



K&L GATES



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# Exchange-Traded Funds (ETFs)

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# THE DOMESTIC ETF LANDSCAPE

## U.S. Listed Exchange Traded Funds



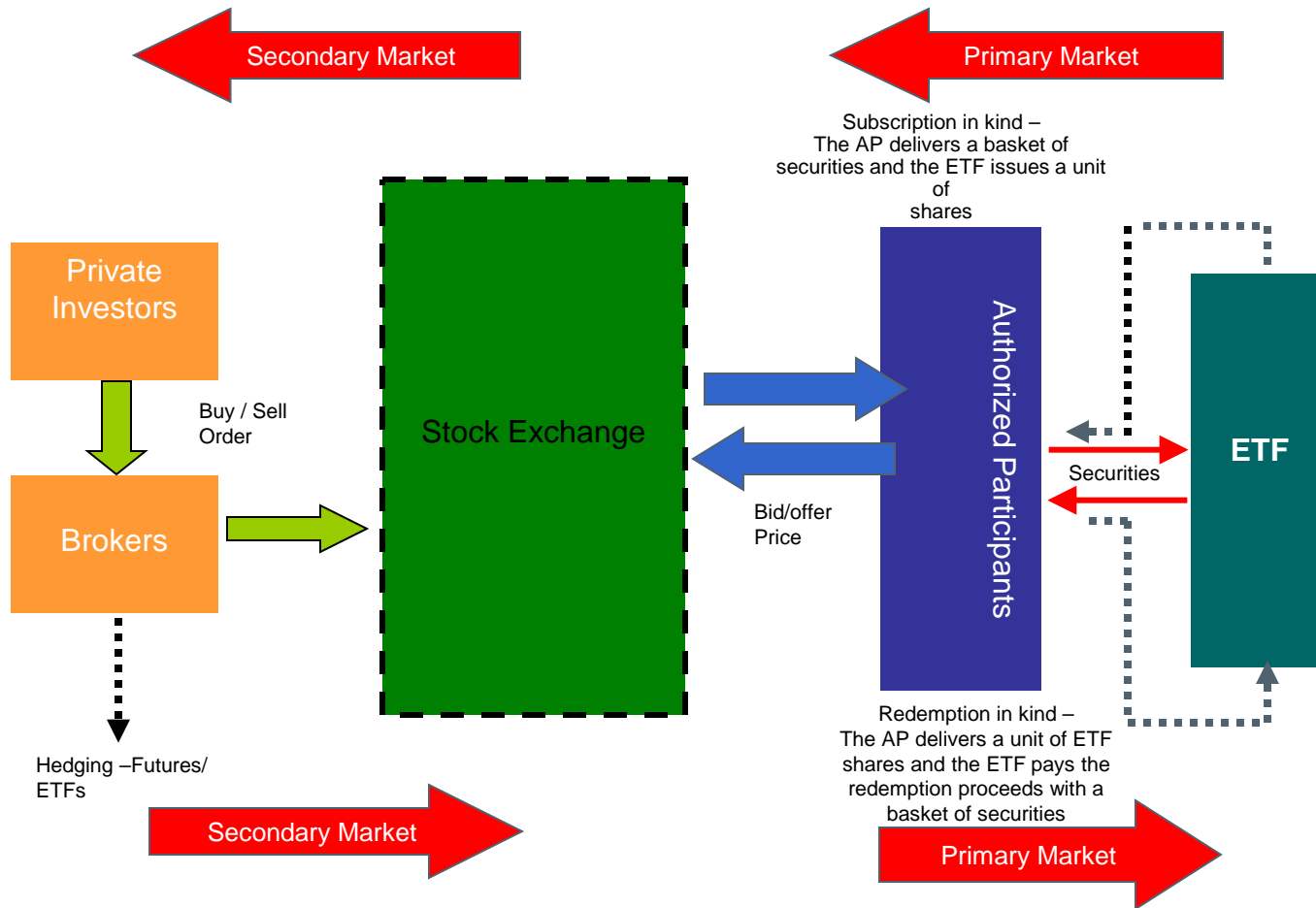
Source: NYSE Group, Inc.

## DEFINITIONS ARE IMPORTANT: ETFS

- ETVs – exchange-listed equity securities
  - ETVs: Generic term
  - ETPs: Commodity funds, currency funds
  - ETFs: Registered funds
- Not ETNs - Unsecured, debt 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
  - Custom Baskets
- Authorized Participants (who purchase Creation Units) sell individual ETF shares on the stock exchange



# ETF STRATEGIES

- ETF strategies available:
  - Index ETFs – Passive Investing
  - “Smart beta” (bespoke index) ETFs – Factors, Committees & Artificial Intelligence
  - Fully transparent actively managed ETFs
- ETF strategies pending:
  - Periodically-Disclosed Active ETFs
  - Verified iNAV-only Active ETFs
  - Crypto Currency ETFs & ETPs



## PART II INDUSTRY EXPECTATIONS – NEW DEVELOPMENTS

- SEC ETF Rule Proposal
- “True” Active ETFs
- Liquidity Risk Rule for ETFs



## ETF RULE PROPOSAL

- SEC issues rule proposal release on June 28, 2018.
- Public comment period ended October 1, 2018.
  - Well received by the industry – An “A-” effort.
- Streamlines regulatory burdens.
- Levels the playing field – custom baskets.
- Some questions remain.





## ETF PROPOSED RULE 6C-11

- Allows ETFs to come to market without first securing an exemptive order from Investment Company Act restrictions.
- Solves broker issues under Securities Exchange Act by declaring ETF securities “redeemable securities.”



## ETF DEFINED

- ETF defined as open-end management investment company that creates and redeems its shares in creation unit aggregations with designated authorized participants in exchange for baskets of securities and/or cash whose shares are traded on national securities exchanges at market prices.
  - No requirement as to Creation Unit size



## ETF RULE CONDITIONS - #1

- In order to rely on the rule, the ETF must meet four conditions:
- #1 – Must make prominent web disclosure each Business Day (A) before the opening of trading and (B) before accepting creation or redemption orders of:
  - (1) portfolio holdings used for next NAV, and basket contents and cash needed for CU transactions;



## ETF RULE CONDITIONS - #1

- (2) NAV, closing market price and premium or discount of previous Business Day, and a Premium/Discount table and line graph for the last calendar year and for the last quarter or quarters since the last December 31st.
- (3) If a Premium or Discount condition of  $>2\%$  persists for 7 consecutive Business Days, then for the next year explain on the website why.



## ETF RULE CONDITIONS - #2

- #2 – Must operate on a T+1 basis – trades today go into NAV tomorrow.
  - A couple of ETFs do same day settlement (T+0).



## ETF RULE CONDITIONS - #3

- #3 – Must adopt policies and procedures governing the construction and acceptance of deposit baskets.
- If engaging in “custom baskets”, must adopt “detailed parameters” for their construction and acceptance, and designate the title of the person who determines custom basket complies with policies and procedures.
  - “Custom Basket” = not pro rata slice of portfolio.



## ETF RULE CONDITIONS - #4

- #4 - ETF cannot provide leveraged returns of an index.
  - Seems to allow indexes with fluctuating leverage.
  - Rule does not otherwise distinguish between indexed (passive) and managed (active) ETFs



## PROPOSED ETF RULE ISSUES

- Industry unhappiness at putting someone outside of portfolio management team with sign off authority on custom baskets.
  - Risk and compliance can oversee the process but not basket construction – cannot become de facto portfolio managers involved day-to-day.
- Clarity sought on what is a custom basket – cash in lieu?
- Good balance being struck overall





## PROPOSED ETF RULE ISSUES

- “T minus 1” ETFs negatively affected by Condition #1 – publish portfolio before taking orders.
  - T-1 order window is 1 hour after close of market day before T – order seeks T’s NAV valuation
  - Important for ETFs with foreign securities holdings that trade when US markets are closed.
  - SEC staff – Nontransparent ETF
  - Industry – APs know enough about actual portfolio to protect themselves & this is a voluntary transaction.



## PROPOSED ETF RULE ISSUES

- Form N-1A amendments – The SEC’s love affair with Bid/Ask Disclosure:
  - Summary Prospectus – 6 Q&A style disclosures
    - Qualitative discussion of what spreads are & why important;
    - Quantitative disclosure of median bid/ask spreads
- Median Bid/Ask Spread = for 253 trading days per year, average of each day’s spread calculated at 10 second intervals.
- ETFs must provide interactive spread calculator.



## PROPOSED ETF RULE ISSUES

- Industry strongly objects to proposed Bid/Ask Spread disclosure requirements;
  - Securities Act liability – data is outside of the ETF;
  - ETF not best source of this information – FAs;
  - Each ETF's calculator will be different – SEC can provide this in SEC's website; and
  - Isn't this really a market order problem?



## PROPOSED ETF RULE ISSUES

- Proposed Rule will rescind all prior ETF orders to the extent that an ETF “could rely” on the new rule.
  - How do you know if your order has been rescinded? Clarity being sought.
  - If rescinded, ETF has one year to bring itself into compliance with rule.



## “TRUE” ACTIVE ETFS

- Semi-Transparent or Periodically-Disclosed
  - Proxy Portfolios
  - NAV & iNAV - only
- Semi-Transparent Active ETF Hallmarks
  - Transparency substitute
  - Tax-efficiency
- Arbitrage & Actual Portfolio Replication



# 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





# The SEC's "Liquidity Rule"



# AGENDA

1. Historic Regulatory Framework
2. SEC Rationale for Updating Framework
3. New Regulatory Framework: The Liquidity Rule
4. Board Responsibilities
5. Compliance Dates
6. Program Features





# HISTORIC REGULATORY FRAMEWORK

- Section 22(e) of the Investment Company Act of 1940 (“1940 Act”) provides that no registered fund shall suspend the right of redemption or postpone the date of payment of redemption proceeds for more than **seven days** after tender of the security
- Rule 22c-1 under the 1940 Act requires funds to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to purchase or redeem fund shares (“forward pricing”)
- Current SEC guidelines generally limit a registered fund’s aggregate holdings of “illiquid assets” to 15% of the fund’s net assets
  - A portfolio security is considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment



# SEC RATIONALE FOR UPDATING FRAMEWORK

- Need to reduce “*liquidity risk*,” defined as *the risk that a fund could not meet requests to redeem fund shares without significant dilution of remaining investors’ interests in the fund*
- Significant increase in less liquid strategies, such as bank loans, distressed debt and alternatives
  - In 2015, the Third Avenue Focused Credit Fund collapsed amidst a downturn in the distressed debt markets. The fund stopped meeting redemptions, which would have required it to dispose of assets at fire-sale prices.
- Evolution towards a shorter settlement period for open-end fund redemptions and inflows into strategies that invest in instruments with longer settlement periods



# NEW REGULATORY FRAMEWORK: THE LIQUIDITY RULE

- A fund must assess, manage and periodically review (at least annually) its liquidity risk, considering the following factors *as appropriate*:
  - its investment strategy and the liquidity of its portfolio holdings during normal and reasonably foreseeable stressed conditions, including whether the strategy is appropriate for an open-end fund, portfolio concentration, the size of its positions, borrowings and investments in derivatives
  - short-term and long-term cash flows during normal and reasonably foreseeable stressed conditions
  - cash holdings and ability to borrow to meet redemptions
  - ETFs must also evaluate the relationship between their portfolio liquidity and their arbitrage mechanism, including the bid-ask spreads at which their shares trade, the level of participation by market participants and how their basket composition affects their liquidity
- The Administrator must develop policies and procedures for communicating and coordinating with sub-advisers regarding Program requirements



# BOARD RESPONSIBILITIES

- A fund's board (including a majority of independent directors) must:
  - Initially approve the fund's *written* liquidity risk management program ("Program")
  - Designate an "Administrator" responsible for administering the Program
  - Review a written report (at least annually) on the adequacy and effectiveness of the Program and its implementation
  - Receive reports if a fund --
    - Breaches the 15% limit on illiquid investments, as established by the Liquidity Rule, or
    - Experiences a shortfall in its highly liquid investment minimum ("HLIM"), as established in the Program:
      - Shortfall < 7 consecutive days, report at next regular board meeting
      - Shortfall > 7 consecutive days, report on next business day
      - Approval of any change to the HLIM during a shortfall



# COMPLIANCE DATES

Element	Compliance Date**
Assessment by Administrator (on behalf of Fund) of Liquidity Risk as part of Liquidity Risk Management Program*	December 1, 2018
Implement 15% Limit on Illiquid Assets (as defined by Liquidity Rule)*	December 1, 2018
Adopt Policies and Procedures for In-Kind Redemptions*	December 1, 2018
<b>Board Designation of Program Administrator*</b>	December 1, 2018
Non-public Classification of Investments into Buckets*	June 1, 2019
Establish Highly Liquid Investment Minimum (HLIM), if applicable*	June 1, 2019
<b>Board Approval of Liquidity Risk Management Program*</b>	June 1, 2019
<b>Annual Board Review of the Program*</b>	June 1, 2020
Begin to File N-LIQUID, as necessary, and N-PORT	December 1, 2018 and June 1, 2019
Disclose operation and effectiveness of the liquidity risk management program in shareholder report	December 1, 2019

\*The compliance dates for the related recordkeeping requirements coincide with the Element's compliance date.

\*\*The compliance dates reflected are based on the fund complex's current assets under management ("AUM"). Fund complexes with AUMs under \$1 billion have a built-in extension of six-months compared to those with over \$1 billion in assets.

## PROGRAM FEATURE: “BUCKETING”

- A fund must classify investments into 4 buckets based on the number of days it reasonably expects it would take to convert the investment to cash (or dispose of if less liquid or illiquid investments) without significantly changing the market value
- Classifications should take into account relevant market, trading, and investment considerations and market depth, and whether sales would significantly change the market value of the investment. Considerations may include:
  - (1) activeness of the trading market;
  - (2) the frequency of trades and quotes;
  - (3) bid-ask spreads;
  - (4) the number of dealers willing to purchase or sell the security and the number of other potential purchasers;
  - (5) dealer willingness to make a market;
  - (6) maturity and date of issue;
  - (7) position size; and
  - (8) the method of soliciting offers and mechanics of transferring.



## PROGRAM FEATURE: “BUCKETING”

- **Highly Liquid:** includes cash and investments convertible into cash in 3 business days or less
- **Moderately Liquid:** convertible into cash in more than three calendar days but no more than seven calendar days
- **Less Liquid:** sale in seven calendar days or less, but settlement reasonably expected in more than seven calendar days
- **Illiquid Investments:** cannot be sold or in seven calendar days or less without the sale or disposition significantly changing the market value of the investment



## PROGRAM FEATURE: “BUCKETING” EXEMPTION FOR IN-KIND ETFS

- In-Kind ETFs are ETFs that redeem using only a de minimis amount of cash under all market conditions are exempt from the “bucketing” requirement
  - SEC guidance: 10% is maximum amount of cash that can be considered de minimis
  - Balancing amount is per se de minimis
  - “Proportional cash” is excluded from 10% allowance but cash in lieu of investments that cannot be transferred in kind counts against the 10% allowance
  - Factors for determining In-Kind ETF status:
    - Redemption history
    - Disclosed redemption practices
    - Process and rationale for including cash in redemptions





## PROGRAM FEATURE: HLIM

- Highly Liquid Investments: cash and investments convertible into cash in 3 business days or less
- ***Funds that hold 50% or less of their assets in Highly Liquid Investments must establish an “Highly Liquid Investment Minimum” (or HLIM)***
  - HLIM is the minimum percentage of highly liquid assets a fund will hold
  - The same liquidity risk factors as those considered when assessing liquidity risk should be kept in mind, considering normal and reasonably foreseeable stressed conditions
  - A fund’s board is not required to approve the highly liquid investment minimum (unless the fund is below its minimum and seeks to change it)
- ***Primarily Highly Liquid funds are exempt from establishing an HLIM***
  - Funds that hold more than 50% of their assets in Highly Liquid Investments
  - According to an Investment Company Institute study, 76% of funds expect to be exempt and some large fund complexes reported they expect 90% of their funds will be exempt.



## PROGRAM FEATURE: HLIM SHORTFALL

- *Compliance with the HLIM should be tested daily.*
- *Funds must have Shortfall Policies and Procedures*
- For “shortfalls” --
  - < 7 calendar days: report to the board at the next regular meeting
  - > 7 calendar days:
    - Report to the board within one business day; and
    - Report to the SEC on Form N-LIQUID
- Shortfall policies and procedures could describe actions to be taken based on facts and circumstances; how stress event(s) will be evaluated and responses will be shaped
- During a shortfall, a fund may still purchase assets that are not highly liquid, provided the purchases are in accordance with the fund’s shortfall policies and procedures



# PROGRAM FEATURE: 15% LIMIT ON ILLIQUID INVESTMENTS

- An illiquid security is one that cannot be sold or disposed of in 7 days without significantly changing the market value
- Funds are prohibited from **acquiring** an illiquid investment if it causes the fund's illiquid investments to exceed 15% of the fund's net assets
- If a fund **holds** 15% or more of its net assets in illiquid investments:
  - Report to board within 1 business day, including extent and causes of occurrence and steps to reduce illiquid investments
    - If breach extends more than 30 days, board must assess if plan continues to be in best interest of shareholders
  - Report to SEC within 1 business day on Form N-LIQUID (non-public filing)
    - Form N-LIQUID requires, among other things, a fund to disclose dates the fund exceeded the limit on illiquid investments and details of each illiquid asset. A fund must file on Form N-LIQUID again when illiquid assets fall below the threshold but will still be required to list each illiquid security.



# PROGRAM FEATURE: NON-PUBLIC SEC REPORTING

- The Liquidity Rule introduces new and amended SEC forms, including:
  - **N-PORT**: Non-public reporting of:
    - Investment classifications; generally a single classification per investment except in three scenarios
    - The asset type the fund has assigned to each investment (using any labeling scheme the fund uses for portfolio management)
    - Fund's HLIM
  - **N-LIQUID**: Non-public reporting when:
    - A fund's highly liquid investments fall below its HLIM for more than 7 days
    - A fund's illiquid investments exceed 15% of net assets and again when a fund's illiquid investments fall below 15% of net assets.
    - Adopting Release suggests the SEC expects these filing to be rare



## PROGRAM FEATURE: PUBLIC SEC REPORTING

- Funds will include a narrative discussion in the annual shareholder report concerning the operations and effectiveness of the Program
  - Funds may use the information that was provided to the board about the operation and effectiveness of the Program
  - To the extent performance is impacted by liquidity, funds should discuss liquidity in the management's discussion of fund performance



# PROGRAM FEATURES: TESTING

Frequency	Process Review/Testing	Reporting
Daily	Test for compliance with HLIM, if applicable	<ul style="list-style-type: none"> <li>If shortfall &lt; 7 days, report to board at next quarterly meeting</li> <li>If shortfall &gt;7 days, report to board by next business day and report to SEC on Form N-LIQUID</li> </ul>
	Test that illiquid assets are less than 15% of fund's net assets	<ul style="list-style-type: none"> <li>If breached, report to board by next business day and report to SEC on Form N-LIQUID</li> </ul>
Monthly	Classify investments into one of four liquidity buckets (change intra-month if reclassification is material)	Report to SEC on Form N-PORT
Quarterly	Test for compliance with established HLIM	See Daily HLIM compliance testing
Annually	Liquidity risk assessment - assess if strategy is suitable for an open-end fund	Included in report to the board prior to fund launch, to be reassessed if necessary
	Board reporting – review of the Program	Routine annual board reporting
	Shareholder reporting – narrative discussion	Narrative section of shareholder report

Note: Reviews should occur more frequently if information becomes available suggesting assessment or classification has changed.

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