Wall Street LAWYER
Securities in the Electronic Age
December 2014 ■ Volume 18 ■ Issue 12

# Exchange-Traded Managed Funds and What They Mean for APs

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**Publisher's Note***: This article is a follow-up to the article* **SEC's Denial of Non-Transparent ETFs Means APs Can Rest Easy—For Now***, which appeared in the November issue of Wall Street Lawyer.*

In our article that appeared in the November issue of *Wall Street Lawyer*, we discussed a series of recent applications for exemptive relief that proposed the offering of exchange-traded registered investment companies with non-transparent portfolios. The product structures described in these proposals generally can be categorized as one of three different types. The first structure would use a blind trust to effect creation and redemption transactions between exchange-traded funds (ETFs) and authorized participants (APs). (By way of background, APs are broker-dealers and other financial intermediaries who are contractually permitted to transact directly with ETFs in large chunks of ETF shares known as creation units, often in exchange for an in-kind basket of the ETF's underlying securities). The second structure would provide the market with an extensive set of data that would in effect act as a substitute for the ETFs' having to disclose their portfolio holdings daily. The third structure would offer shares of a registered investment company that would trade intraday at a premium or discount to a net asset value (NAV) that would be determined once a day at the close of trading. The products in this third proposal would have characteristics of both ETFs and mutual funds and accordingly were named exchange-traded managed funds—or "ETMFs"—by the applicants.

At the end of October, the Securities and Exchange Commission (SEC) preliminarily denied two fund sponsors that had submitted blind trust proposals.[1] In response to the SEC's notices, both firms requested to withdraw their applications for exemptive relief and the SEC granted their requests on November 14.[2] In our November article, we discussed in detail

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**Wall Street Lawyer**

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One Year Subscription ■ 12 Issues ■ $867.96
(ISSN#: 1095-2985)

the SEC's denials. At that time, we surmised that, given the degree of detail set forth by the SEC in denying the two applications, the SEC's repeated references that its views were "preliminary," and the general creativity exhibited by fund managers in forming and offering new product structures, that it was only a matter of time before non-transparent ETFs or ETMFs were approved. We also pointed out that the request for exemptive relief for ETMFs had been accompanied by a request to create a new rule on the NASDAQ Stock Market—Rule 5745—that would permit trading in ETMFs and we further noted that two initial registration statement filings had been made with the SEC, which would create trusts with multiple series of ETMFs—all of which indicated that ETMFs in particular may be viable candidates for exemptive relief from the SEC.

But we didn't expect the SEC to grant its approval of the ETMF application for exemptive relief so quickly after its denial of the two blind trust applicants. On November 6—as our November article was going to print—the SEC issued a notice indicating that it intends to grant the exemptive relief requested by the ETMFs.[3] The following day, the SEC also indicated that it would approve Nasdaq's proposed rule that will permit the exchange to list and trade ETMF shares.[4] In this follow-up to our November article, we will provide additional background information on ETMFs and also discuss how this new product may affect APs.

## A Snapshot of ETMFs

Here is a quick rundown of the key characteristics of ETMFs:

- ETMFs will trade on an exchange at a premium or discount to an NAV that will be determined at the end of the day.
- ETMFs will disclose their full portfolio holdings quarterly, with a 60-day lag.
- Only APs can transact directly with the ETMF (through an AP agreement with the ETMF's distributor) and such transactions will be done in creation unit size.
- An ETMF's portfolio will be confidential and creation baskets of deposit securities will not reflect a pro rata slice of the ETMF's portfolio.
- An intraday indicative value will be published for each ETMF every 15 minutes.

## ETMFs: Kind of Like ETFs, Kind of Like Mutual Funds

ETMFs will have a hybrid structure that combines features of both mutual funds and ETFs. This structure may appeal to retail investors who prefer the accessibility and cost structure of exchange-traded products. For example, ETMFs will have lower transfer agency fees than mutual funds and will not charge sales loads or asset-based distribution or service fees. This structure also may appeal to asset managers who employ an active investment strategy, because it will be less likely than ETFs to fall victim to front running and reverse engineering due to its lack of daily portfolio disclosure.

Like ETFs, shares of an ETMF can be created and redeemed only in transactions between an AP and the ETMF in creation unit size. However, ETMFs are expected to have creation units that will range in size from 5,000 to 50,000 ETMF shares, which would be significantly smaller than the 25,000 to 50,000 shares that typify most creation units of traditional ETFs. Also like ETFs, ETMF shares will be listed and traded on a national securities exchange and creations and redemptions in ETMFs will typically be effected in-kind to maximize tax efficiency and minimize transaction costs. However, because of the non-transparent nature of its portfolio, an ETMF will be more likely to have a significant portion of its creation basket set aside as cash than a traditional ETF. Like mutual funds, ETMFs are only required to disclose their portfolio holdings on a quarterly basis with a 60-day lag.[5]

## ETMF Creation Baskets

Each day prior to the start of trading, an ETMF will transmit a "composition file" to NSCC, which NSCC will then disseminate to the market. The composition file will reflect the basket of securities and cash that the ETMF will accept from APs in connection with a creation order, or will deliver to APs in connection with a redemption order for that day. The same composition file will be used for both creation orders and redemption orders. The composition file will include both cash and securities to be delivered in-kind and will be constructed in accordance with policies and procedures that have been approved by the ETMF's board of trustees and which will be administered by the ETMF's chief compliance officer in accordance with Rule 38a-1 under the Investment Company Act of 1940.

Each security in an ETMF's composition file will be a current holding of the ETMF, but not all of the ETMF's portfolio holdings will be in the composition file and the weightings of the ETMF's portfolio will not be disclosed. For example, if an ETMF's portfolio consisted of 50 stocks, each of which represented 2% of the ETMF's assets, the ETMF's composition file might include 30 of those stocks (and would not include any stocks that are not in the ETMF's portfolio), each of which represents 43% of the composition file and a cash amount that represents 10% of the composition file. Thus, the composition file would provide no indication that the ETMF's portfolio included 20 other stocks and would provide no indication of each stock's relative weighting within the ETMF's portfolio. The ETMF also may exclude from the composition file securities that it plans to add or remove from its portfolio. For example, if an ETMF's active investment strategy dictated that the ETMF sell stock of Company X and purchase stock of Company Y for its portfolio, neither Company X stock or Company Y stock would be included the ETMF's composition file, but Company Y stock may be included sometime after the ETMF has substantially acquired its position.[6]

Other than limited circumstances in which cash-in-lieu will be permitted, all APs will transact in the same composition file on a given day. The SEC stated in its notice that cash-in-lieu will only be permitted where deposit securities are not available in sufficient quantity, deposit securities are not eligible for trading by the AP (or the client for whom the AP is placing a creation order),[7] or where receipt of the ETMF's underlying securities as part of an in-kind redemption for ETMF shares would result in unfavorable tax treatment. The SEC also stated that ETMFs may determine, upon receiving a creation or redemption order, to require the order to be made entirely in cash. If an ETMF adviser has an affiliated broker-dealer, it must erect a fire wall between personnel to control access to information on the composition file and changes to the ETMF's portfolio holdings. In addition, personnel who determine the ETMF's portfolio must be subject to policies and procedures designed to prevent the use and dissemination of such non-material non-public information.

## ETMF Pricing and Trading

The biggest difference between ETMFs and ETFs is in their intraday pricing. ETMF shares will trade at prices based on the end of day NAV of the ETMF, plus or minus a negotiated premium or discount.

As with both ETFs and mutual funds, a daily NAV will be determined for each ETMF at the end of each trading day. Like ETFs, creation and redemption transactions will be based on the daily NAV of the ETMF. However, unlike ETF shares, which trade in the secondary market intraday at prices expressed as absolute dollar amounts, ETMF shares will trade in the secondary market intraday at prices expressed as premium or discount to the ETMF's to-be-determined NAV (*e.g.*, "NAV + $0.01"). For each trade, the premium/discount (which may be zero) will be locked in at trade execution, but the final transaction price will not be determined until the end of the business day after the ETMF's NAV is calculated.

The amount of an ETMF's premium or discount will depend on a variety of factors, including the supply and demand for the ETMF's shares, transaction costs incurred by the ETMF as a result of creation and redemption orders (which would be passed along to APs in the form of transaction fees), competition among the ETMF's market makers, inventory positions and strategies of the ETMF's market makers, and the volume of trading in the ETMF's shares. The SEC also stated in its notice to the ETMF applicants that any premium or discount would not be a "sales charge" subject to NASD Rule 2830.[8]

Also unlike ETFs, which contract with their listing exchange to disseminative an intraday indicative value (IIV)[9] every 15 *seconds*, Nasdaq will only disseminate an ETMF's IIV every 15 *minutes*. This IIV will be calculated in absolute dollars and not in the premium/discount to NAV format in which intraday trading will occur. According to the ETMF notices, a more frequent IIV is not necessary for ETMFs because market makers will not be subject to intraday risk and therefore they will not need the calculation to assist them with continuously monitoring and hedging their risk. Instead, the 15 minute IIV is only meant to help investors determine if they want to transact in an approximate dollar amount of ETMF shares. In other words, a 15 minute IIV could give an investor some indication of the approximate per share value of his or her end of day trade, which would permit him or her to better approximate the number of shares he or she should buy or sell if he or she wanted to purchase or sell a specific dollar amount of shares. For example, if the last calculated IIV was $21.50 and the investor wanted to move a $1500.00 position, the investor could place the order for 70 shares. The SEC even went so far to state that more frequent disclosure of the IIV could provide information about the ETMF's current portfolio trading activity sufficient to permit traders to reverse engineer the ETMF's trading strategy.

The SEC relied significantly on this pricing structure in approving the ETMF application for exemptive relief. According to the SEC, the NAV-based trading approach creates ETMF prices that will be directly linked to NAV, and as such, ETMFs can be expected to trade at consistently narrow premiums/discounts to NAV and tight bid/ask spreads, even in the absence of full portfolio transparency.

To accommodate this new pricing structure, Nasdaq has indicated that it will implement a new "NAV-Based Trading" protocol where all bids, offers and execution prices for an ETMF will be expressed as a premium or discount to the ETMF's next-determined NAV. Trades in ETMF shares using the NAV-Based Trading protocol will be binding once orders are matched on Nasdaq. Transaction prices will be contingent on the ETMF's NAV determination at the end of the trading day. ETMF ticker symbols will have a unique identifier to indicate that they use the NAV-Based Trading system, but existing Nasdaq order types and interfaces will be used to transmit bids and offers to Nasdaq. Nasdaq's proprietary data feed will use the "NAV +/-" format, but the consolidated tape will use a proxy price to stand in for the ETMF's next-determined NAV. For example, a trade at NAV + $0.02 would appear as 100.02 on the consolidated tape if $100/share was used as a proxy price for the to-be-determined NAV. Nasdaq has stated that it will work with member firms and market data providers to ensure that bid, offer and execution prices that are disseminated to the investing public reflect the "NAV +/-" format. Nasdaq has also stated that it will work with brokers to ensure that appropriate systems are installed prior to the launch of the ETMFs, which will permit buy and sell orders to be in "NAV +/-" format. Nasdaq will also implement written surveillance procedures for ETMF shares and procedures designed to prevent the use and dissemination of material, non-public information regarding the ETMF's portfolio positions, and changes in those positions.

After the ETMF's NAV is calculated at the end of the day, it will be reported to Nasdaq and all trades entered during the day with respect to that ETMF will be priced. Once each trade is priced, Nasdaq will deliver the data to National Securities Clearing Corp. (NSCC) for clearance and settlement, pursuant to the standard NSCC processes for exchange-traded securities. Trading prices will then be confirmed to the member firms participating in the trades.

Nasdaq has stated that it will inform its members by means of an information circular prior to each ETMF's commencement of trading whether Nasdaq Rule 5745(f) applies to the ETMF, which would require members to provide purchasers with a written description of the ETMF not later than the time a confirmation is delivered. Nasdaq members would also have to include a written description with any sales materials provided to customers or the public, and must include a statement in such sales material indicating the availability of the written description circular. The SEC indicated that members carrying an omnibus account for a non-member broker-dealer must inform such non-member that execution of an ETMF order will constitute an agreement by the non-member to make the written description available to its customers. ETMFs will be prohibited from holding themselves out as an open-end investment company, mutual fund or ETF. In addition, as with ETFs, advertising materials with respect to ETMFs must indicate that they are not individually redeemable.

## Differences Between ETMFs and Non-Transparent ETFs

The non-transparent ETF proposals differ from ETMFs in several ways. First, the blind trust applicants sought to operate non-transparent ETFs based on the traditional ETF intraday trading and pricing approach as opposed to the "NAV-based trading" used by ETMFs. As such, those ETFs would have traded in the secondary market in absolute dollar terms.

Second, both the blind trust model and the proxy data model for non-transparent ETFs proposed various substitutes for daily transparency. In the case of the blind trusts, the applicants relied heavily on the ETFs' IIV, prospectus disclosure, and quarterly portfolio holdings disclosure. The proxy data applicants proposed to provide a much more detailed set of data about each ETF on a daily basis. Accordingly, both the blind trust and the proxy data models proposed to still rely on the arbitrage pricing mechanism of ETFs (*i.e.*, APs placing creation and redemption orders to profit from differences between an ETF's market price and NAV). In contrast, ETMFs effectively sidestepped this issue by linking their intraday trading price directly to NAV (plus or minus a market-based premium or discount). This lack of reliance on an arbitrage pricing mechanism eliminates the need for market makers to engage in intraday hedging of their positions, which also eliminates the need to provide market makers with daily portfolio holdings or equivalent data. Nonetheless, ETMFs will provide substantial information to the market place. An ETMF's adviser will be required to set up a free public Web site that includes current information about the ETMF and links to the ETMF's prospectus and current documents. The website must also include the ETMF's prior day's NAV, intraday high, low, average and closing trade prices, midpoint of highest bid and lowest offer prices as of the close, and the spread between the highest bid and lowest offer prices as of the close.

Third, the blind trust model would have required additional structures to be built (*e.g.*, the blind trust), agreements to be negotiated (*e.g.*, the trust agreement) and operational procedures to be implemented by APs (*e.g.*, standing procedures to liquidate or hedge deposit securities held by the blind trust in connection with a redemption order). ETMFs (as well as the proxy data ETF models) will be able to rely on substantially the same structures and agreements as existing ETFs. However, because of the novel method in which ETMF shares will trade intraday, there will be certain operational changes that will need to be implemented and the market will need to be educated about this new trading protocol.

## Effect on APs

Unlike in ETFs, where APs often seek to profit through arbitrage pricing, APs trading ETMFs will be able to secure a discount or premium at trade execution with only limited market risk and profit to the extent that the premium or discount is greater than the transaction fee charged by the ETMF for creating or redeeming creation units. As with traditional ETFs, where APs engage in distribution activities to such an extent that they could be at risk of being characterized as an underwriter by the SEC, they may want to analyze their business risk and consider engaging in a due diligence process to review the ETMF's offering documents, particularly with respect to disclosures around trading, pricing and premiums/discounts to NAV.

 

Because ETMFs are a brand new type of investment product, APs will have to incorporate them into their existing policies and procedures for trading and compliance and APs will have to become familiar with how ETMFs operate and are structured. To transact in ETMF shares, APs likely will have to become acquainted with new inventory management techniques, modified order placement and delivery protocols, and possibly different provisions in their AP agreements and the order processing handbooks. It is worth pointing out, however, that ETMFs' smaller creation unit sizes relative to traditional ETFs may assist APs in managing their inventory.

Finally, ETMF shares can be expected to seek relief similar to that secured by ETFs under various sections of the Securities Exchange Act of 1934 These will likely include Rule 14e-5 (prohibiting a person playing a role in a tender offer from otherwise dealing in the securities that are the subject of the tender offer), Section 11(d)(1) of the Exchange Act (prohibiting a broker-dealer from extending or maintaining credit, or arranging for the extension or maintenance of credit, on shares of new issue securities, where the broker-dealer participated in the distribution of the new issues securities within the preceding 30 days),[10] Section 13(d) (requiring beneficial owners of 5% or more of an issuer's outstanding securities to file reports with the SEC) and Section 16(a) (requiring certain insiders (including 10% beneficial owners) to file reports with the SEC). Because the SEC previously has provided relief from these reporting provisions in the context of traditional ETFs, it is likely that the SEC will provide similar relief in the context of ETMFs. Nasdaq has also indicated that it will adopt a market surveillance program with respect to ETMFs to monitor the use of material non-public information, which could result in additional compliance requirements for APs. Additional requirements may apply under the Exchange Act and other regulations.

In conclusion, as ETMFs come to market—which is now a certainty—APs will have to consider how to integrate them into their existing operations, recognizing that they are not the same as ETFs. Indeed, APs should watch regulatory developments related to ETMFs to understand where the SEC and FINRA may treat them as ETFs, and where they are viewed as mutual funds or afforded new and distinct treatment. Further changes may still be on the horizon as well if additional non-transparent ETF products gain regulatory approval and come to market. In general, the regulatory approval of this new investment product represents an exciting time for both the buy side and the sell side of the market and it will be interesting to watch related new developments in the regulatory space.

**NOTES**

1. *See* Precidian ETFs Trust, et al, Notice of Application, Investment Company Act Rel. No. 31,300 (Oct. 21, 2014), *available at* https://www.sec.gov/rules/ic/2014/ic-31300.pdf; Spruce ETF Trust et. al, Notice of Application, Investment Company Act Rel. No. 31,301 (Oct. 21, 2014), *available at* https://www.sec.gov/rules/ic/2014/ic-31301.pdf. Three other fund families had sought similar exemptive relief. SSgA Active ETF Trust and SSgA Master Trust, along with SSgA Funds Management, Inc. and State Street Global Markets, LLC, filed an application for exemptive relief with the SEC on June 7, 2013 (File No. 812-14165-02). On June 5, 2014, PowerShares Actively Managed Exchange-Traded Fund Trust II, Invesco PowerShares Capital Management LLC and Invesco Distributors, Inc. filed an application with the SEC (File No. 812-14319). Capital Group ETF Trust, Capital Research and Management Company and American Funds Distributors, Inc. filed an application with the SEC on July 28, 2014 (File No. 812-14339).
2. *See* Precidian ETFs Trust, et al, Order Permitting Withdrawal of Application, Investment Company Act Rel. No. 31,336 (Nov. 14, 2014), *available at* http://www.sec.gov/rules/ic/2014/ic-31336.pdf; Spruce ETF Trust et. al, Order Permitting Withdrawal of Application, Investment Company Act Rel. No. 31,337 (Nov. 14, 2014), *available at* http://www.sec.gov/rules/ic/2014/ic-31337.pdf.
3. *See* Eaton Vance Management, Eaton Vance ETMF Trust and Eaton Vance ETMF Trust II, Notice of Application, Investment Company Act Rel. No. 31,333 (Nov. 6, 2014), *available at* http://www.sec.gov/rules/ic/2014/ic-31333.pdf.
4. *See* NASDAQ Stock Market LLC, Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to Listing and Trading of Exchange-Traded Managed Fund Shares, Exchange Act Rel. No. 73,562 (Nov. 7, 2014), *available at* https://www.sec.gov/rules/sro/nasdaq/2014/34-73562.pdf.
5. Mutual funds are required to disclose their holdings in full at least once quarterly, with a lag of not more than 60 days, on Form N-CSR (annual and semi-annual shareholder reports that include a schedule of portfolio holdings) and Form N-Q (quarterly reports of portfolio

holdings for the first and third fiscal quarters where neither an annual nor a semi-annual report is filed).

6. We note that where an ETMF's strategy sought to remove a stock from its portfolio, it would be beneficial to the ETMF to be able to deliver such stock in-kind to APs upon a redemption. However, because the same composition file must be used for both purchases and redemptions, the ETMF would have to take delivery of potentially more of that stock than it delivered out during such day if more purchase orders were placed than redemption orders. Accordingly, the ETMF would likely sell out of the position into the market. In limited circumstances, the composition file may also consist entirely of cash, in which case the tax efficiencies and minimizing of transaction costs would be reduced compared to a composition file that was primarily effected in-kind.

7. For example, where the stock of the AP's parent company is included in the composition file.

8. NASD Conduct Rule 2830 imposes restrictions on a FINRA member broker-dealer's ability to accept certain selling charges in connection with the sale of open-end registered investment companies.

9. IIV is based on the value of an ETF's portfolio and is calculated by a calculation agent using the last available market quotation or sale price of the ETF's portfolio holdings. The IIV is not the NAV, it is a reference produced by a third party seeking to approximate the ETF's underlying NAV.

10. Class relief from Section 11(d)(1) has been provided in several instances to various types of ETFs. *See e.g.*, Securities Industry Association, Derivative Products Commission, SEC No-Action Letter (Nov. 21, 2005), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/sia112105.htm. It is as yet unclear whether this could be applied to ETMFs.