2017 WASHINGTON D.C. INVESTMENT MANAGEMENT CONFERENCE

Exchange-Traded Funds (ETFs)

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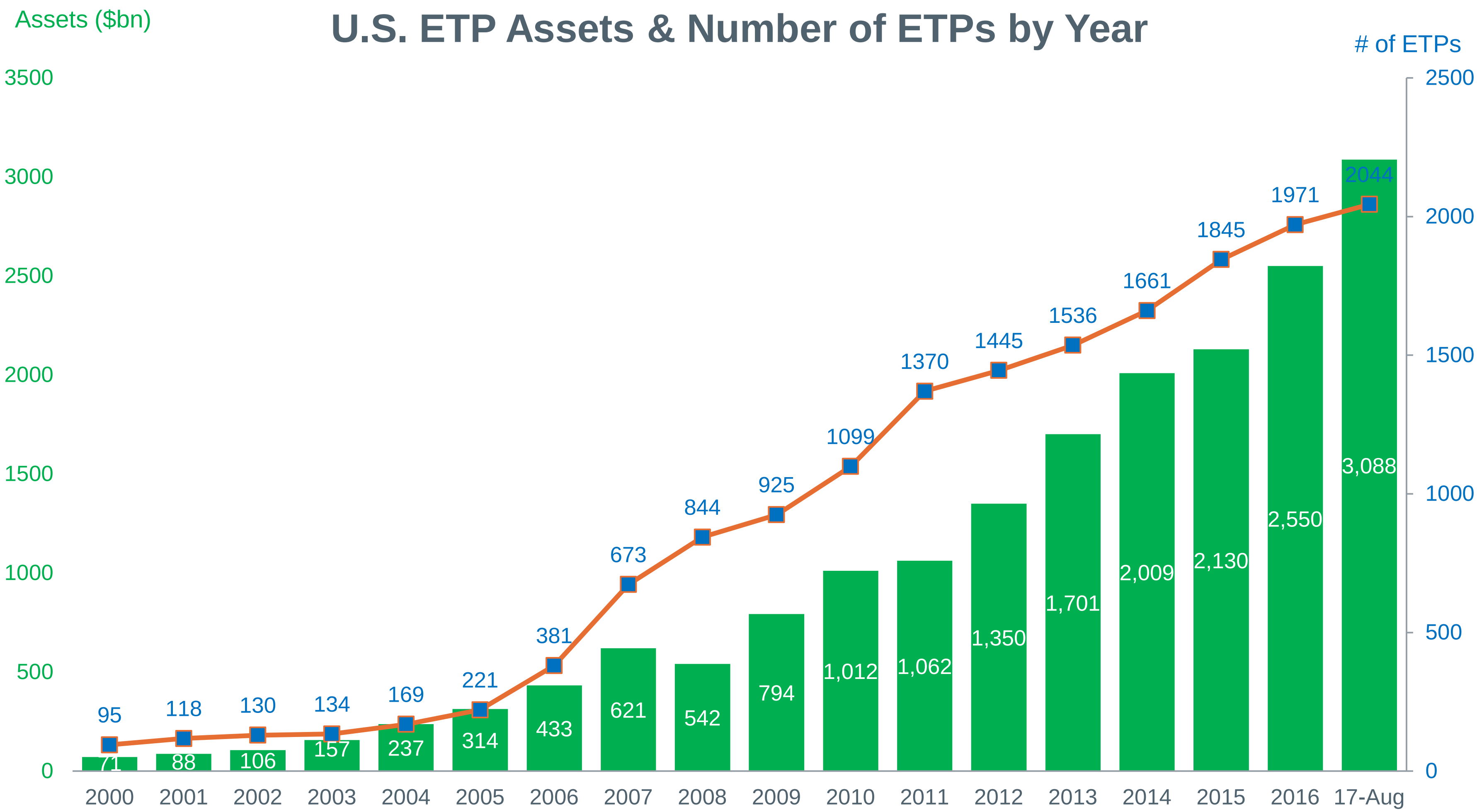
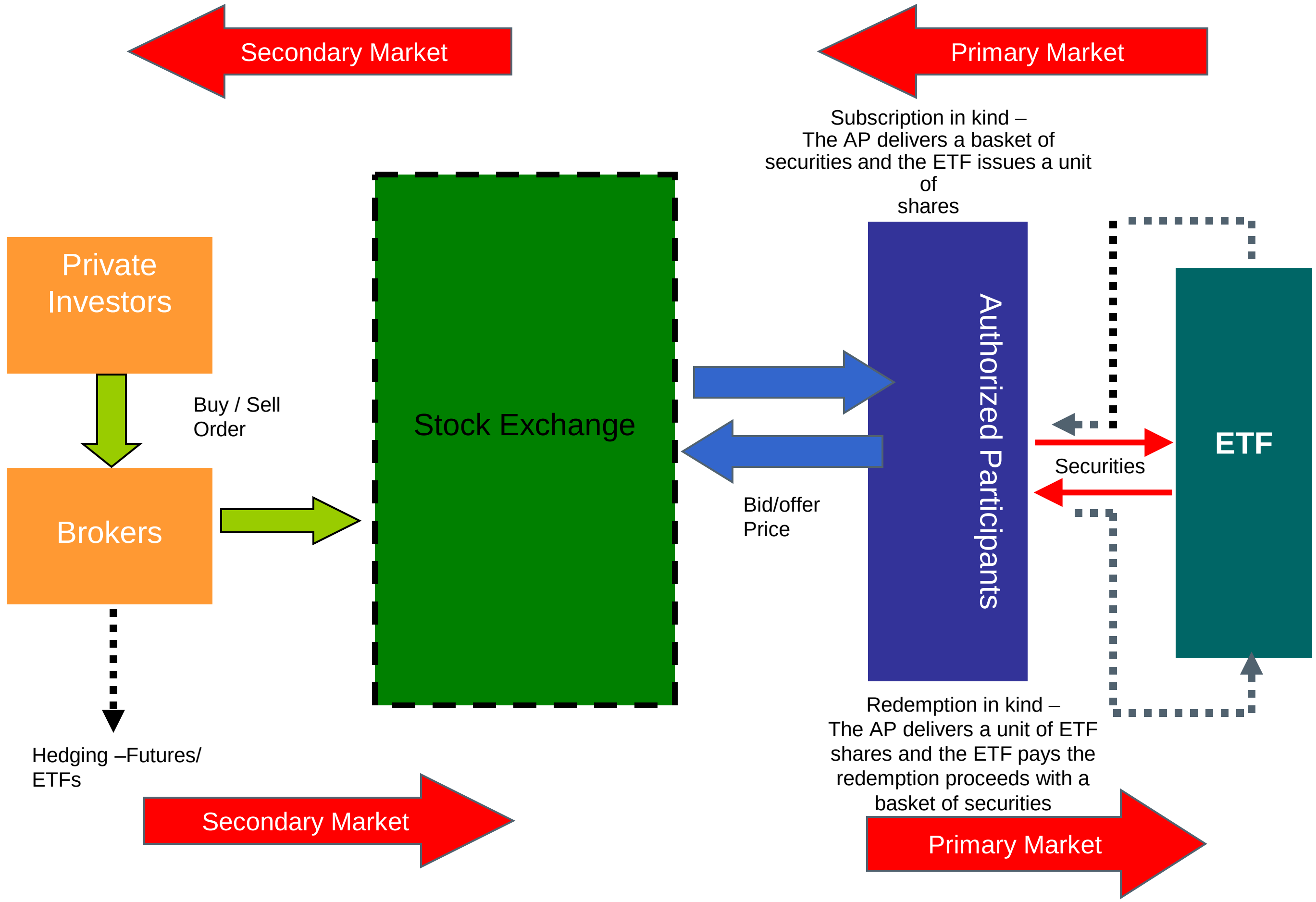
BUSINESS CONSIDERATION



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
  - Overview of ETMFs

HOW DO ETFS WORK?



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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"

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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

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REGULATORY UPDATE – IMPACT ON ETFS

- N-PORT/N-CEN
  - ETFs largely subject to same reporting as mutual funds plus additional reporting
- Swing Pricing
  - ETFs not eligible
- Liquidity Rule
- Continued Listing Standards
- FAIRA

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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)

LIQUIDITY RULE - IMPACT ON ETFs

- Liquidity Risk Management Program for ETFs
  - Assess, manage and review liquidity risk using ETF-related factors
  - Assign 1of 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 <u>with carveouts</u>
    - <u>No requirement</u> to assign investments to 1 of 4 “days-to-cash” buckets
    - <u>No requirement</u> of highly liquid investment minimum
  - Must report designation as an In-Kind ETF on Form N-CEN

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
- Impact of Fiduciary Rule, MiFID II and trend towards passive investing

Hurdles to market entry

- Increased Regulatory Scrutiny
  - Market structure issues
- Strategy considerations
  - Passive market somewhat saturated in areas
  - Active ETF issues
    - Somewhat smaller market segment
    - Portfolio transparency
  - "Smart-beta" alternatives
  - Semi/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

SEMI/NON-TRANSPARENT ACTIVE

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

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]"

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