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2018 WASHINGTON D.C. INVESTMENT MANAGEMENT CONFERENCE

Exchange-Traded Funds (ETFs)

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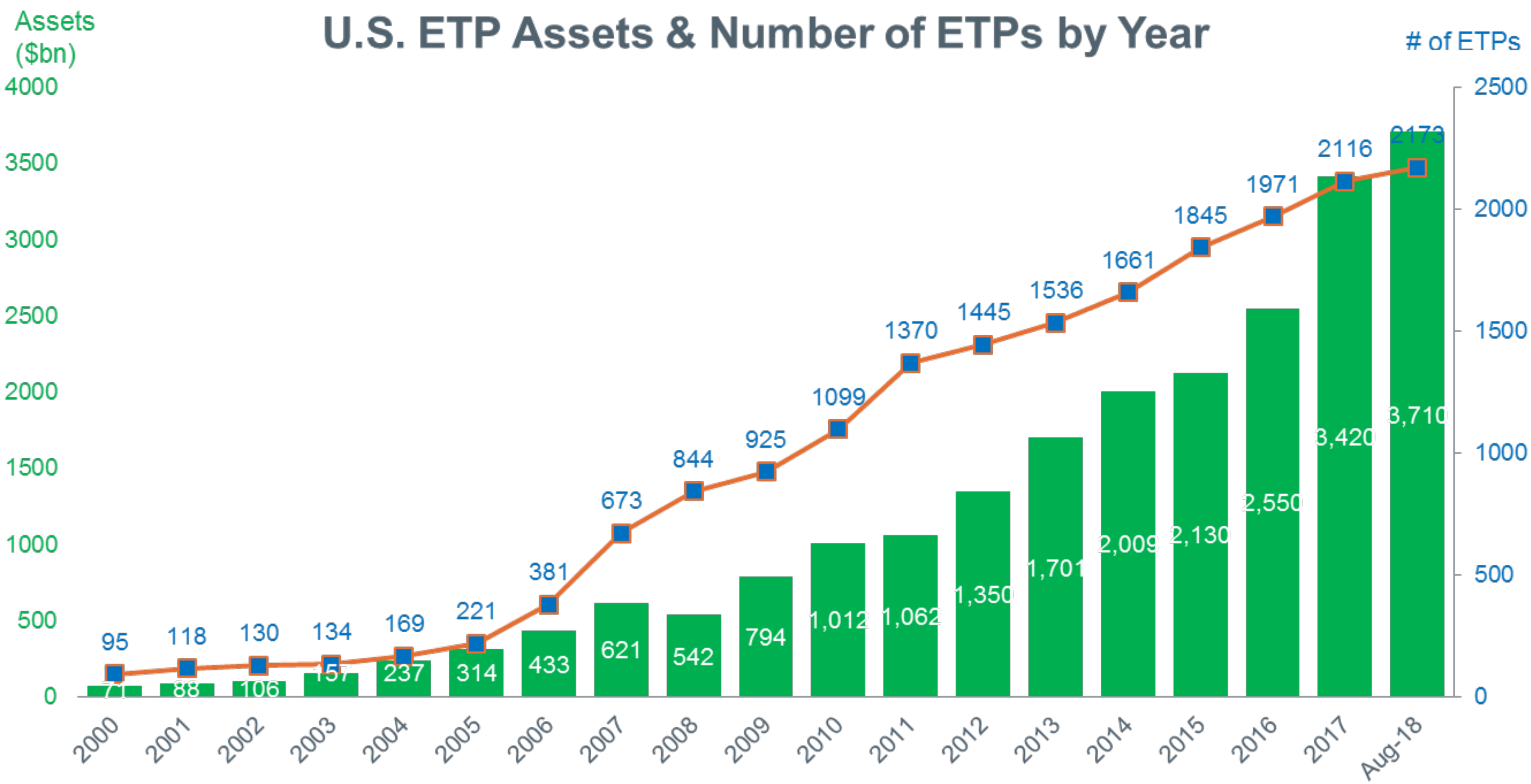
BUSINESS CONSIDERATIONS



BUSINESS CONSIDERATIONS

ETFs' popularity

- Changes in distribution models have increased demand by RIAs, Roboadvisers
  - Lower Expenses
    - Enhanced returns
  - Transparency
  - Tax Efficiency
  - Investor Protections
    - Intra-day liquidity
    - Market timing
- Impact of Fiduciary Rule, MiFID II and trend toward passive investing

Hurdles to market entry

- Strategy considerations
  - Broad-based passive market saturated
  - Active ETF issues
    - Smaller market segment
    - Portfolio transparency
  - "Smart-beta" alternatives
  - Periodically Disclosed Active ETFs

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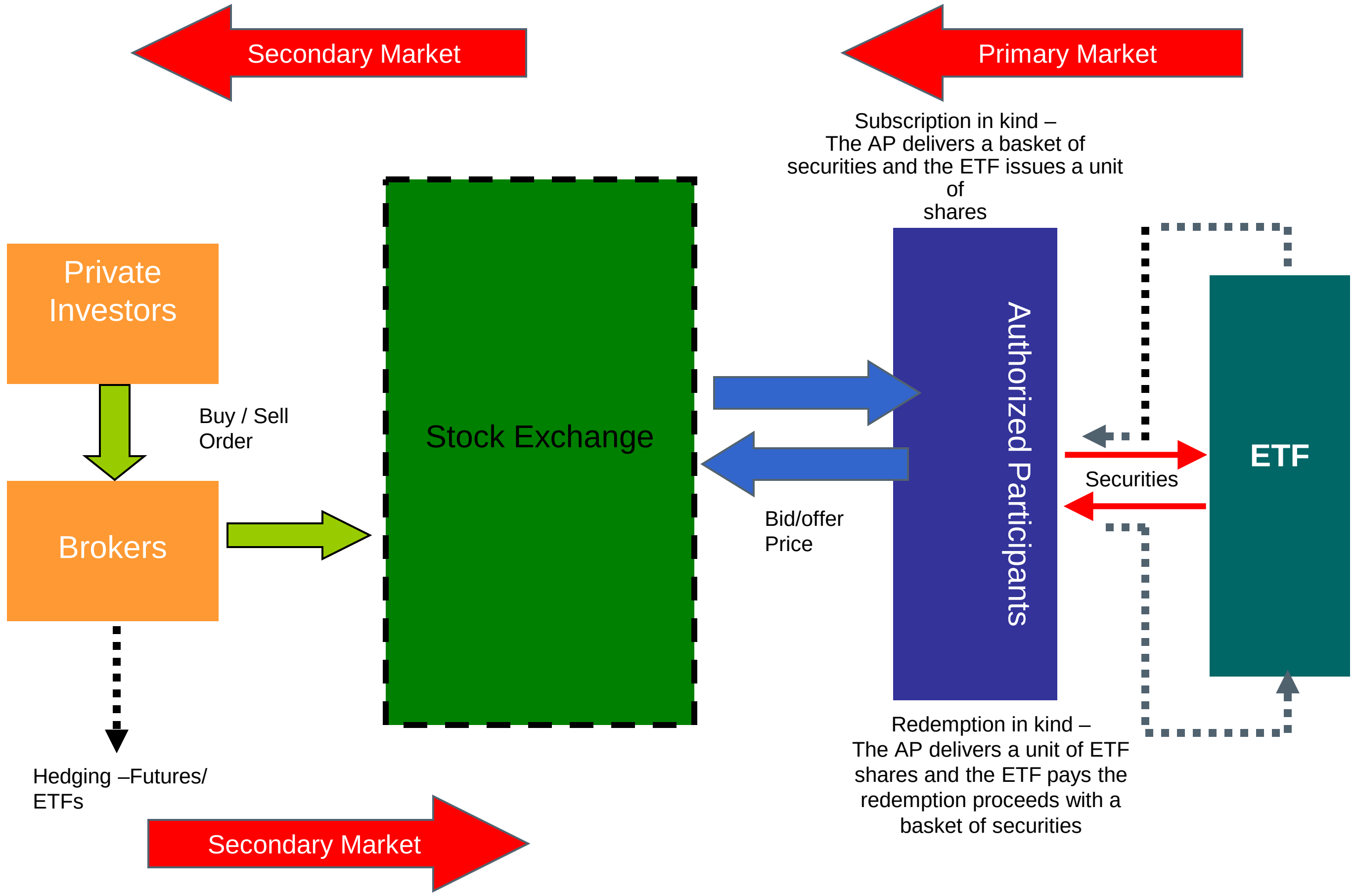
HOW DO ETFS WORK



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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" or "APs")
- These "primary market" transactions occur in large blocks of (at least 25,000) shares called "Creation Units"

HOW DO ETFS WORK?

- Authorized Participants (who purchase Creation Units) sell individual ETF shares on the stock exchange
- 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
    - Early exemptive orders provide more flexibility
    - Proposed ETF rule would “level the playing field” by broadly allowing for custom baskets

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COMPARISON TO MUTUAL FUNDS

- Session I: Overview of the Investment Company Complex
  - ETFs also subject to the Securities Exchange Act of 1934 and exchange listing rules
  - Have some key additional relationships to consider – APs and market makers (“MMs”)

COMPARISON TO MUTUAL FUNDS

- Session II: Organizing an Investment Company, Registering Its Shares and Maintaining a Continuous Offering and Complying with the Tax Code
  - Governing document cannot require redemptions of individual shares
  - Form N-1A has ETF variations to ensure its relevance to retail investors

COMPARISON TO MUTUAL FUNDS

- Session III: Compliance Programs
  - For ETFs, SEC examinations typically focus on ETF-unique operational issues, such a composition of in-kind baskets, website required by ETF exemptive relief and exchange trading issues
  - Recent focus on continued listing standards
  - Near-term focus on Liquidity Rule

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COMPARISON TO MUTUAL FUNDS

- Session IV: Distribution of Mutual Fund Share and Open-End Fund Advertising
  - ETFs do not pay 12b-1 fees
  - ETFs must provide performance disclosure at both NAV and market price
  - In the last 5 years, some of FINRA’s most significant letters have been precipitated by ETFs’ request to be able to use back-tested index performance more broadly in marketing materials

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COMPARISON TO MUTUAL FUNDS

- Session V: Transactions with Affiliates
  - APs and MMs may frequently hold >5% of new or small ETFs’ shares
  - ETFs need to consider whether/how to trade with their affiliates, given Sections 17(a) and 17(e)
- Session VI: Portfolio Brokerage Practices
  - ETFs need to have policies and procedures to ensure that trades are not being directed to broker dealers based on affiliated APs’ or MMs’ active trading of ETF shares

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COMPARISON TO MUTUAL FUNDS

- Session VII: Mutual Fund Valuation
  - An ETF's arbitrage mechanism depends on APs being able to predict NAV
- Session VIII: The Fund's Board of Directors and Committees
  - ETFs' Independent Trustees must make finding that each has "no material interest" in the sponsor

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PROPOSED ETF RULE

- On June 28, 2018, the SEC proposed Rule 6c-11 under the Investment Company Act of 1940
- Rule 6c-11 would allow the “vast majority” of ETFs to operate without obtaining an SEC exemptive order

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PROPOSED ETF RULE

- Would rescind previously-issued exemptive orders of existing ETFs that would be permitted to rely on the proposed rule
  - Does not rescind 12(d)(1)(A) relief typically obtained simultaneously
- Does not rescind exemptive relief for leveraged/inverse, multi-class and UIT ETFs because they would not be permitted to rely on the proposed rule

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PROPOSED ETF RULE

- Collapses distinction between index-based ETFs and fully transparent actively-managed ETFs by requiring simple portfolio transparency
- Deems ETFs that operate in reliance on the rule to be “redeemable securities” rather than providing an exemption
- Permits use of custom baskets; no minimum creation unit size
- No longer required to publish intraday indicative value (“IIV”) every 15 seconds of the trading day

PROPOSED ETF RULE - CONDITIONS

- Condition (1): Website disclosure each business day of:
  - Prior day's NAV, market price and premium-discount
  - Table and line graph showing premium-discount for last calendar year and subsequent quarters
  - When applicable, explanation why premium-discount exceeded 2% for 7 consecutive trading days at any point during past year; and
  - Before accepting orders for execution based on a day's NAV, the portfolio holdings that will inform the NAV as well as the basket and cash balancing amount related to such NAV
    - Negation of T-1 order window

PROPOSED ETF RULE - CONDITIONS

- Rationale for negation of T-1 order window
  - Arbitrage efficiency
  - Implicitly allows non-transparent ETFs
- Implications if maintained
  - Increased risk for authorized participants and arbitrageurs; wider bid-ask spreads

PROPOSED ETF RULE - CONDITIONS

- Condition (2): Employ traditional T+1 accounting
  - ETFs that utilize T+0 accounting are outside the Rule

- Condition (3): Adopt policies and procedures for the construction and the process to be used for the acceptance of baskets
  - If an ETF utilizes custom baskets, the policies and procedures must:
  - Include “detailed parameters” for construction and acceptance, “including the process for any revisions to, or deviations from, those parameters”
  - Specify the titles of the adviser’s employees who are required to review each basket for compliance with the parameters
  - Ensure records maintained state that each custom basket complied with applicable policies and procedures

PROPOSED ETF RULE - CONDITIONS

- Condition (4): An ETF "may not seek, directly or indirectly, to provide returns that exceed the performance of a market index by a specified multiple, or to provide returns that have an inverse relationship to the performance of a market index, over a fixed period of time"
  - Implication: Compounding concerns the Commission
  - Leveraged ETFs may not rely on the rule

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PROPOSED ETF RULE – N-1A AMENDMENTS

- Applies to all ETF using Form N-1A, including ETFs that do not rely on the proposed rule
- Item 3 (Risk/Return Summary: Fee Table) – ETFs must include a series of Q&As regarding bid-ask spreads in their ETF shares
- Six Q&As:
  - What information do I need to know about how the ETF trades?
  - What costs are associated with trading shares of an ETF?
  - What is the bid-ask spread?
  - How does the bid-ask spread impact my return on investment?
  - What if I plan to trade ETF shares frequently?
  - Where can I get more trading information for the ETF?
    - Interactive calculator

PROPOSED ETF RULE – N-1A AMENDMENTS

- Interactive Calculator on Website
  - Determine median bid-ask spread for last fiscal year
    - For each trading day:
      - Pull bid-ask spread at 10-second intervals;
      - Calculate average bid-ask spread;
      - Median is midpoint of daily averages
  - Determine high-end bid-ask spread for last fiscal year
    - 95th percentile of daily averages

REACTION TO THE PROPOSED ETF RULE

- Welcome development in the ETF community
- Comments to proposed rule:
  - Support for:
    - No Minimum Creation Unit Size
    - Custom Baskets
    - Required Website Disclosures
    - Removing Index vs. Active Distinction
    - Treating ETF Shares as Redeemable Securities

REACTION TO THE PROPOSED ETF RULE

- Comments to proposed rule:
  - Opposition to:
    - Timing and Formatting Requirements for Portfolio Holdings and Creation Basket Disclosures
    - One year explanation for any Premium/Discount Over 2% for Seven Days
    - Q&As in Item 3
    - Interactive Calculator on Website
- Many comments supporting a Bitcoin ETF

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PERIODICALLY DISCLOSED ETFS

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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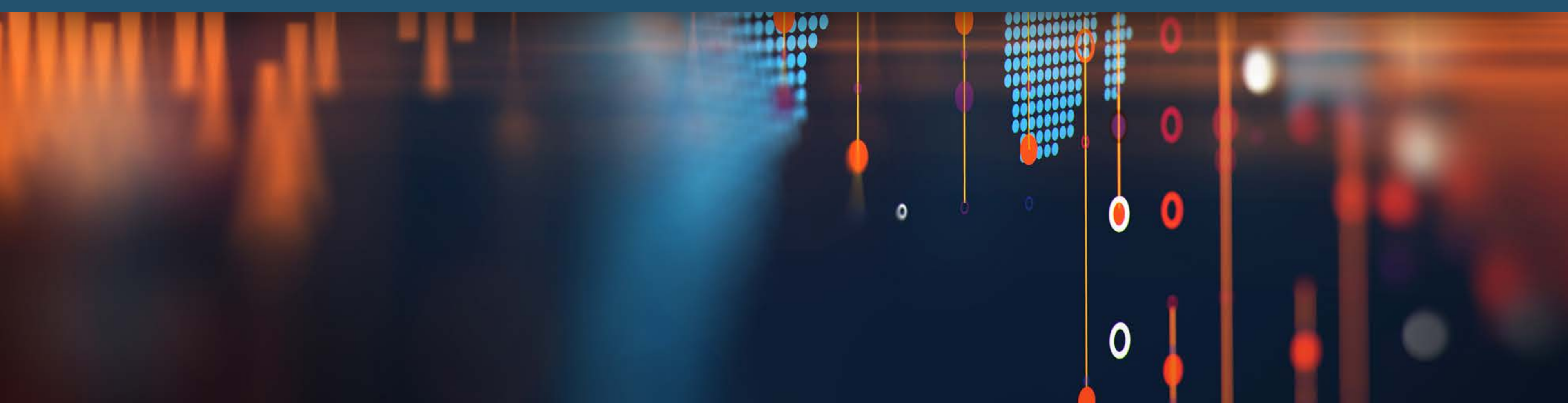
PERIODICALLY DISCLOSED ETFS

- Value Arbitrage Proposal
  - Portfolio transparency provided to confidential agent of blind trust for bona fide arbitrage
  - Verified Intraday Indicative Value published every [second] throughout the trading day
  - Applicants: Precidian
- Hedge Portfolio Proposals
  - Partial portfolio transparency provided through public disclosure of partially overlapping hedge portfolio
  - Tracking error, daily deviation and other statistical correlations provided for portfolio and hedge portfolios
  - Applicants: T. Rowe Price; Fidelity; NYSE Arca/Natixis; Blue Tractor

QUESTIONS



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