

The image features a red rectangular box in the top left corner containing the text "K&L GATES" in white, bold, sans-serif font. The background is a dark blue gradient with a glowing effect, overlaid with a bar chart and a line graph. The bar chart has vertical bars of varying heights, and the line graph is a red line connecting several points. In the lower part of the background, there are horizontal lines of glowing blue binary code (0s and 1s).

K&L GATES

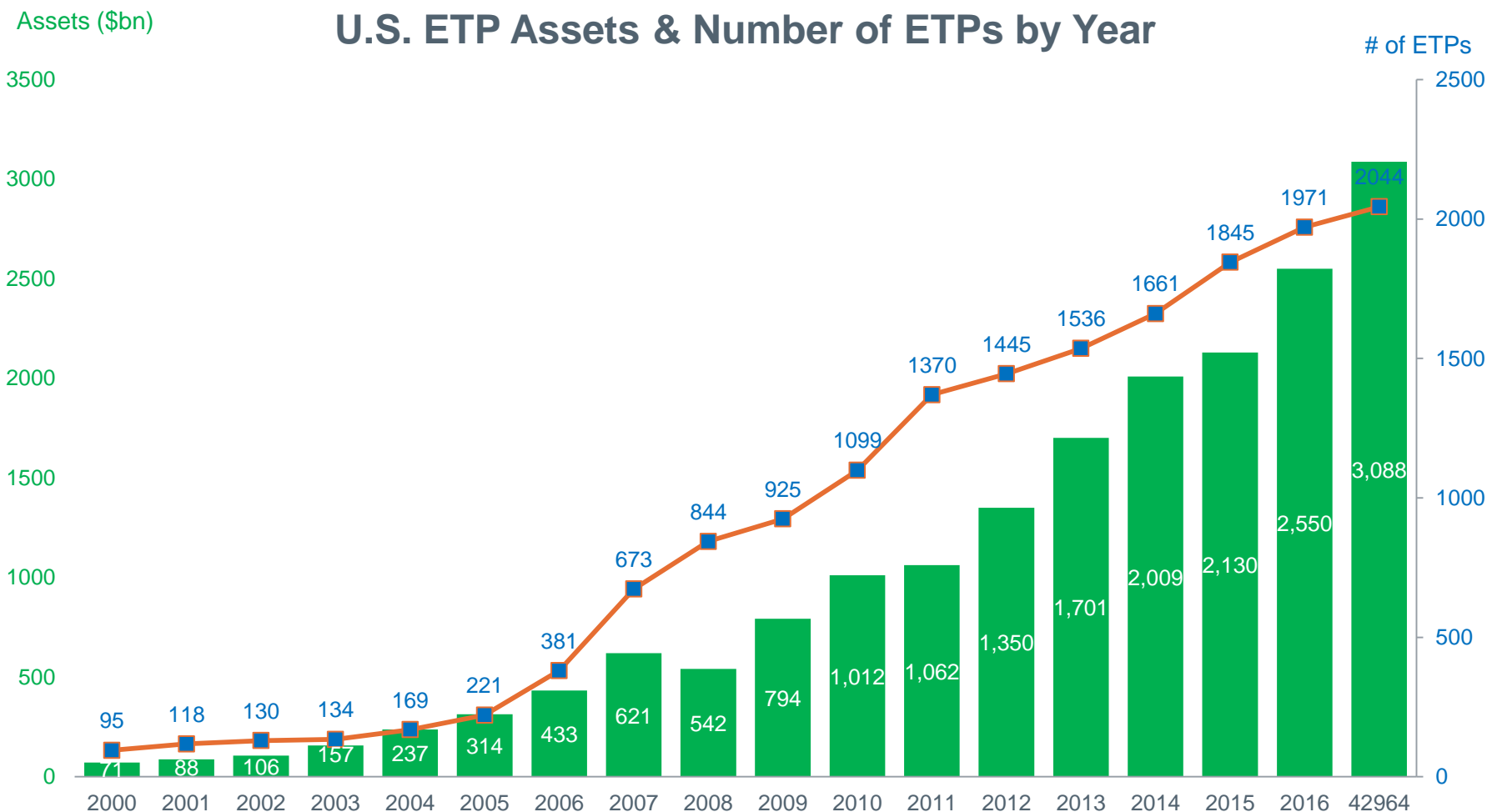
2017 BOSTON INVESTMENT MANAGEMENT CONFERENCE

Exchange-Traded Funds (ETFs)

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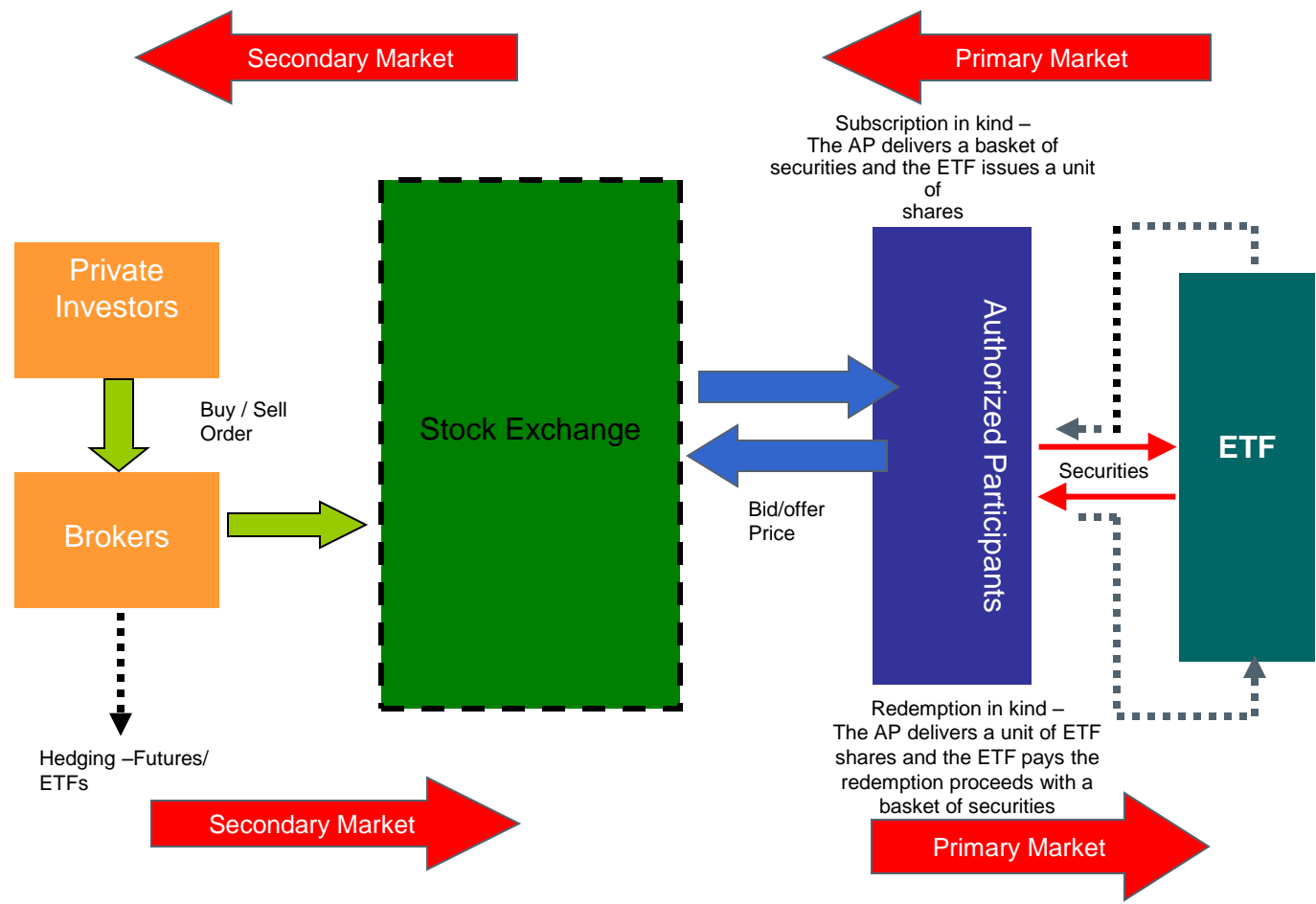
PART I: ETF MARKET DYNAMICS



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
- Not ETMFs
 - Mutual funds that trade on exchange
 - Intra-day pricing at premium/discount to end-of-day NAV

HOW DO ETFs WORK?

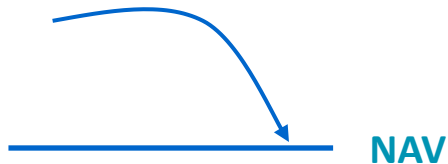


HOW DO ETFs WORK?

- 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
 - Recent exemptive applications filed with more flexible requirements
 - Potential for ETF rule that would change this dynamic
- Authorized Participants (who purchase Creation Units) sell individual ETF shares on the stock exchange

HOW DO ETFs WORK?

Market Price at
premium to NAV



1. Buy index portfolio, sell ETF short
2. Deliver index portfolio to create ETF at NAV
3. Close short by selling ETF at profit

OR

1. Create ETF shares at NAV
2. Sell them for a profit in the open market

NAV

Market Price at
discount to NAV



1. Buy ETF, sell index portfolio short
2. Redeem ETF at NAV in exchange for index portfolio
3. Close short by selling index portfolio at profit

OR

1. Buy ETF shares in the open market
2. Redeem block of ETF shares at NAV



This ensures that the ETF trades close to its NAV



The NAV does not change, the trading price does

ETFs

- What strategies have been permitted by the SEC to date?
 - Broad-based index ETFs
 - “Smart beta” (index) ETFs
 - Fully transparent actively managed ETFs
 - Exchange-traded managed funds (ETMFs)

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

PART II: BOARD OVERSIGHT OF ETFs

Overview

- Market Entry
 - Threshold Issues for Boards of fund groups seeking ETF market entry
- Regulatory/Structural Obligations
 - Exemptive order conditions for Board
 - Board duties under exchange listing standards
 - Contractual approvals
- Ongoing Reporting and Oversight
 - Tracking error, trading and NAV premium/discount
 - Customized compliance reporting to Board

MARKET ENTRY ISSUES – ETF BOARDS

- Issues for index-based and “smart beta” ETFs
 - Market saturation means challenges in availability of desirable indexes to track
 - Intense fee competition means to compete sponsor requires financial resources and economies of scale
 - No transaction fee ETF platform participation
 - Impact on comparable (mutual) fund
- Additional issues for “smart beta” ETFs:
 - Establishment of affiliated index provider
 - Costs
 - Feasibility of firewalls

MARKET ENTRY ISSUES – ETF BOARDS

- Issues for fully transparent active ETFs
 - Full portfolio transparency
 - Fiduciary duty concern
 - Impact on comparable (mutual) funds
 - Cannibalization
 - Unique concerns if – Master-feeder or ETF share class
 - Capacity constraints
 - ETFs may not be permitted to “close” (as mutual funds do when reaching capacity)
 - Strategy dilution

REGULATORY/STRUCTURAL OBLIGATIONS

- Exemptive order conditions
 - Exemptive orders have specific terms to be satisfied
 - Representations made to SEC staff and
 - Ongoing conditions
- Duties under stock exchange listing standards
 - ETFs have fewer regulatory duties than traditional exchange-listed (closed-end) mutual funds
 - Exchanges have initial + continuing listing standards
- Contracts and service providers
 - ETF-specific considerations for advisory, sub-advisory and distribution relationships
 - Index licensing fees, exclusivity, termination rights

ONGOING REPORTING AND OVERSIGHT

- Specialized Reporting
 - Index tracking error and correlation
 - Bid-Ask spreads and trading volume
 - NAV premium/discount
 - Custom baskets; in-kind redemptions
- Customized Compliance
 - Exception reports
 - Prospectus/SAI updates
- Importance of ETF Distribution
 - Number of APs and market makers
 - Trading volumes for APs and market makers

PART III INDUSTRY EXPECTATIONS – NEW DEVELOPMENTS

- Continuing Listing Standards
- Custom Baskets
- ETF Risk
- “True” Active ETFs
- Liquidity Risk Rule for ETFs

CONTINUING LISTING STANDARDS

- Effective for NYSE ARCA, BATS and NASDAQ on January 1, 2018
- Big impact on index ETFs
- New indices designed for ETFs need to bake New Listing Standards into index methodology
- Existing Indexes

CONTINUING LISTING STANDARDS

- SEC imposed on Exchanges
- Regulation of index providers
- Exchanges interpret their own rules
- Active ETFs vs. Index ETFs
 - ETF portfolio liquidity
 - Index component liquidity

CONTINUING LISTING STANDARDS

- US Equity Portion of Index
 - 90% minimum market value \geq \$75 million
 - 70% have:
 - Minimum Monthly Trade Volume: 250,000 shares or
 - 6-Month Average Monthly Trade Volume: \$25 million
 - Single Stock \leq 30%
 - Any 5 Stocks \leq 65%
 - Minimum 13 Stocks (unless component is index ETF or derivative are 100% of component)
 - All components are US listed and “NMS Stock” under Rule 600 of Reg. NMS

CONTINUING LISTING STANDARDS

- Similar standards for Non-US equity portions of Index
- Just as complicated for Fixed Income Indices

CUSTOM BASKET

- Deposit Basket is different for Creations and Redemptions
- Deposit Basket varies on single day for certain AP
- Deposit Basket contains cash (outside fixed allowances)
- Used to benefit ETF shareholders: tax harvesting, portfolio management efficiencies, etc.

CUSTOM BASKETS

- Since 2012 SEC restricted ability of ETFs to deal in custom baskets
- Current Restriction: Proportionate Share of Portfolio with very limited exceptions
- SEC feared abuse/overreach by APs on ETFs – without evidence
- Still no evidence of abuse
- Tilted Playing Field

CUSTOM BASKETS

- Solution:
 - Exemptive Relief
 - No-Action
 - Risk

ETF RULE

- Time is Ripe – Commission Staffing & Priorities
- Level the Playing Field

“TRUE” ACTIVE ETFs

- Semi-Transparent
 - Proposals on a continuum of disclosure: Current, fully-transparent, active ETFs vs. mutual fund disclosure standard
 - Proxy Portfolios
 - NAV & iNAV - only
- Semi-Transparent Active ETF Hallmarks
 - Transparency substitute
 - Tax-efficiency
- Arbitrage & Actual Portfolio Replication

“TRUE” ACTIVE ETFs - SEC INTERESTS

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]”

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



Questions?

