

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

K&L GATES

A blurred background image of a server rack with glowing lights in blue, yellow, and green.

2016 INVESTMENT MANAGEMENT CONFERENCE

# Exchange-Traded Funds (ETFs)

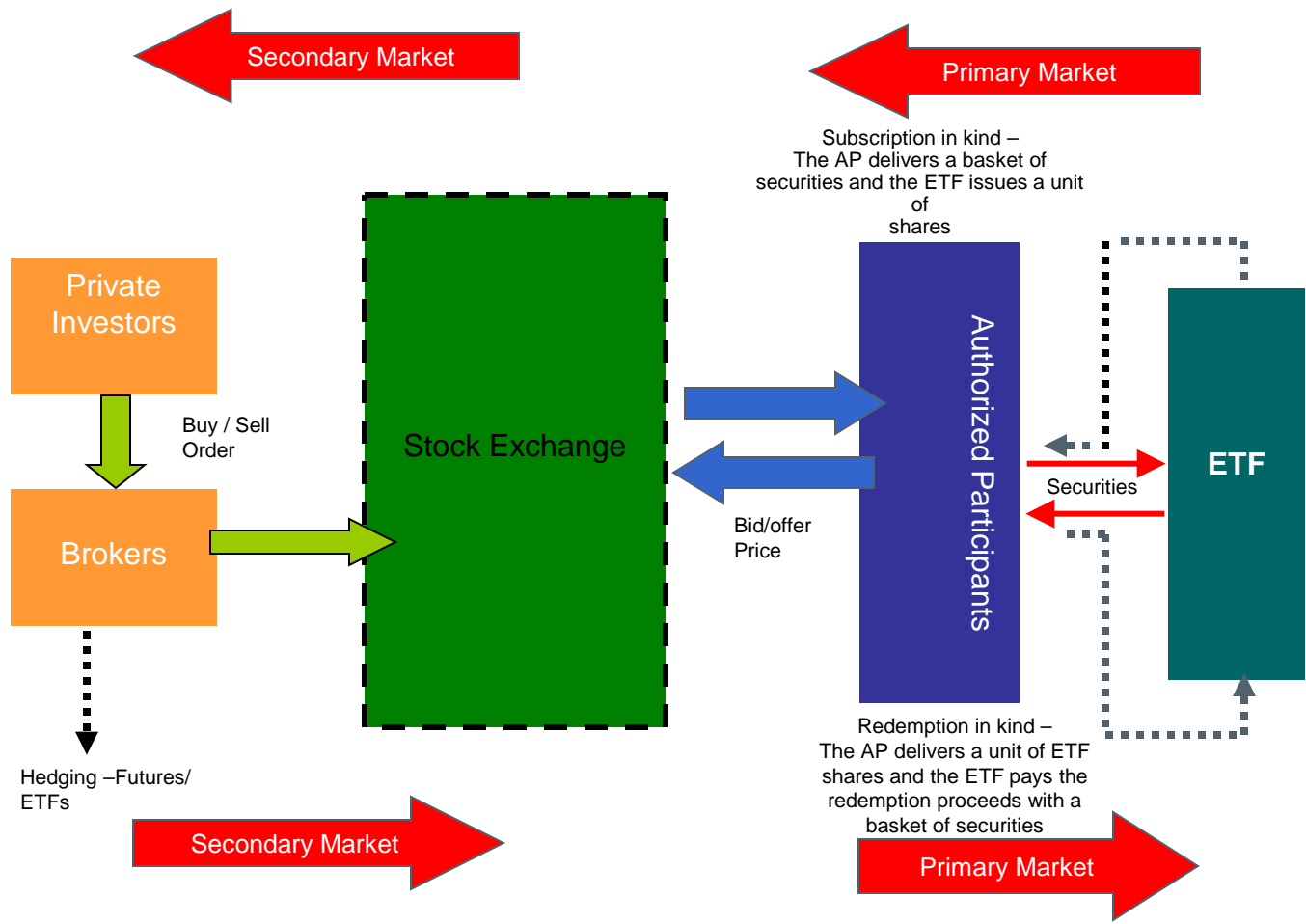
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# WHY ARE ETFs SOMETIMES REFERRED TO AS ETVs?

- ETVs – exchange-listed equity securities
  - ETVs: Generic term
  - ETPs: Commodity funds, currency funds
  - ETFs: Registered funds
- *Not* ETNs
  - Unsecured, debt securities
    - *Unlike ETVs, ETNs are not equity securities*

# HOW DO ETFS WORK?



## HOW DO ETFS WORK?

- ETFs sell and redeem their shares at NAV *directly* to unaffiliated broker-dealers with whom the ETF has entered into an agreement (“Authorized Participants”)
- These “primary market” transactions occur in large blocks of (at least 25,000) shares called “Creation Units”

## HOW DO ETFS WORK?

- Authorized Participants purchase and redeem Creation Units in-kind in exchange for the “Creation Basket”
  - *Pro rata* slice requirement
  - Exceptions to *pro rata* slice requirement
  - “Custom” baskets
- Authorized Participants (who purchase Creation Units) sell individual ETF shares on the stock exchange

# HOW DO RETAIL INVESTORS BUY ETFS?



- These transactions take place on the exchange between investors and their brokers and don't involve the ETF itself

## REGULATORY UPDATES – IMPACT ON ETFs

- Money Market Reform - Rule 2a-7
  - SEC Staff Position: ETFs cannot invest exclusively in 2a-7 instruments
- N-PORT/N-CEN
  - ETFs subject to same reporting as mutual funds
- Swing Pricing
  - ETFs not eligible
- Liquidity Rule

## N-PORT/N-CEN – IMPACT ON ETFS

- Form N-PORT
  - All ETFs are required to report portfolio-wide and position-level holdings data in XML format on Form N-PORT
- Form N-CEN
  - All ETFs required to complete Part E of Form N-CEN
  - All required to complete Parts A and B and Exhibits (G), and either Part C (if a management company) or Part F (if a UIT)
  - Also applicable to exchange-traded managed funds





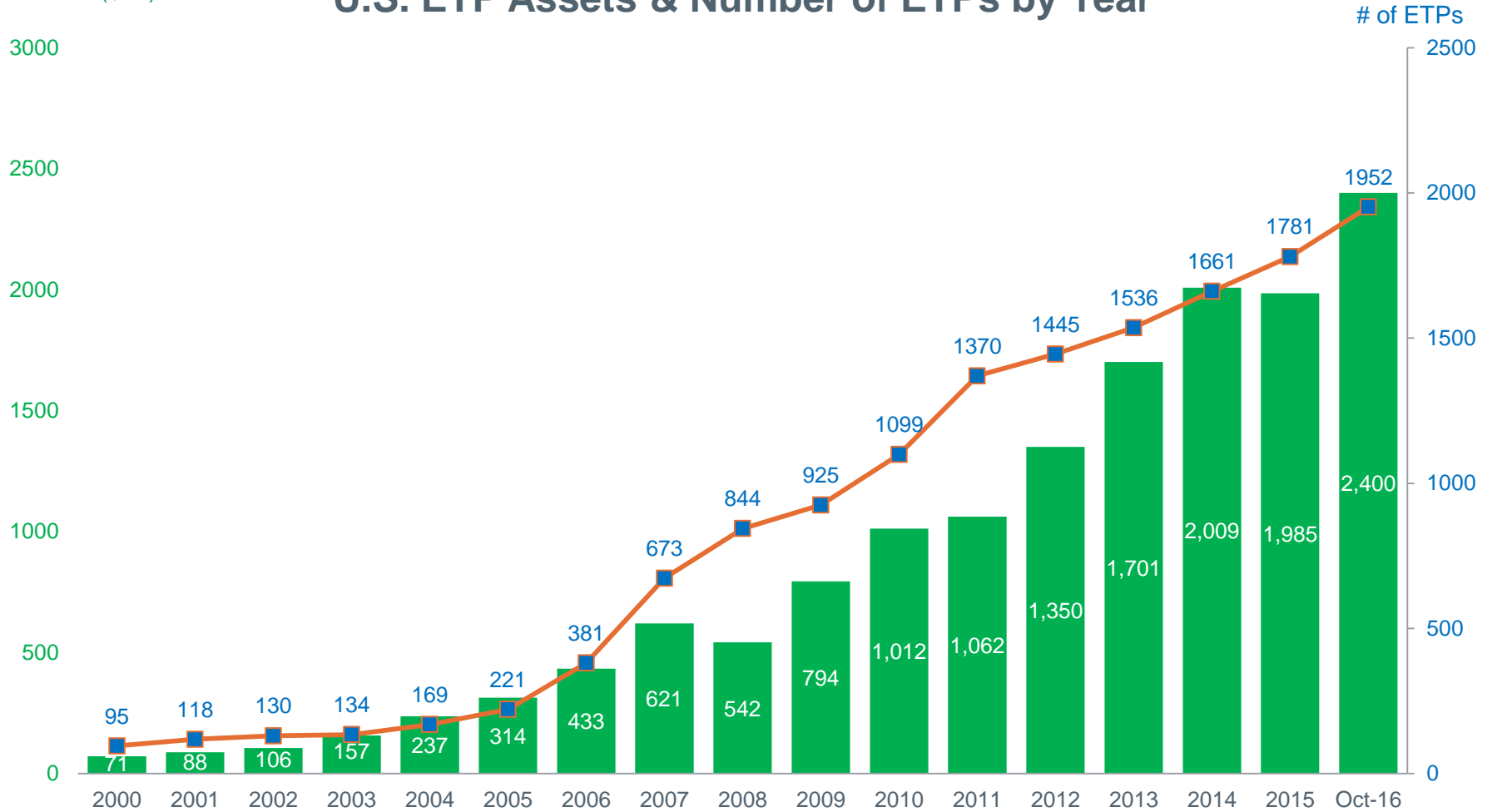
# LIQUIDITY RULE - IMPACT ON ETFs

- Liquidity Risk Management Program for ETFs
  - Assess, manage and review liquidity risk using ETF-related factors
  - Assign 1 of 4 “days-to-cash” buckets to each investment
  - Establish a highly liquid investment minimum
  - Stay below 15% limitation on illiquid investments
  - Provide disclosures on N-1A, N-PORT, N-CEN, N-LIQUID
- Exception = “In-Kind ETF”
  - Using more than *de minimis* amount of cash to meet redemptions disqualifies designation as In-Kind ETF
  - Liquidity Risk Management Program required with carveouts
    - No requirement to assign investments to 1 of 4 “days-to-cash” buckets
    - No requirement of highly liquid investment minimum
  - Must report designation as an In-Kind ETF on Form N-CEN

# BUSINESS CONSIDERATIONS

Assets (\$bn)

## U.S. ETP Assets & Number of ETPs by Year



# BUSINESS CONSIDERATIONS

## ETFs' popularity

- Changes in distribution models have increased demand by RIAs
  - Lower Expenses
    - Enhanced returns
  - Transparency
  - Tax Efficiency
  - Investor Protections
    - Intra-day liquidity
    - Market timing

## Hurdles to market entry

- Increased Regulatory Scrutiny
  - Market structure issues
- Strategy considerations
  - Passive market saturated
  - Active ETF issues
    - Small market segment
    - Portfolio transparency
    - Potential regulatory delays
  - “Smart-beta” alternatives
  - Non-transparent active ETFs

## WHAT IS "SMART BETA?"

- Bespoke indexing
  - Quantitative, normally, investment strategies
  - Reduced to algorithm
  - Full portfolio disclosure
- Variation: Index committee replaces algorithm
  - Potential for “closet” active management
  - SEC position

# IS NON-TRANSPARENT ACTIVE VIABLE?

- Non-Transparent Active ETF Hallmarks
  - Transparency substitute
  - Tax-efficiency



## IS NON-TRANSPARENT ACTIVE VIABLE?

- Precidian Proposal (“Blind Trust”)
  - IIV and “Reinforcement Learning”
- SEC Preliminary Denial
  - IIV
    - Stale (every 15 seconds)
    - Unreliable (no standard calculation methodology)
  - Reinforcement Learning
    - Statistical arbitrage
- Prologue: VIIV
  - Withdrawn by Precidian



# IS NON-TRANSPARENT ACTIVE VIABLE?

- Transparency Substitute
  - Tracking Portfolio
    - NYSE Arca (formerly AMEX) “Black Box”
  - Partial Transparency
    - Vanguard
    - T. Rowe Price

# SEC CONCERNS

## Transparency substitute

- Arbitrage mechanism

“A 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.”

- Statistical arbitrage
  - Market volatility
- Misleading baskets
- Front-running/free-riding

## Tax efficiency

- Role in 6(c) findings

- “necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the [Act]”



## OTHER STRUCTURES

### “ETMFS” (EATON VANCE)

- NAV-based trading
  - No intra-day pricing
  - No intra-day market risk for APs
  - Limited need for an arbitrage mechanism

“Because Share trading prices are based on end-of-day NAV, a market maker holding positions in Shares is not exposed to intraday market risk. Whether an ETMF’s underlying value goes up or down over the course of a trading day will not affect how much profit a market maker earns by selling (or buying) Shares in the market at a net premium (discount) to NAV... No intraday market risk means no requirement for intraday hedging, and therefore no associated requirement for the market maker to know the current composition of the ETMF’s non-Basket holdings.”

### “ETAFS” (FIDELITY)

- Closed-end fund with weekly repurchase offers
  - No need for relief from Section 22(d) and Rule 22c-1
  - Reduced pressure on effectiveness of arbitrage mechanism

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