also eliminates the requirement under the Proposed Rule that an ETF disclose the median bid-ask spread in its prospectus. According to the Adopting Release, under the Final Rule, if an ETF’s premium or discount is greater than 2% for more than seven consecutive trading days, the ETF will also be required to post such information on its website, and disclose the “factors that are reasonably believed to have materially contributed to the premium or discount.” This information must be posted on the “trading day immediately following the eighth trading day on which the ETF had a premium or discount greater than 2%,” and must remain on the ETF’s website for one year after its initial posting in order “to help investors identify ETFs that historically have had persistent deviations between market price and NAV per share.” According to

the Adopting Release, these requirements are "designed to provide investors with key metrics to evaluate their trading and investment decisions in a location that is easily accessible and frequently updated." Additionally, the Final Rule does not include the bid-ask spread examples or interactive calculator requirements from the Proposed Rule.

- Recordkeeping – According to the Adopting Release, under the Final Rule, an ETF will be required to comply with certain recordkeeping requirements, including to preserve and maintain copies of all written authorized participant agreements. Additionally, according to the Adopting Release, for each basket exchanged with an authorized participant, an ETF will be required to maintain a record including: (i) the ticker symbol, CUSIP or other identifier, description of holding, quantity of each holding and percentage weight of each holding within the basket; (ii) identification of the basket as a custom basket and stating that the custom basket complies with the ETF's custom basket policies and procedures (if applicable); (iii) the cash balancing amount (if any); and (iv) the identity of the authorized participant. The Proposed Rule would have required an ETF to disclose the name and quantity of each position. Under the Final Rule, an ETF will be required to maintain such records for at least five years, and do so in an easily accessible place for the first two years. The Adopting Release notes that these records "will help [SEC] examination staff understand how baskets are being used by ETFs, evaluate compliance with the rule and other provisions of the [Investment Company] Act and rules thereunder and other applicable law, and examine for potential overreach by ETFs in connection with the use of custom baskets or transactions with affiliates." In this regard, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") issued a Risk Alert in November 2018 indicating it is conducting an examination initiative focused on ETFs that track custom-built indexes and smaller ETFs and/or ETFs with little secondary market trading volume. For more information regarding the OCIE Risk Alert, please see the November 20, 2018 Davis Polk **Investment Management Regulatory Update**.

Rescission of Certain ETF Exemptive Relief

According to the Adopting Release, the SEC believes that rescinding exemptive relief in connection with the Final Rule will "result in a consistent, transparent, and efficient framework for ETFs that operate in reliance on [the Final Rule], as those ETFs would no longer be subject to differing and sometimes inconsistent provisions of their exemptive relief."

According to the Adopting Release, one year from the effective date of the Final Rule, the SEC will rescind exemptive relief previously granted to ETFs eligible to rely on the Final Rule, as well as exemptive relief that currently permits ETFs to operate in a master-feeder structure (as the Adopting Release notes that few ETFs utilize this structure). The SEC noted that many of the exemptive orders it has provided to ETFs provide for their automatic expiration upon the effective date of a rule permitting the operation of ETFs. The Adopting Release noted that these orders have been amended to provide that they will also terminate one year from the effective date of the Final Rule. The Final Rule will grandfather existing master-feeder arrangements involving ETF feeder funds, but prevent the formation of new ones. The Final Rule will not rescind the exemptive orders

the SEC has provided to UIT ETFs, leveraged/inverse ETFs, share class ETFs or Non-Transparent ETFs.

The Final Rule will also not rescind exemptive relief that permits ETF fund of funds arrangements or relief from Section 12(d)(1) of the Investment Company Act, which "generally limits the ability of registered investment companies (including ETFs) to acquire securities issued by other investment companies in excess of certain thresholds, and the ability of registered open-end investment companies (including ETFs) from knowingly selling securities to other investment companies in excess of certain thresholds." The Adopting Release further notes that proposed rule 12d1-4 under the Investment Company Act, proposed in order to "enhance the regulatory framework applicable to fund of funds arrangements for registered investment companies, including ETFs[,]" has not yet been adopted. For a further discussion regarding proposed rule 12d1-4, please see the January 22, 2018 Davis Polk Client Memorandum, **SEC Proposes Rule Changes for Fund of Funds Arrangements**.

Provisional 12(d)(1) Relief

According to the Adopting Release, ETFs relying on the Final Rule that do not have existing exemptive relief from sections 12(d)(1)(A) and (B) and section 17(a)(1) and (2) of the Investment Company Act "may enter into fund of funds arrangements as set forth in [the SEC's] recent ETF exemptive orders, provided that they satisfy the terms and conditions for fund of funds relief in those orders." This is a new portion of the Final Rule that was not included in the Proposed Rule, and has been added to ensure that "new entrants to the ETF market" would not be at a disadvantage to those existing ETFs that have this fund of funds relief. According to the Adopting Release, this relief will only be available "until the effective date of a new [SEC] rule permitting registered funds to acquire the securities of other registered funds in excess of the limits in section 12(d)(1), including rule 12d1-4 if adopted."

Form Amendments

The Adopting Release notes that several amendments to Form N-1A, the registration form used by open-end funds to register under the Investment Company Act and to offer securities under the Securities Act of 1933 (the "**Securities Act**"), are being adopted to "provide ETF investors with additional information regarding ETF trading and associated costs," 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). However, the Final Rule streamlines several of the requirements from the Proposed Rule. For example, under the Proposed Rule, changes to Item 3 of Form N-1A, would have required additional fee and expense disclosures in a Q&A format. According to the Adopting Release, under the Final Rule, ETFs are not required to adopt a Q&A format and may post certain cost information on their websites rather than in their registration statement. Under the Final Rule, ETFs are required to add the following language to the disclosure required under Item 3 of Form N-1A for all registrants: "You may pay other fees not described below, such as brokerage commissions and other fees to financial intermediaries,

which are not reflected in the tables and examples below." Additionally, under the Proposed Rule, amendments to Item 3 would have included information in the fee table disclosure regarding costs associated with trading shares of an ETF, including information on the bid-ask spread and how that would impact investment returns. However, the Final Rule instead adopts amendments to Item 6, which "(i) will require an ETF to provide narrative disclosure identifying specific costs associated with buying and selling ETF shares and directing investors to its website for additional information; and (ii) allow an ETF that is not subject to [the Final Rule] the option to provide disclosure regarding the ETF's median bid-ask spread [for the most recent fiscal year] on its website or in its prospectus." According to the Adopting Release, Form N-1A will further require an ETF not relying on the Final Rule that chooses to disclose premium and discount information on its website to do so in conformity with the requirements in the Final Rule. The Final Rule also requires disclosure regarding an ETF's bid-ask spread and secondary market transaction as part of Item 6 of Form N-1A. The Adopting Release notes that moving this disclosure from Item 3 to Item 6 of Form N-1A, may help "avoid overemphasizing these costs."

In addition, under the Proposed Rule the amendments to Form N-1A would have required an ETF to provide: "(i) examples in the ETF's prospectus showing how bid-ask spreads impact the return on a hypothetical investment for both buy-and-hold and frequent traders; and (ii) an interactive calculator in a clear and prominent format on the ETF's website that would allow an investor to customize the hypothetical bid-ask spread calculations to its specific investing situation." In response to concerns raised by commenters regarding the operational cost and utility of these requirements, the Final Rule eliminates the bid-ask spread examples and interactive calculator requirements. Additionally, certain other form amendments include: (i) an additional requirement that an ETF's summary prospectus or summary section cross-reference the ETF's website; (ii) the elimination of premium and discount requirements in Items 11(g)(2) and 27(b)(7)(iv) of Form N-1A for ETFs relying on the Final Rule; (iii) the elimination of the requirement to specify the number of shares an ETF issues or redeems in exchange for "the deposit or delivery of basket assets"; and (iv) the elimination of certain disclosures only applicable to "ETFs that issue or redeem shares in creation units of less than 25,000."

In addition, the Final Rule will amend Form N-8B-2, the registration form used by UIT ETFs to register under the Investment Company Act, requiring disclosures "regarding ETF trading and the associated costs" that mirror the disclosure changes in Form N-1A for ETFs organized as open-end funds in order to ensure that investors "receive consistent disclosures for ETF investments, regardless of the ETF's form of organization." The Final Rule will also amend Form N-CEN to, among other things, add a requirement that ETFs report if they are relying on the Final Rule.

Implications for UIT ETFs

As discussed above, UIT ETFs cannot rely on the Final Rule because the SEC believes these types of ETFs should "continue operating pursuant to their exemptive orders, which include terms and conditions more appropriately tailored to address the unique features of a UIT." According to

the Adopting Release, the SEC "acknowledge(d) that excluding UIT ETFs will result in a segment of ETF assets outside the regulatory framework of [the Final Rule]. However, [the SEC does] not believe there is a need to include UIT ETFs within the scope of the [Final Rule] given the limited sponsor interest in developing ETFs organized as [unit investment trusts]." Consistent with the Proposed Rule, the Final Rule will not rescind existing exemptive orders that allow UIT ETFs to operate.

Although UIT ETFs are excluded from the scope of the Final Rule, as discussed above, they will be subject to form amendments to Form N-8B-2, which will require UIT ETFs to provide "certain additional disclosures regarding ETF trading costs." The Adopting Release noted that these form amendments under the Final Rule will require UIT ETFs to provide "disclosures similar to those provided by other ETFs that are subject to the Investment Company Act." In particular, they will be required to, among other things, "furnish an explanation [in the prospectus] that an ETF investor may pay additional fees not described by any other item in [Form N-8B-2], such as brokerage commissions and other fees to financial intermediaries[,]" as well as "provide a table [in the prospectus] showing the number of days the [m]arket [p]rice of the [ETF] shares was greater than the [ETF's] net asset value and the number of days it was less than the [ETF's] net asset value…for the most recently completed calendar year, and the most recently completed calendar quarters since that year." With respect to the requirement to disclose the table noted above, an ETF may omit such information if it complies with sections (c)(1)(ii)-(iv) and (v) of the Final Rule, which require daily website disclosure of related information. Additionally, UIT ETFs will be required to disclose in its prospectus: (i) that individual ETF shares may only be bought and sold through a broker dealer in the secondary market at a market price; (ii) that since ETF shares "trade at market prices rather than net asset value, shares may trade at a price greater than net asset value (premium) or less than net asset value (discount)"; (iii) "[t]hat an investor may incur costs attributable to the difference between the highest price a buyer is willing to pay to purchase shares of the [ETF] (bid) and the lowest price a seller is willing to accept for shares of the [ETF] (ask) when buying or selling shares in the secondary market"; (iv) "[i]f applicable, how to access recent information, including information on the [ETF's] net asset value, [m]arket [p]rice, premiums and discounts, and bid-ask spreads, on the [ETF's] website"; and (v) the ETF's median bid-ask spread for the most recent fiscal year. Further, with respect to (v) above, the ETF may omit this information if it if complies with section (c)(1)(v) of the Final Rule, which requires daily website disclosure of similar information.

Exchange Act Order

According to the SEC's press release issued in connection with the adoption of the Final Rule (the "**Press Release**"), in addition to adopting the Final Rule and form amendments under the Investment Company Act (and related form changes), the SEC has also issued an exemptive order (the "**Exchange Act Order**") that "harmonizes certain related relief" under the Exchange Act. The Exchange Act Order provides conditional exemptive relief to broker-dealers and other persons from certain requirements under

the Exchange Act with respect to ETFs that fall within the scope of the Final Rule and that satisfy certain requirements. The Press Release noted that these requirements are "designed to protect investors, including [by requiring compliance with] conditions regarding transparency and disclosure." According to the Exchange Act Order, "commenters on [the Proposed Rule] also recommended that the [SEC] harmonize with [the Final Rule] certain Exchange Act relief that ETFs currently rely on in order to operate, including relief from section 11(d)(1) of the Exchange Act and Exchange Act rules 10b-10, 15c1-5, 15c1-6, and 14e-5." The Exchange Act Order notes that "broker-dealers and certain other persons that engage in these transactions and satisfy the conditions [noted in the order], as applicable, would not raise the issues or concerns that underlie those provisions."

In order for a broker-dealer to rely on the Exchange Act Order (other than with respect to the relief from rule 14e-5), a transaction must involve an ETF that satisfies the diversification requirement applicable to regulated investment companies in Internal Revenue Code section 851(b)(3)(B), meaning that an ETF must generally have not more than 25% of the value of its total assets invested in: (i) securities (other than government securities or securities of other regulated investment companies) of any one issuer; (ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the ETF controls and which are determined, under regulations prescribed by the Secretary of the Treasury, to be engaged in the same or similar trades or businesses or related trades or businesses; or (iii) the securities of one or more qualified publicly traded partnerships.

The Exchange Act Order grants exemptions from certain requirements under the Exchange Act for qualifying ETFs, including:

- Section 11(d)(1): Section 11(d)(1) prohibits a broker-dealer from extending, maintaining or arranging for credit on a security for which the broker-dealer acted as a distribution participant within 30 days. The Exchange Act Order grants an exemption from this restriction for an authorized participant that is a registered broker-dealer ("**Broker-Dealer AP**"), subject to certain conditions. The conditions require: (i) that the Broker-Dealer AP may not directly or indirectly (including through any affiliate) receive from the fund complex any payment, compensation or other economic incentive to promote or sell the shares of the ETF to persons outside the fund complex, other than certain non-cash compensation currently permitted under Financial Industry and Regulatory Authority rule 2341(l)(5)(A), (B), or (C); and (ii) that the Broker-Dealer AP does not "extend, maintain or arrange for the extension or maintenance of credit to or for a customer on shares of the ETF before thirty days have passed from the date that the ETF's shares initially commence trading." The Exchange Act Order also provides an exemption from section 11(d)(1) for a broker-dealer that transacts in shares of an ETF relying on the Final Rule, "exclusively in the secondary market, when it extends or maintains or arranges for the extension or maintenance of credit to or for customers on such ETF shares."
- Rule 10b-10: According to the Exchange Act Order, rule 10b-10 requires a broker or dealer that effects a securities transaction for a customer to send the customer, at or before the completion of the transaction, a written confirmation disclosing certain information, including the identity, price, and number of share or units (or principal amount) of the security. According to the Exchange Act Order, when a Broker-Dealer AP engages in creation and redemption transactions for its customers, each tender or receipt of a component security of a basket is considered a purchase or sale of a security, which requires a confirmation statement. The Exchange Act Order grants an exemption from this requirement that will allow a Broker-Dealer AP effecting an in-kind creation or redemption transaction to confirm the transaction "without providing a contemporaneous statement of the identity, price or number of

shares or units (or principal amount) of each component security tendered to or delivered by the ETF," subject to the following conditions: (1) the confirmation statements must contain all the information specified in paragraph (a) of rule 10b-10 other than identity, price, and number of shares or units (or principal amount) of each component security tendered or received by the customer in the transaction; (2) any confirmation statement of an issuance or redemption transaction in ETF shares that omits the identity, price, or number of shares or units (or principal amount) of component securities must contain a statement that such omitted information will be provided to the customer upon request; and (3) all such requests must be fulfilled in a timely manner in accordance with rule 10b-10.

- Rules 15c1-5 and 15c1-6: According to the Exchange Act Order, rule 15c1-5 requires broker-dealers effecting transactions to disclose "any control relationship with an issuer of a security that [the broker-dealer] purchases for or sells to a customer." Rule 15c1-6 requires broker-dealers to disclose their participation or interest in a primary or secondary distribution of a security that they "purchase for or sell to a customer." The Exchange Act Order grants an exemption from these requirements for a broker-dealer "effecting an in-kind creation or redemption transaction on behalf of a customer to effect that transaction without providing [the required] disclosure[,]" subject to the condition that broker-dealers provide any information to which a customer is entitled under rules 15c1-5 and 15c1-6 upon request and fulfill such requests in a timely manner.

"Covered Person" is defined in rule 14e-5 to mean: "(i) The offeror and its affiliates; (ii) The offeror's dealer-manager and its affiliates; (iii) Any advisor to any of the persons specified in [(i) and (ii) above], whose compensation is dependent on the completion of the offer; and (iv) Any person acting, directly or indirectly, in concert with any of the persons specified in this paragraph…in connection with any purchase of arrangement to purchase any [S]ubject [S]ecurities or any [R]elated [S]ecurities."

- Rule 14e-5: According to the Exchange Act Order, rule 14e-5 "prohibits 'covered persons' from directly or indirectly purchasing or arranging to purchase any securities that are the subject of a tender offer ("**[S]ubject [S]ecurities**") or any securities that are immediately convertible into, exchangeable for, or exercisable for subject securities ("**[R]elated [S]ecurities**") except as part of such tender offer." The Exchange Act Order states that the term "covered person" includes, among others, "a dealer-manager of a tender offer and any person acting, directly or indirectly, in concert with other covered persons in connection with any purchase or arrangement to purchase any [S]ubject [S]ecurities or any [R]related [S]ecurities." The Exchange Act Order grants an exemption to an ETF as well as "the legal entity of which the ETF is a series, and authorized participants and any other persons who create and redeem shares of the ETF in creation units pursuant to contractual arrangements pertaining to such legal entity and the ETF, and who are covered persons with respect to a tender offer involving an ETF's component securities." The exemption allows such persons to (i) "to redeem ETF shares in creation unit sizes for a redemption basket that may include a [S]ubject [S]ecurity or [R]elated [S]ecurity, (ii) to engage in secondary market transactions with respect to the ETF shares after the first public announcement of the tender offer and during such tender offer given that such transactions could include, or be deemed to include, purchases of, or arrangements to purchase,

[S]ubject [S]ecurities or [R]elated [S]ecurities, and (iii) make purchases of, or arrangements to purchase, [S]ubject [S]ecurities or [R]elated [S]ecurities in the secondary market for the purpose of transferring such securities to purchase one or more creation units of ETF shares." Reliance on the exemption is subject to the following conditions: (1) no purchase of Subject Securities or Related Securities made by a broker-dealer acting as a dealer-manager of a tender offer will be effected for the purpose of facilitating a tender offer; (2) if the basket transactions do not qualify for the rule 14e-5(b)(5) exception (*e.g.,* because it has fewer than 20 Subject Securities or Related Securities or the Subject Securities and Related Securities make up more than 5% of the value of the basket), then any purchases of an ETF component security by that dealer-manager "will be effected for the purpose of adjusting a basket of securities in the ordinary course of its business and not for the purpose of facilitating a tender offer"; and (3) any broker-dealer acting as a dealer-manager of a tender offer will otherwise comply with Rule 14e-5.

Comparison of Proposed Rule and Final Rule

The following table compares the main elements of the Proposed Rule and the Final Rule.

Description of Provision	Proposed Rule	Final Rule
UITs	Not included in automatic exemptive relief.	Not included in automatic exemptive relief.
Actively Managed ETFs	Included in automatic exemptive relief.	Included in automatic exemptive relief.
Index ETFs	Included in automatic exemptive relief.	Included in automatic exemptive relief.
Leveraged ETFs	Explicitly excluded from automatic exemptive relief.	Not included in automatic exemptive relief.
Non-Transparent ETFs	Not discussed.	Not included in automatic exemptive relief.
Custom baskets	Permits ETF to construct baskets using cash, securities or other positions, provided that ETF satisfies certain specified conditions.	Adopted as proposed.
Automatic section 12(d)(1) relief	Not included.	Automatic relief allowing ETFs that do not have existing exemptive relief from sections 12(d)(1)(A) and (B) to rely on the same 12(d)(1) relief granted in recent exemptive orders.
Portfolio transparency	Full portfolio transparency required for all ETFs.	Adopted as proposed, except:

Description of Provision	Proposed Rule	Final Rule
requirements		Does not require portfolio holdings disclosure to be provided each business day before opening of trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting creation and redemption orders; instead requires the ETF to disclose the portfolio holdings that will form the basis for the ETF's next calculation of NAV per share each business day before regular trading on the primary listing exchange of the ETF's shares. Does not require portfolio holdings to include information prescribed by Article 12 of Regulation S-X; instead requires disclosure of a limited set of information for each holding on a daily basis.
Additional time for delivering redemption proceeds		
Allowance to delay redemption in certain scenarios for ETFs with foreign investments	As soon as practicable up to 15 days plus 10-year sunset provision.	As soon as practicable up to 15 days. Eliminates sunset provision.
Requirement to disclose in registration statement the foreign holidays that may delay redemption	Not required.	Not Required.
Definition of "foreign investment"	Any security, asset or other position of the ETF issued by a foreign issuer (as defined by rule 3b-4 under the Exchange Act) for which there is no established U.S. public trading market.	Any security, asset or other position of the ETF issued by a foreign issuer (as defined in rule 3b-4 under the Exchange Act) and that is traded on a trading market outside of the United States.
Requirement to disseminate the	Not required.	Not required.

Description of Provision	Proposed Rule	Final Rule
Intraday Indicative Value (IIV) at regular intervals during the trading day		
Requirement to post at least one published basket on the ETF's website	Required.	Not required.
Rescission of exemptive orders	Rescinds most (but not all) orders one year after the rule goes into effect, but preserves the section 12(d)(1) relief provided in existing orders.	Adopted as proposed, except that ETFs relying on the Final Rule that do not already have exemptive relief from sections 12(d)(1)(A) and (B) and 17(a)(1) and (2) may operate pursuant to, and subject to the conditions of, certain exemptive orders recently issued to other ETFs.
Website Disclosure	Each ETF must post on its website:	Each ETF must post on its website:
Portfolio Transparency Requirements	See above.	See above.
Published Basket	See above.	See above.
Daily Disclosure	An ETF's NAV, market price and premium or discount, as of the end of the prior business day.	Adopted as proposed.
Bid-Ask Spread Disclosure	Historical information regarding the median bid-ask spreads for an ETF's shares over the most recent fiscal year. Also required disclosure in an ETF's registration statement.	Requires most recent 30 days rather than most recent fiscal year. Provides a formula for calculating the median bid-ask spread information by reference to an ETF's national best bid and national best offer as of that time. No required disclosure in an ETF's registration statement.

Description of Provision	Proposed Rule	Final Rule
Premium/Discount Disclosure	Historical information about the extent and frequency, in a table and line graph, describing an ETF's premiums and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year. If an ETF's premium or discount is greater than 2% for more than seven consecutive trading days, ETF must post such information on its website and disclose the "factors that are reasonably believed to have materially contributed to the premium or discount." Information must be posted on the trading day immediately following the eighth trading day on which the ETF had a premium or discount greater than 2%, and must remain on the website for one year after its initial posting.	Adopted as proposed.

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