

The logo for K&L GATES is displayed in white, bold, sans-serif capital letters on a dark blue rectangular background. The background of the entire slide features a complex financial data visualization with a world map, various line and bar charts, and scattered numerical values in shades of blue and white.

K&L GATES

2019 Washington D.C. Investment Management Conference

Exchange-Traded Funds (ETFs)

Stacy L. Fuller, Partner, K&L Gates LLP

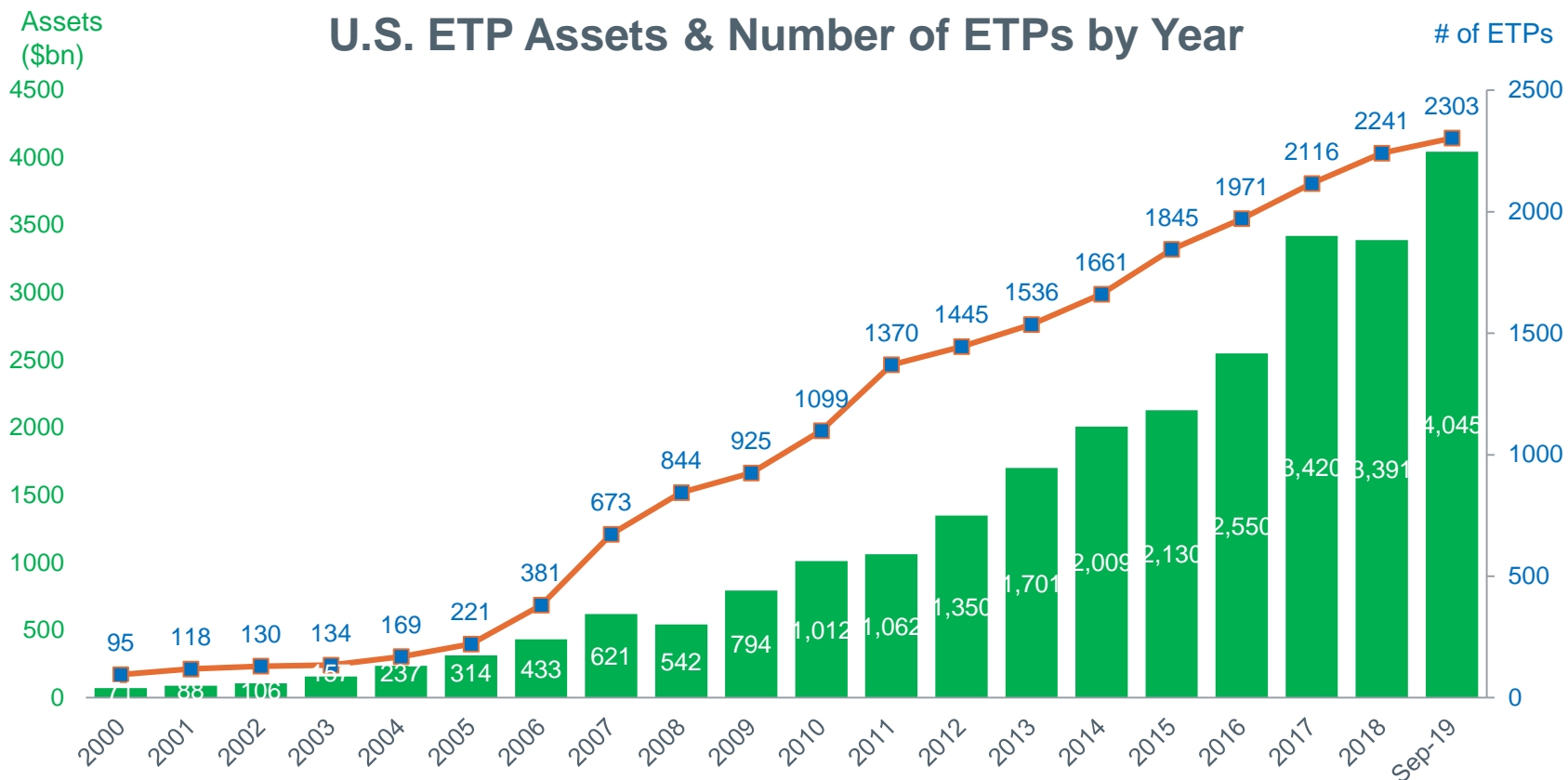
Alyssa B. Sherman, Associate, K&L Gates LLP

OVERVIEW

- Industry Background
- ETF Mechanics
- New ETF Rule and Implications
- Periodically Disclosed ETFs



INDUSTRY BACKGROUND

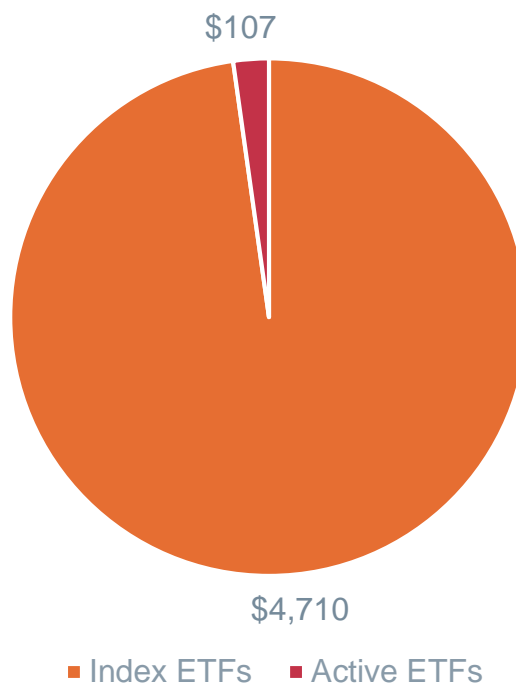


Source: ETFGI data sourced from ETF/ETP sponsors, exchanges, regulatory filings, Thomson Reuters/Lipper, Bloomberg, publicly available sources, and data generated in-house.



INDUSTRY BACKGROUND

Global ETF/ETP Assets in USD
(in Billions)



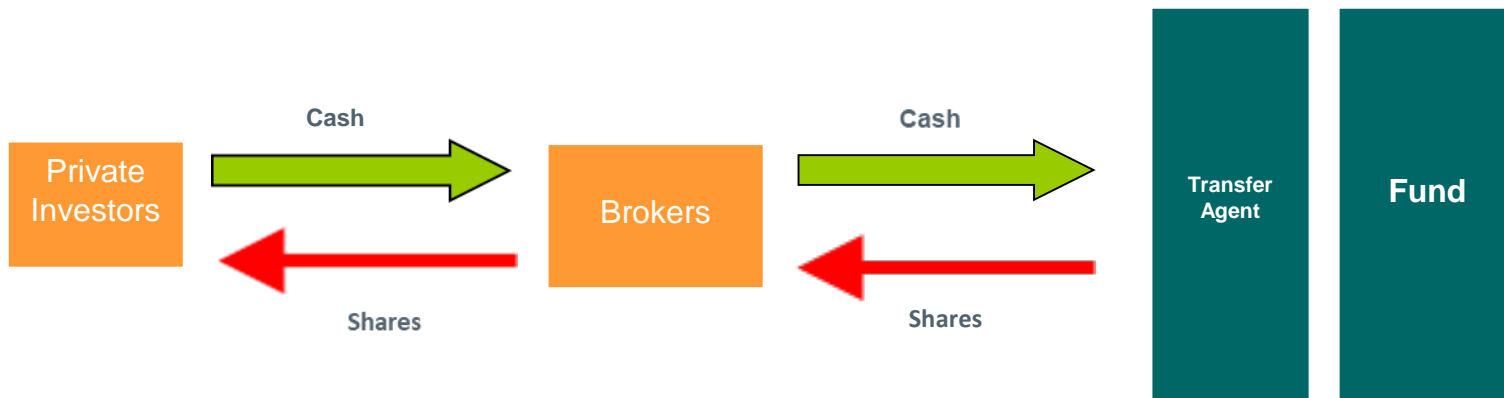
Source: ETFGI data sourced from ETF/ETP sponsors, exchanges, regulatory filings, Thomson Reuters/Lipper, Bloomberg, publicly available sources, and data generated in-house. Data as of December 31, 2018.

INDUSTRY BACKGROUND

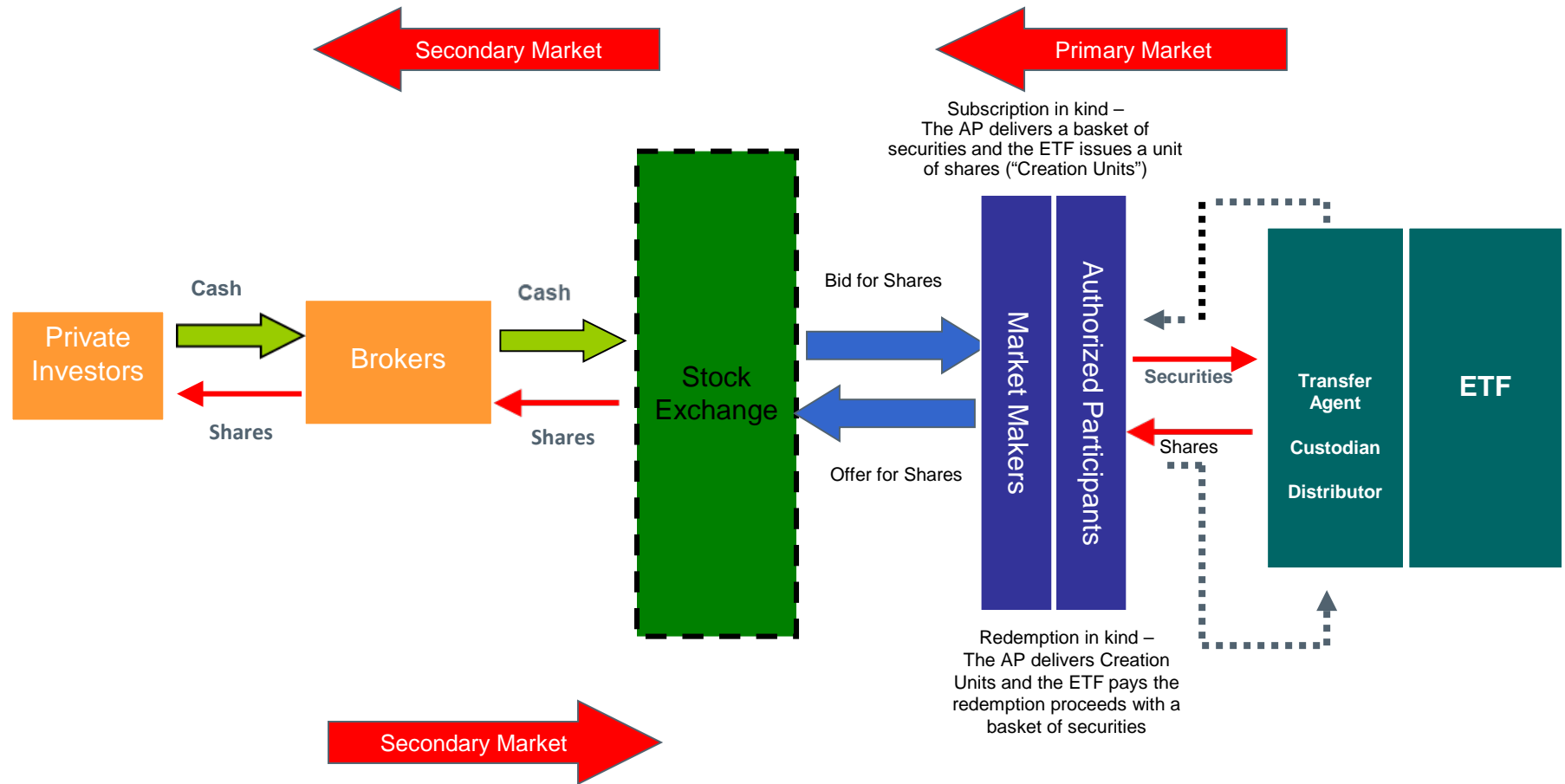
- ETF Popularity
 - Lower expenses → enhanced returns
 - Portfolio transparency
 - Tax efficiencies
 - Investor protections
 - Intra-day liquidity
 - Market timing
- Hurdles to Entry
 - Broad-based passive market saturated
 - Active ETF Issues
 - Smaller market share
 - Underperformance
 - Portfolio transparency concerns
 - Front-running and reverse engineering
 - Periodically disclosed ETFs



MUTUAL FUND MECHANICS



ETF MECHANICS



ETF MECHANICS

- 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 (usually, at least 25,000) shares called “Creation Units”



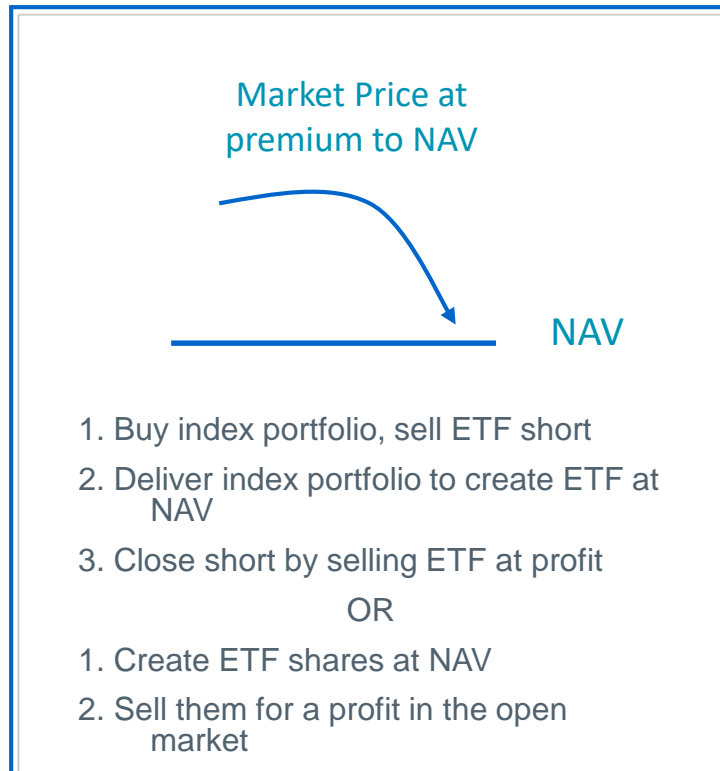
ETF MECHANICS

- 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



ETF MECHANICS

- ETF structure enables arbitrage between market price and NAV



- This allows the ETF shares to trade close to NAV
- The NAV does not change; the market price does



NEW ETF RULE AND IMPLICATIONS

- On September 25, 2019, the SEC approved Rule 6c-11 under the Investment Company Act of 1940 (the “Rule”) and related amendments to Form N-1A (“Disclosure Amendments”)
- The Rule will rescind previously-issued exemptive orders of ETFs that are “permitted to rely” on it one year from its effective date, which is December 23, 2019.



NEW ETF RULE AND IMPLICATIONS

- Permitted to rely on the Rule:
 - Index-based ETFs
 - Fully transparent active ETFs
- Not permitted to rely on the Rule:
 - ETFs organized as UITs
 - Leveraged and inverse ETFs
 - Multi-class ETFs
 - Periodically disclosed active ETFs
- Allow the “vast majority” of ETFs to operate without obtaining an SEC exemptive order



NEW ETF RULE AND IMPLICATIONS

- “Exchange-traded fund” – a registered open-end management company:
 - that issues (and redeems) creation units to (and from) authorized participants
 - in exchange for a basket and a cash balancing amount if any; and
 - whose shares are listed on a national securities exchange and traded at market-determined prices.



OVERVIEW OF THE ETF RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
 - Full portfolio transparency



OVERVIEW OF THE ETF RULE

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 - Full portfolio transparency
 - Bid-ask spread information



OVERVIEW OF THE ETF RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
 - Full portfolio transparency
 - Bid-ask spread information
 - Daily premium/discount calculation



OVERVIEW OF THE ETF RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
 - Full portfolio transparency
 - Bid-ask spread information
 - Daily premium/discount information
 - Premium/discount table of frequency



OVERVIEW OF THE ETF RULE

TABLE 1: SAMPLE PREMIUM AND DISCOUNT TABLE

	Calendar Year 2018	First Quarter of 2019
Days traded at premium	202	59
Days traded at discount	47	2



OVERVIEW OF THE ETF RULE

- Condition #1: Each business day, an ETF must disclose certain information prominently on its website, which is publicly available and free of charge:
 - Full portfolio transparency
 - Bid-ask spread information
 - Daily premium/discount information
 - Premium/discount table of frequency
 - Premium/discount line graph of amounts



OVERVIEW OF THE ETF RULE

- Condition #2: ETF calculates NAV only once per day



OVERVIEW OF THE ETF RULE

- Condition #3: Policies and procedures that govern the construction of baskets and the process that will be used for the acceptance of baskets
 - If the ETF utilizes a custom basket, these written procedures must:
 - Be more detailed; and
 - Identify adviser employees responsible for basket-by-basket
- Recordkeeping required for all AP agreements and baskets



OVERVIEW OF THE ETF RULE

- Condition #4: ETF cannot be leveraged



EXEMPTIONS PROVIDED BY THE RULE

- Section 22(d) and Rule 22c-1
- Exemption permits secondary market trading of ETF shares at market-determined prices



EXEMPTIONS PROVIDED BY THE RULE

- Section 17(a)
- Exemption permits APs to deposit and receive in-kind baskets in creation unit transactions if only affiliation with ETF comes from share ownership



EXEMPTIONS PROVIDED BY THE RULE

- Section 22(e)
- Exemption permits delivery of foreign investments as soon as practicable but in no event later than 15 days after the tender to the ETF



CHANGES MADE BY THE RULE TO THE CURRENT ETF REGULATORY SCHEME

- No minimum creation unit size
- More detailed premium-discount disclosure and new bid-ask disclosure on website
- Basket flexibility
- No intraday indicative value (“IIV”) required



CHANGES MADE BY THE RULE TO THE CURRENT ETF REGULATORY SCHEME

- All ETF shares deemed to be redeemable securities of open-end investment companies
 - Certain exemptions under Exchange Act become available to ETFs for secondary market transactions in ETF shares
 - SEC issued exemptive order granting other necessary relief for secondary market transactions in ETF shares



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]”



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
 - Concomitant ability of AP contemporaneously to purchase and sell both creation units of ETF and the ETF's portfolio securities
 - Relief granted to Precidian and ActiveShares ETFs
 - Available for license by active managers
- 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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