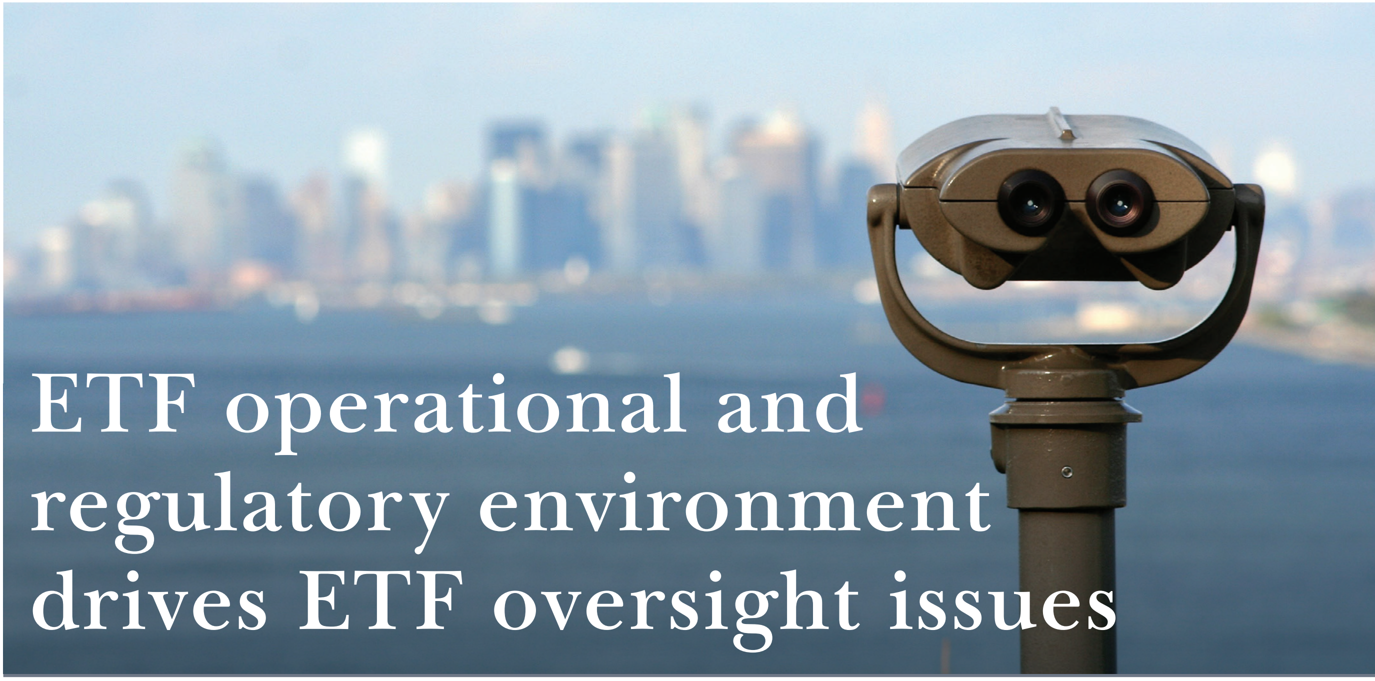

ETF operational and regulatory environment drives ETF oversight issues

Nuances present oversight considerations distinct from their mutual fund counterparts

By Peter Shea, Timothy Bekkers and George Attisano

Exchange-traded funds share many governance oversight characteristics with traditional mutual funds. While some ETFs have been structured as unit investment trusts that lack a board structure, most ETFs are classified as open-end investment companies governed by a board under the Investment Company Act of 1940 and subject to U.S. Securities and Exchange Commission jurisdiction. Nevertheless, ETFs have unique operational and regulatory characteristics that raise additional issues on which ETF board members must focus in discharging their oversight duties.

Operationally, ETFs typically create and redeem their shares in large blocks called creation units only with authorized broker-dealer participants (APs). Creation unit transactions occur at the ETF's net asset value per share. Many ETFs conduct these transactions on an in-kind basis where APs deliver or receive a proportional slice of the ETF's portfolio securities (a deposit basket). APs may deal in ETF shares with the public through the ETF's stock exchange at current trading prices. Individual investors can only buy and sell ETF shares through a broker at current exchange trading prices. This operational environment generates capital market data that will demand board attention.

To operate as an ETF, a 1940 Act exemptive order must have been issued by the SEC. For instance, 1940 Act Section 22(d) and Rule 22c-1 prevent exchange trading of mutual fund shares at prices that differ from a fund's next-computed NAV. Thus, compliance with an ETF's exemptive order's terms and conditions is a significant regulatory feature with ETF-specific governance oversight implications.

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Operational oversight

ETF boards receive and evaluate various types of quarterly reports that are unique to ETFs. For index-based ETFs, quarterly reports on the ETF's tracking error will be generated. For all ETFs, regular reports on ETF share trading price bid-ask spreads, trading volume, and premium/discount to NAV typically will be prepared for board review.

Tracking error

An index-based ETF seeks to replicate the performance of a specified financial index as its stated investment objective. The deviation in ETF performance from underlying index performance is tracking error. A full index replication strategy tends to minimize tracking error. Alternatively, a representative sampling strategy can be pursued where less than all the component securities of the underlying index are represented in the ETF portfolio. Representative sampling typically increases tracking error. Regulatory investment limitations, such as portfolio diversification requirements or industry concentration limits, can also cause tracking error as can fair valuation issues, particularly for foreign securities. Tracking error will also increase due to poor portfolio management, and can be exacerbated when an ETF experiences significant redemptions.

High tracking error implies that the ETF is not meeting its investment objective. Higher tracking error also attracts SEC staff attention because the ETF's SEC relief will have representations as to the expected upper limit for tracking error. Persistent and significant tracking error is a red flag for an ETF board. Board members should understand the expected sources of tracking error, the causes of changes in tracking error (positive or negative) and the ETF manager's remedies for tracking error.

Bid-ask spreads and trading volume

The difference in price at which a broker will contemporaneously buy or sell ETF shares is referred to as the bid-ask spread. Bid-ask spreads can widen for reasons such as a shallow market for the ETF's shares; low trading volume; a failure to successfully market the ETF to investors; and dysfunction by the market makers of the ETF's shares. The SEC staff is particularly concerned with chronically wide bid-ask spreads because large spreads are seen as the main obstruction to an ETF investor's ability to participate in the ETF's stated performance.

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Chronically low trading volumes for an ETF's shares indicate low investor demand for the ETF. Low trading volume for an ETF's shares can also result from many of the same causes of wide bid-ask spreads, but is typically more closely related to a lack of marketing for and investor interest in the ETF.

ETF boards usually receive quarterly reports detailing the trading days that the ETF's bid-ask spread exceeded particular ranges. These reports also will detail an ETF's average daily trading volume. If an ETF's bid-ask spreads are wide, or if average daily trading volume is persistently low, boards need to understand the reasons why and what corrective steps fund management will take.

Premium/discount to NAV

A key feature of the ETF market is the ability of APs to arbitrage the market price at which an ETF trades against the NAV of the ETF's portfolio securities. An ETF's trading price will primarily vary from its NAV based on ETF share supply and demand.

If an ETF's trading prices are at a premium to its NAV, an AP can:

- Buy a deposit basket of securities required for creation unit transactions,
- Tender the deposit basket to the ETF to create creation units at NAV, and then
- Sell the newly created ETF shares on the exchange for an arbitrage profit.

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If trading prices are at a discount to NAV, an AP can:

- Buy the ETF's shares from the open market in creation unit aggregations,
- Redeem the creation units, and then
- Sell the deposit basket securities in the market for an arbitrage profit.

In a well-functioning market that is responsive to increases and decreases in the quantity of publicly traded ETF shares with corresponding ETF trading price changes, the premium or discount to NAV of an ETF should be within a narrow band typical of its ETF peer group universe. ETF boards receive quarterly premium/discount reports. Consistently high premiums or discounts may indicate that the AP arbitrage mechanism is not functioning properly or that the lack of investor interest in the ETF is severe. Ultimately, failure of the arbitrage mechanism may impair the ETF's ability to comply with its investment objective. A board should understand why larger premium or discount conditions exist and what remedial steps the ETF's sponsor will be taking.

Regulatory oversight

The SEC exemptive order that an ETF relies upon has representations and conditions that need to be observed. The full set of order representations and conditions will be found in the last amended application for the SEC order filed by the ETF sponsor. In addition to express conditions, many representations in the application are viewed by the SEC staff as further conditions to obtaining the order's relief.

All these conditions and representations eventually end up as a part of the ETF's compliance program. Consequently, board members need to pay particular attention to compliance failures involving breaches of the conditions and representations underlying the ETF's SEC order because loss of the relief can be fatal to continued operation as an ETF

Variations in deposit baskets

The SEC staff has a stated concern that large AP firms may attempt to overreach on ETF investors by trying to extract more favorable creation and redemption terms through improperly dictating what the contents of the deposit basket for their transaction will be. To date, no occurrence of such impropriety or overreach has been publicly acknowledged by the staff. Custom baskets are at variance from the standard deposit basket that contains a proportionate slice of the ETF's portfolio. SEC ETF orders dating from about 2010 to present permit custom baskets in very limited circumstances. Older SEC ETF orders are not so constrained, and can allow custom baskets for legitimate goals, such as tax harvesting in the portfolio for the benefit of ETF investors. Boards should be briefed by fund counsel of the custom basket limitations imposed by the relevant SEC order and monitor the ETF's compliance with those limitations.

ETF website

Each ETF must maintain a website on which it or a service provider posts certain information every trading day at specified deadlines as a condition of its SEC relief. The ETF board should receive reports from the ETF's adviser or administrator regarding any disruptions to the website or inaccurate data postings. The ETF board must focus on the continuous and accurate operation of the website and the parties responsible for maintaining the website because enormous liabilities under the ETF's exemptive order or to market participants could result from the website's failure to function properly.

ETF board members should be aware of these differences and the significance of these differences to the governance oversight functions of the board. ETF-specific data and reports will be presented to the board periodically, and board members need to understand them or seek advice from capable service providers to fulfill their oversight duties.