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The Non-Transparent Future of ETPs

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The registered fund industry may be at the threshold of a very significant change in the types of pooled investment products available to investors. This is because the US Securities and Exchange Commission (SEC) recently granted exemptive relief to a new type of exchange-traded product – Exchange-Traded Managed Funds or "ETMFs"[1] – and is currently considering several proposals for non-transparent, actively-managed exchange-traded funds (ETFs). ETMFs and, if approved, non-transparent ETFs, have attributes that benefit both investors and asset managers. As with traditional ETFs, in time these benefits could lead to substantial market acceptance and use.[2] In this article, we will provide an overview of the legal and operational aspects of both ETMFs and the recently proposed models of non-transparent ETFs and point out some key similarities and differences between these products. We will also suggest some ways in which these new exchange-traded product (ETP)[3] structures could affect the asset management industry at large.

A Brief History of ETFs and Non-Transparent ETPs

Currently, there are three basic types of registered investment companies in the US market, as contemplated in the 1940 Act: open-end funds, closed-end funds and unit investment trusts.[4] ETFs have some characteristics that are similar to traditional unit investment trusts, open-end funds (commonly referred to as "mutual funds") and closed-end funds, and some characteristics that are different. For example, ETFs are like closed-end funds because their shares trade at market prices on national securities exchanges during normal market hours. Further, ETFs are like mutual funds because, among other reasons, they issue and redeem shares on a continuous basis at net asset value (NAV). ETFs, unlike mutual funds, closed-end funds and traditional unit investment trusts, issue and redeem shares only in large aggregations of shares called "creation units" and only with banks and broker-dealers that have entered into an agreement with the ETF's distributor. These banks and broker-dealers are known as "authorized participants," or "APs."

Because the key features of ETFs differ from the key features of investment companies contemplated when the 1940 Act was originally enacted, ETFs do not easily fit within the statutory framework of the 1940 Act. Accordingly, as a prerequisite to coming to market, ETFs must obtain exemptive relief from the SEC from several sections of the 1940 Act.[5] These exemptions permit, among other things, (i) ETF shares to trade in the secondary market at market prices rather than NAV per share, (ii) ETF shares to be redeemable in creation-unit size (rather than individual shares), and (iii) certain affiliated persons of the ETF (specifically APs) to buy securities from, and sell securities to, the ETF.

When granting exemptive relief, the SEC requires applicants to make a number of representations and imposes a number of specific conditions. These representations and conditions are designed, among other things, to help ensure that ETF shares will trade at market prices that approximate the intraday NAV per share of the ETF (the total asset value of the ETF's entire portfolio of underlying securities, less outstanding liabilities, divided by the total number of shares outstanding). The ability of ETF shares to trade at or near intra-day NAV per share is largely the result of APs fueling an arbitrage pricing mechanism. A relatively simple example of ETF arbitrage is presented by the following scenario. If an ETF's shares are trading at a premium (that is, the current market price is higher than the current intraday value of the ETF's portfolio holdings), then one or more APs will be incented to assemble a basket (referred to as a creation basket) of the ETF's underlying securities and deliver it in-kind to the ETF in exchange for the issuance of new ETF shares. This allows the AP to capture the difference in value between the underlying securities and the ETF shares. In addition, by increasing the available supply of ETF shares, this transaction effectively resets the alignment between market price of the ETF shares and NAV (that is, the increase in the supply of ETF shares should incrementally push the premium back towards NAV). Similarly, if an ETF's shares are trading at a discount (that is, the current market price is lower than the current intra-day value of the ETF's portfolio holdings), then one or more APs will be incented to assemble a basket of ETF shares, redeem them back to the ETF in exchange for a basket of the underlying securities and retain the difference as profit. APs are able to capture these differences in value by other means as well, such as by using derivatives and other strategies. This arbitrage pricing mechanism exists because APs are able to determine the real-time value of the ETF's portfolio (largely due to the transparency of the ETF's portfolio), are able to access the ETF's underlying securities (or derivatives based on such securities) and are able to increase/decrease the supply of ETF shares through the creation/redemption process. In short, a key element of successful ETF arbitrage, and a key element of all ETF exemptive orders to-date, has been portfolio transparency.

This concern over portfolio transparency, as well as the transparency of the underlying markets in which ETFs invest, is reflected in the types of products the SEC has approved and the timeline for the approval of such products. For example, the first ETFs approved by the SEC in the early to mid-1990s were based on US large capitalization equity securities. The first fixed income ETF was not approved and launched until 2002. In 2006, the SEC permitted certain leveraged and inverse index-based ETFs to come to market. In 2008, the SEC granted exemptive relief to the first actively managed ETFs.[6] Portfolio transparency continues to be a concern for the SEC as highlighted by the express requirement in active ETF orders that each business day before commencement of trading the ETF will disclose on its website the identities and quantities of the portfolio instruments held by the ETF that will form the basis for the ETF's calculation of NAV at the end of such business day.[7]

It appears that many active managers have kept away from the ETF space mainly out of concern that daily disclosure of their active portfolio holdings would be a competitive disadvantage. These managers presumably are concerned that their proprietary investment strategies could be reverse engineered by competitors who would be able to mine trends and strategies from the daily holdings disclosure required by the SEC as a part of their exemptive relief. The total number of ETFs in the United States has grown by over 1,100 percent from 2002 to the end of 2013, with assets growing by over 1,600 percent during the same period.[8] However, the growth rate in actively managed ETFs has not kept up with that of passively-managed (index-tracking) ETFs.[9] We believe this is due, at least in part, to the requirement that ETFs daily disclose their portfolio holdings.

In their requests for exemptive relief from the SEC, ETMFs and non-transparent ETFs challenge the notion that the portfolio must be transparent in order to keep exchange prices in line with NAV.

Non-transparent ETFs were first proposed to the SEC in the mid-2000s, but did not gain regulatory approval.[10] Within the last few years, a number of prominent registered fund complexes have filed applications for exemptive relief with the SEC that sought to permit some form of non-transparent, exchange-traded, registered investment fund.[11] Certain fund families also paired with stock exchanges in an effort to convince the SEC to take action, but also presumably to strategically position themselves for market share if such products were permitted.[12]

On October 21, 2014, the SEC issued preliminary denials to two exemptive relief applications, which acted as a setback to those market participants seeking to launch non-transparent ETF structures, resulting in both proposals later being withdrawn.[13] In the wake of the SEC's denials, other applicants similarly withdrew their proposals for virtually identical blind trust structures.[14] In responding to these applications, the SEC was substantially concerned that the pricing mechanisms proposed as an alternative to a fully transparent portfolio were insufficient to ensure that ETF shares would consistently trade on the exchange at prices sufficiently close to their NAV per share. However, the SEC was careful to state that its views on the proposals were "preliminary." We believe this indicates that the SEC's statements could act as a roadmap to create non-transparent ETFs that are more likely to gain regulatory approval. In addition, both of the applications that were withdrawn proposed to use a similar "blind trust" structure instead of providing a transparent portfolio, but without providing additional information to the market as a proxy for daily portfolio transparency. As discussed herein, one of the two fund sponsors has since submitted an enhanced proposal for exemptive relief that would still use a blind trust model, but would also provide the market with a "verified IIV" – or "VIIV."

Shortly thereafter, on November 6, 2014, the SEC issued a notice indicating that it intended to grant exemptive relief that would permit the launch and operation of ETMFs.[15] The following day, November 7, 2014, the SEC also indicated that it would grant a proposed rule change filed by NASDAQ Stock Market (Nasdaq) that would permit the exchange to list and trade shares of ETMFs.[16] The SEC then approved ETMFs on December 2, 2014.[17]

In addition, two other applicants have proposed a structure for non-transparent ETFs that would not use a blind trust and would daily provide the market with a set of data about each ETF, from which APs could evaluate and hedge their risks as market makers.[18] The SEC has not yet addressed this third category of proposals.

ETMFs: A Hybrid of Mutual Funds and ETFs

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 generally lower cost structure of exchange-traded products, which do not charge sales loads or asset-based distribution or service fees. This structure also may appeal to asset managers who employ active investment strategies because, unlike traditional ETFs, the ETMF structure does not require daily portfolio disclosure, making it less likely that an ETMF's investment strategy can be reverse engineered.

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 shares, which would be significantly smaller than the 25,000 to 50,000 share size of creation units for most traditional ETFs. Also like ETFs, ETMF shares will be listed on a national securities exchange (for example, Nasdaq) and traded in the secondary market. As with most ETFs, 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 their portfolios, ETMF creation and redemption baskets are not required to represent a pro rata slice of the ETMF's portfolio and an ETMF may be more likely to have a significant portion of its creation basket set aside as cash than a traditional ETF (depending on its investment strategy). Like mutual funds, ETMFs are only required to disclose their portfolio holdings on a quarterly basis with a 60-day lag.

Pricing

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

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, ETMF shares will not trade in the secondary market intraday at absolute dollar prices. Instead, ETMF shares will trade at prices expressed as a premium or discount to the ETMF's to-be-determined NAV (for example, NAV + $0.05). For each trade, any premium/discount will be locked in at trade execution, but the final transaction price will not be determined until the end of the business day when 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 potentially 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.

Also unlike ETFs, which contract with their listing exchange to disseminate an IIV[19] 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 intraday 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. The SEC even stated that more frequent disclosure of the IIV could provide information about the ETMF's current portfolio trading activity sufficient to permit traders to determine the ETMF's manager's strategy. The SEC relied significantly on this pricing structure and the fact that all trades are based on the ETMF's end-of-day NAV 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.

Creation Baskets

Each day prior to the start of trading, an ETMF will transmit a "composition file" to the National Securities Clearing Corporation (NSCC), which will then disseminate such file to the public. 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 1940 Act.

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. An ETMF also may exclude from the composition file securities that it plans to add or remove from its portfolio.[20]

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. Cash-in-lieu will only be permitted where deposit securities are not available in sufficient quantity, where deposit securities are not eligible for trading by the AP (or the client for whom the AP is placing a creation order),[21] 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.

Trading and Marketing

The SEC relied significantly on this pricing structure and the fact that all trades are based on the ETMF's end of day NAV 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 through which exchanges report their trades and quotes in real time 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 were used as a proxy price for the to-be-determined NAV per share. 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 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.

ETMFs will be prohibited from holding themselves out as open-end investment companies, mutual funds or ETFs. In addition, as with ETFs, advertising materials with respect to ETMFs must indicate that they are not individually redeemable. Also, if an ETMF adviser has an affiliated broker-dealer, it must erect a firewall 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 material non-public information.

Blind Trusts ETFs

Under the blind trust proposals that were addressed by the SEC, APs would have been required as part of the authorized participant agreement to establish a blind trust and to appoint the ETF's custodian as trustee of the blind trust, acting for the benefit of the AP. Further, the custodian, as trustee of the blind trust, would have been paid a fee by the AP.

For all creation orders, the AP would deliver cash to its blind trust trustee, which then could have assembled a creation basket of deposit securities for in-kind (or partial in-kind) delivery to the ETF on a confidential basis. For redemption orders, the ETF (acting through its custodian) would have delivered in-kind portfolio securities to the AP's blind trust. As proposed, upon redemption the trustee of the blind trust would liquidate the portfolio securities delivered by the ETF and pass along the cash proceeds without disclosing the identity of the portfolio securities to the AP. APs likely would have instructed the trustee of the blind trust to liquidate portfolio securities in connection with a redemption order on the date of the redemption order so as to realize redemption proceeds as close as possible to the ETF's NAV on the redemption date.[22]

The blind trust proposals stated that an IIV would be published every 15 seconds by the exchange during trading hours. The IIV would have been calculated by a calculation agent who would have had full insight into the ETF's portfolio. In addition, the proposed ETFs would have included a back-up mechanism pursuant to which retail investors could have redeemed shares directly back to the ETF other than in creation-unit size in certain circumstances, but subject to a redemption fee that could have been up to two percent of the amount being redeemed and brokerage commissions incurred as a result of the transaction.

In denying two of the blind trust models, the SEC explained that daily portfolio transparency results in a "close tie" between an ETF's market price and its NAV per share, which serves as the "foundation for why the prices at which retail investors buy and sell ETF shares are similar to the prices at which [APs] are able to buy and redeem shares directly from the ETF at NAV."[23] The SEC stated that the proposed structures fell "far short of providing a suitable alternative" to daily portfolio transparency.[24] The SEC stated that market makers would not be able to glean sufficient information about an ETF's holdings from prospectus disclosure or quarterly disclosures of full portfolio holdings provided as of a date 60 days earlier. The SEC criticized IIV as being calculated based on "stale data" relative to the speed at which market makers operate.[25] The SEC also noted that IIV is not subject to a uniform methodology of calculation and that generally no party agrees to take responsibility for its accuracy. Further, because IIV uses last-available market quotations or sale prices as inputs, the SEC warned that it could be an insufficient indication of actual value for an ETF with fair-valued securities, thinly traded instruments, or foreign securities that trade during different hours. Further, the SEC warned that all of these issues could be significantly pronounced during times of market stress or volatility.

On December 22, 2014, one of the ETF sponsors that was denied by the SEC filed a new application for exemptive relief.[26] The revised application still proposes to use a blind trust model through which APs would transact with the ETF. The ETF would be subject to the same portfolio disclosure obligations as mutual funds (quarterly with a 60-day lag) and would also maintain a public website with quantitative information that would be updated daily. Such information would include average daily trading volume, the prior day's closing price, NAV and the bid-ask spread at the time the NAV was calculated, and a chart showing the frequency distribution of discounts and premiums of the bid-ask spread over the prior four calendar quarters.

But the critical piece of the revised proposal is the ETFs' verified IIV, – or "VIIV." VIIV is an enhanced intraday valuation methodology designed in response to the SEC's prior criticisms of IIV. VIIV would include the ETF's accrued income and expenses, including any extraordinary expenses.[27] Further, VIIV would use price quotations rather than last-sale information in order to address the concerns expressed about IIV and stale price information for infrequently traded securities. Each ETF will also employ two independent pricing sources and a verification agent and would establish a protocol that continuously compares the two data streams in real time.[28] The ETF's board would establish and review procedures used to calculate the VIIV and maintain its accuracy and the VIIV calculation methodology would be publicly disclosed. In addition to the publicly disseminated VIIV, each ETF would disclose to the various blind trust trustees the ETF's securities, cash and dividends and interest accrued on the ETF's assets, less expenses, which would represent a pro rata slice of the ETF. Each blind trust trustee could then use this information to independently calculate an IIV on a real time basis. This IIV would provide additional information to APs about the value of such ETF's portfolio. Because each AP would be in contractual privity with its blind trust trustee, APs could negotiate for this information to be treated with a higher standard of care than may have been provided by a third-party calculation agent, as originally proposed. With this information, the AP presumably would be able to instruct the blind trust trustee to engage in bona fide arbitrage activity. The revised proposal appears designed to protect the confidentiality of the ETF manager's proprietary strategies while providing, in effect, the same daily transparency of portfolio holdings as a traditional ETF, but only to an entrusted agent that can act for the benefit of the AP with which it has a contractual relationship. It will be interesting to see whether this VIIV methodology provides the SEC with sufficient comfort that there will be a "close tie" between an ETF's market price and its NAV per share. If the SEC can be convinced that APs transacting directly with the ETF and retail investors buying on an exchange will be able to purchase at or sufficiently near the same price, including during volatile markets, and that APs will not have any undue advantage over other market participants, it would seem likely that exemptions under this model would be granted. If other blind trust applicants submit similar revised proposals and exchanges follow suit with rule proposals to list the shares of such ETFs, it could further influence the SEC to act.

Proxy Data ETFs

An alternative approach to non-transparent ETFs would rely on publication of "proxy data" about the ETF's portfolio instead of the use of a blind trust mechanism. Under this approach, an ETF, instead of publishing its portfolio holdings, would publish a representative portfolio of securities and cash while providing a constant stream of data about the characteristics of its actual portfolio to the market. This information is designed to permit APs to hedge their risk of transacting in ETF shares while at the same time maintaining confidentiality of the ETF's full portfolio holdings. These proxy data proposals would provide a more robust set of information to the market than what was proposed by the original blind trust models. However, it is still unclear whether the SEC will consider such data to be substantial enough to ensure that an ETF's market price and intra-day NAV per share remain closely tied to each other. As with the use of the blind trust model, the SEC is likely to be particularly concerned as to whether this approach will be effective during periods of market volatility and stress.

In addition to the proposals first submitted in 2007 and 2008, there are currently two such proposals with the SEC. Under the first proposal,[29] ETFs would disclose their full portfolio holdings monthly on a 30-day lag and would daily disclose a trading basket composed of recently disclosed portfolio holdings and representative ETFs. The ETFs would also disseminate an IIV every 15 seconds. The contents of the trading basket would be designed to track closely the performance of the applicable ETF. The expectation is that APs would be able to use the trading basket as a reliable hedging vehicle for the ETF. Based on the SEC's statements in its October 24, 2014 notices to the blind trust applicants, it is unlikely that the SEC will give much weight to the provision of IIV and the monthly disclosure of portfolio holdings with a 30-day lag. Instead, the SEC's approval of this proposal would likely turn on how closely the trading basket resembles the ETF's actual portfolio such that market makers will be comfortable transacting in ETF shares at a level sufficient to ensure that market prices and NAV remain sufficiently close, particularly during volatile market conditions.

Under the second proposal,[30] the ETFs would provide both a "high-quality pricing signal" for ETF shares and a "high-quality hedging signal" for positions in ETF shares. As proposed, the ETF's IIV per share would be a "high-quality pricing signal" because (i) at least 95 percent of the ETF's holdings will be traded on an exchange (and accordingly will have a market price), (ii) at least 95 percent of the ETF's holdings will be traded in sync with the ETF's shares such that their prices can be continuously updated throughout the trading day, (iii) there will be sufficient trading volume and liquidity in at least 95 percent of the ETF's portfolio holdings, and (iv) the entity that calculates the IIV will know the ETF's portfolio holdings. As a result, at least 95 percent of such ETFs' portfolios will be invested in common stocks and exchange-traded equity securities (including fund shares), depositary receipts, short positions, exchange-traded futures, exchange-traded options, exchange-traded swaps, money market instruments, cash and cash equivalents. Although this highly liquid portfolio may satisfy the SEC's concern over the limited usefulness of IIV with respect to the valuation of fair-valued and illiquid securities, these characteristics also effectively limit the types of strategies that could be employed in such non-transparent ETFs.

For a "high-quality hedging vehicle," the ETF would identify a hedge portfolio that would be designed to have low tracking error against the ETF's NAV and that would trade in sync with the ETF's shares on an exchange and with sufficient liquidity and volume. Each hedge portfolio would either be a broad-based securities index or the ETF's recently disclosed portfolio holdings. The ETF would invest at least 80 percent of its total assets in the same instruments as the hedge portfolio, although the ETF's adviser could change the hedge portfolio at any time. In addition, 95 percent of the ETF's portfolio holdings and the instruments in the hedge portfolio would be liquid and traded on an exchange.

As proposed, each ETF would also publish historical data regarding differences between the ETF's NAV and the performance of the ETF's hedge portfolio. The ETF's adviser would also manage the ETF so that its performance was sufficiently similar to that of the hedge portfolio. The ETF would also provide APs with (i) the daily deviation between the ETF's NAV and its hedge portfolio for a rolling one-year period; (ii) "tracking error," which would be the standard deviation of the daily deviation as observed over the prior year; and (iii) "empirical percentiles" of daily deviation over the prior year, which effectively would give APs a confidence level in the daily deviation between the ETF's NAV and its hedge portfolio. These three metrics would be disclosed on the ETF's public website.

Differences Between ETMFs and Non-Transparent ETFs

The proposed non-transparent ETF models differ from ETMFs in several significant ways. First, both the blind trust model and the proxy data model applicants seek to operate non-transparent ETFs based on the traditional ETF intraday trading and pricing mechanism. As with traditional ETFs, shares of ETFs using the blind trust and proxy data models would trade in absolute dollar terms (for example, $10.25) as opposed to the "NAV-based trading" used by ETMFs.

Second, both the blind trust model and the proxy data model for non-transparent ETFs propose various substitutes for daily transparency. In the case of the blind trusts, the applicants relied on the ETFs' IIV, prospectus disclosure, and quarterly portfolio holdings disclosure. The revised proposal of one blind trust applicant now offers an enhanced VIIV methodology and confidentially provides full portfolio disclosure to the blind trust trustee, which can be used at the direction of the AP to calculate IIV and engage in bona fide arbitrage activity. The proxy data applicants' proposals would 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, despite their lack of full portfolio transparency, still rely on the traditional ETF intra-day pricing and arbitrage mechanism to keep ETF trading prices in line with intra-day NAV. In contrast, ETMFs effectively sidestepped this issue by linking their intraday trading prices directly to end-of-day NAV (plus or minus a market-based premium or discount). This approach is designed to eliminate the need for market makers to engage in intraday hedging of their positions, thereby minimizing the need for daily disclosure of portfolio holdings.

Third, the blind trust model (including as revised) would require additional structures to be put into place (for example, the blind trust), agreements to be negotiated (for example, the blind trust agreement) and operational procedures to be implemented by APs (for example, arbitrage and hedging instructions for the trustee). ETMFs (as well as the proxy data ETF models) will be able to rely on substantially the same structures as existing ETFs, though they too will require departures from the traditional ETF model. For example, because of the novel method in which ETMF shares will trade intraday, certain operational changes will need to be implemented to facilitate trading and market participants will need to be educated about ETMF trading protocols.

Potential Market Impact

Retail investors seeking an exchange-traded product designed to provide exposure to active trading strategies at a relatively low cost and with trading prices directly linked to the NAV may find ETMFs to be an appealing alternative to ETFs and mutual funds. However, NAV-based trading does not allow true intraday trading because all prices are tied to the end-of-day NAV. The new category may also be attractive to active managers who have until now opted not to sponsor exchange-traded products because of concerns about transparency. The viability of ETMFs will also depend on whether the SEC permits variations on this structure or otherwise opens the door to further non-transparent ETF structures, such as the proxy data model or the revised blind trust model.

APs will be affected by each of the three models. At a minimum, because they would represent a brand new type of investment product, APs would have to incorporate ETMFs and non-transparent ETFs into their existing policies and procedures for trading and compliance and become familiar with how they operate and are structured. APs likely will also want to consider their potential risk of being characterized as an underwriter of any of these products, depending on the particular facts and circumstances, particularly in the context of evaluating their ability to earn a profit from trading in these new structures.

Similar to ETFs, which over time were granted exemptive relief from various provisions of the 1934 Act impacting secondary market trading of ETF shares, ETMFs and, if approved by the SEC, non-transparent ETFs, can be expected to seek relief from various sections of the 1934 Act and the rules thereunder. Such relief would likely take the form of clarifications from the SEC Staff that existing class exemptive relief given to transparent ETFs can be relied on, notwithstanding certain structural differences between ETFs and the new products. Potential areas for exemptive relief could include Section 11(d)(1) of the 1934 Act (relating to extending or maintaining credit on shares of new issue securities), Section 13(d) (requiring five percent beneficial owners to file reports with the SEC), Section 16(a) (requiring certain insiders (including 10 percent beneficial owners) to file reports with the SEC), Rule 10b-10 (delivery of confirmations to customers), Rule 10b-17 (which requires public companies to provide notice of corporate actions), Rule 14e-5 (limitations on transacting in certain tender offers) and Regulation M (market manipulation). Because the SEC previously has provided relief from these provisions in the context of traditional ETFs, it is likely that the SEC will consider providing similar relief in the context of ETMFs and, if approved, non-transparent ETFs.

Other funds and investment advisers that seek to invest in ETMFs and, if approved, non-transparent ETFs, should also become familiar with these products, including their operational and trading attributes. Advisers should be sure that any such investments are appropriate for their clients, in the context of each client's particular financial situation and investment goals. Funds should carefully review relief granted to such products with respect to investments by other funds and, if applicable, tailor their existing policies and procedures designed to comply with Section 12 of the 1940 Act to such new products.

With respect to new product formation, fund shops seeking to implement similar products should consider intellectual property issues, including whether licensing a protected structure may be a viable solution. Fund complexes seeking to obtain their own exemptive relief from the SEC should carefully consider the SEC's discussions in both the October 14, 2014 releases denying the blind trust applicants and the November 6, 2014 release in which ETMFs were approved.

Fund boards will also be tasked with new oversight responsibilities for any new ETMFs or non-transparent ETFs. Boards will be expected to be familiar with the products and how they are structured. In approving ETMFs, the SEC approved a more flexible creation and redemption process that emphasized the board approval of creation and redemption policies and procedures and oversight of the creation and redemption process by chief compliance officers. This treatment is consistent with the position that the ETF industry has been advocating in recent years with respect to ETF creations and redemptions and could signal a potential shift in the way the SEC intends to treat the ETF creation and redemption process in any future ETF rulemaking. Should the revised blind trust proposal be approved, boards would be further tasked with overseeing the VIIV calculation process, which would further heighten the importance of valuation issues with respect to investment company boards generally.

Conclusion

At least one new type of investment product – ETMFs – will be entering the landscape in 2015. Similar non-transparent exchange-traded products may follow, depending on whether the SEC can be assured that market and NAV prices can remain closely tied. As with all new product and regulatory developments, both business and legal questions will arise. Buy-side interests will have to consider whether these products are better investments because of their potentially lower cost base, but will have to be careful to first understand the products given their active management and limited transparency. Sell-side interests will have to familiarize themselves with the products for suitability purposes, while staying abreast of any additional regulatory developments. Because these products are not exactly like any product that currently exists in the marketplace, 2015 should be an exciting time for the investment management industry and its counsel and compliance professionals.

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NOTES

1 *See Eaton Vance Management, et al.*, Investment Company Rel. No. 31,361 (Dec. 2, 2014) (order):

Eaton Vance Management, et al., Investment Company Rel. No. 31,333 (Nov. 6, 2014) (notice). *See also Eaton Vance ETMF Trust, et al.*, Exemptive Application, SEC File No. 812-14139 (Mar. 27, 2013), as amended (Sept. 12, 2013, Jan. 23, 2014, Jan. 23, 2014, Sept. 15, 2014 and Sept. 25, 2014).

2 ETFs, for example, have been one of the most innovative and successful product categories for over a decade. In 2002, 113 ETFs represented $102 billion in assets and as of the end of 2013, 1,294 ETFs represented $1.6 trillion in assets. *See* Investment Company Institute*, 2014 Investment Company Fact Book* 53 (2014), *available at http://www.ici.org/pdf/2014_factbook.pdf.* The numbers are projected to continue to grow.

3 In this article, we use the term "ETF" to refer to registered investment companies (i) that invest primarily in securities, (ii) that issue shares in "creation unit aggregations" and (iii) whose shares trade on national securities exchanges and other markets at specific prices quoted in dollars. We use the term "ETMF" to refer to investment companies (i) that invest primarily in securities, (ii) that issue shares in "creation unit aggregations" and (iii) whose shares trade on national securities exchanges and other markets at *NAV-based prices*, as discussed in more detail below. On its website listing granted orders, the SEC does not categorize ETMFs as actively-traded ETFs. For purposes of this article, we will refer to ETMFs and ETFs together as "exchange-traded products" or "ETPs." The term "ETP" is also used to refer to exchange-traded products that are registered under the Securities Act of 1933 only.

4 Face amount certificate companies, unit investment trusts and management companies are the three types of investment companies expressly contemplated in the 1940 Act. Face amount certificate companies are no longer used, leaving unit investment trusts and management companies (which are subdivided into "open-end" and "closed-end") as the three dominant types of investment companies in use today. Unit investment trusts typically issue redeemable units and make a one-time public offering of a fixed number of units. Unit investment trusts have a set termination date, do not actively trade a portfolio and, accordingly, do not have boards of directors, corporate offices or investment advisers. Some passively-managed ETFs, particularly older ETFs, are structured as unit investment trusts.

5 Section 6(c) of the 1940 Act, for example, permits the SEC to grant exemptions from the 1940 Act "if and to the extent that such exemption is consistent with the protection of investors."

6 Although the first active ETFs were permitted to make extensive use of derivatives, in 2010, as part of an ongoing review of investments in derivatives by registered investment companies, the SEC imposed a moratorium on exemptive relief for actively managed ETFs that use derivatives, pending the completion of the SEC's review. *See SEC Staff Evaluating the Use of Derivatives by Funds*, SEC Press Release 2010-45 (Mar. 25, 2010). The moratorium was lifted in 2012, following a speech by the Director of the Division of Investment Management, Norm Champ. *See* Norm Champ, Remarks to the ALI CLE 2012 Conference on Investment Adviser Regulation (Dec. 6, 2012); *see also* Elizabeth Osterman, Moratorium Lift, SEC No-Action Letter (Dec. 6, 2012).

7 *See, e.g.*, *Dreyfus ETF Trust, et al.*, Investment Company Act Rel. Nos. 3,1365 (December 3, 2014) (notice) and 31,403 (December 30, 2014) (order). It should be noted that, prior to the issuance of the first active ETF orders, the exact language used to describe the level of portfolio transparency required of index ETFs differed slightly between older and newer orders. This, in turn, contributed to slight differences in disclosure practices between index ETF sponsors.

8 *See* Investment Company Institute, *2014 Fact Book*, *supra* n.2 at 53.

9 During 2013, 19 actively managed ETFs were launched, bringing the total to 61, which represented approximately $14 billion in assets as of the end of 2013. This represents less than five percent of total ETFs and less than one percent of total ETF assets. *See id.* at 65.

10 Both Claymore Advisors, LLC (now known as Guggenheim Funds Investment Advisors, LLC) and The Vanguard Group have explored for several years the possibility of non-transparent or semi-transparent ETFs. Vanguard Fixed Income Securities Funds, Vanguard Group Inc. and Vanguard Marketing Corp. filed for exemptive relief in 2007 that would have permitted them to issue an ETF share class of fixed income funds that would disclose a representative sample of portfolio holdings. *See Vanguard Fixed Income Securities Funds, et al.*, SEC File No. 812-13362 (Feb. 9, 2007) and SEC File No. 812-13378 (Apr. 25, 2007). Claymore Advisors, citing an alternative arbitrage pricing methodology and concerns about front-running and free-riding also proposed to disclose portfolio holdings consistent with actively-managed open-end investment companies. *See Claymore Advisors, LLC, et al,* SEC File No. 812-13524 (Apr. 22, 2008). *See also Actively-Managed Exchange Traded Funds*, Investment Company Act Rel. No. 25,258 (Nov. 8, 2001) at n.33 and accompanying text ("it is not clear whether an actively managed ETF would propose to inform investors of the contents of its portfolio in the same manner as index-based ETFs.... This potential for less transparency in the portfolio holdings of an actively managed ETF may make the process of creating and redeeming Creation Units more difficult or present greater investment risk for arbitrageurs"); Christopher Condon and Miles Weiss, "Active Stock ETFs Move Closer to Market After Long Delay," *Bloomberg* (Sept. 27, 2013).

11 *See Eaton Vance ETMF Trust, et al.*, *supra* n.1; *Spruce ETF Trust, et al.,* SEC File No. 812-13953 (Sept. 1, 2011), notice (Oct. 22, 2014), withdrawn (Nov. 14, 2011), order (Nov. 14, 2014); *Precidian ETFs Trust, et al.,* SEC File No. 812-14405 (Dec. 22, 2014) and SEC File No. 812-14166 (Jan. 25, 2013), as amended (Feb. 12, 2013, July 23, 2013), notice (Oct. 22, 2014), withdrawn (Nov. 14, 2014), order (Nov. 14, 2014); *SSgA Funds Management, Inc., et al.*, SEC File No. 812-14165-02 (June 7, 2013); *T. Rowe Price Equity Series, Inc., et al.*, SEC File No. 812-14214 (Sept. 23, 2013), as amended (Mar. 14, 2014); *PowerShares Actively Managed Exchange-Traded Fund Trust II, et al.*, SEC File No. 812-14319 (June 5, 2014), withdrawn (Dec. 23, 2014); *Capital Group ETF Trust, et al.*, SEC File No. 812-14339 (July 28, 2014), withdrawn (Dec. 26, 2014); *Fidelity Beach Street Trust, et al.*, SEC File No. 812-14364 (Sept. 26, 2014).

12 *See NASDAQ Stock Market LLC*, Exchange Act Rel. No. 73,562 (Nov. 7, 2014) (granting accelerated approval of proposed NASDAQ Rule 5745 relating to listing and trading of ETMFs). This NASDAQ rule was first proposed on February 26, 2014 and was published for comment on March 12, 2014. *See* Exchange Act Rel. No. 71,657 (Mar. 6, 2014). The SEC twice extended its review period of the proposed rule. *See* Exchange Act Rel. No. 72,007 (Apr. 23, 2014) and Exchange Act Rel. No. 72,987 (Sept. 10, 2014). Similarly, BATS Exchange filed a Rule 19b-4 application that proposed to adopt BATS Rule 14.11(k) to list and trade shares of Spruce ETF Trust. *See* Exchange Act Rel. No. 72,787 (Aug. 7, 2014). On November 7, 2014, in light of the SEC's preliminary denial of Spruce ETF Trust's exemptive application, the SEC disapproved the BATS proposal. *See* Exchange Act Rel. No. 73,559 (Nov. 7, 2014). NYSE Euronext also filed a Rule 19b-4 application with the SEC that proposed to adopt new NYSE Arca Equities Rule 8.900, which would permit the listing and trading of non-transparent ETFs. Citing its denial of exemptive relief under the Investment Company Act, the SEC disapproved NYSE Euronext's proposal on October 24, 2014. *See* Exchange Act Rel. No. 73,424 (Oct. 24, 2014).

13 *See Precidian ETFs Trust, et al.*, Notice of Application, Investment Company Act Rel. No. 31,300 (Oct. 21, 2014) and *Spruce ETF Trust, et al.*, Notice of Application, Investment Company Act Rel. No. 31,301 (Oct. 21, 2014). Both Spruce ETF Trust (which have been managed by BlackRock Fund Advisors) and Precidian ETFs Trust withdrew their applications following the SEC's preliminary denials. The SEC granted orders of withdrawal on November

14, 2014. *See Precidian ETFs Trust, et al.*, Investment Company Act Rel. No. 31,336 (Nov. 14, 2014), and *Spruce ETF Trust, et al.*, Investment Company Act Rel. No. 31,337 (Nov. 14, 2014). As further discussed herein, Precidian has since filed a revised application for exemptive relief. *See infra* n.23 and accompanying text.

14 *See* PowerShares Actively Managed Exchange-Traded Fund Trust II, *et al.* and Capital Group ETF Trust, *et al., supra* n.11.

15 *See* Eaton Vance Management, *et al.*, Notice of Application, Investment Company Act Rel. No. 31,333 (Nov. 6, 2014).

16 *See NASDAQ Stock Market LLC, supra* n..12. The order grants accelerated approval of Nasdaq Rule 5745 governing the listing and trading of ETMF shares and amends various related Nasdaq rules. Nasdaq Rule 5745(b)(1) provides that Nasdaq will file separate proposals under Section 19(b) of the Securities Exchange Act of 1934, as amended (1934 Act) before listing any specific ETMF shares.

17 *See Eaton Vance Management, et al.*, Order Under Sections 6(c), 12(d)(1)(J) and 17(b) of the Investment Company Act of 1940, Investment Company Act Rel. No. 31,361 (Dec. 2, 2014).

18 *See T. Rowe Price Equity Series, Inc., et al.* and *Fidelity Beach Street Trust, et al.*, *supra* n.11.

19 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 but instead is a reference produced by a third party seeking to approximate the intraday value of the ETF's portfolio holdings.

20 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.

21 For example, where the stock of the AP or its parent company is included in the composition file.

22 Instead of instructing the trustee of the blind trust to liquidate the portfolio securities, APs could have instructed the trustee to hedge or otherwise manage the securities. APs could have worked with the trustee to design generic standing instructions that would have operated without the APs having to know the identity of the portfolio securities.

23 Investment Company Act Rel. No. 31,300, *supra* n.13 at 8.

24 *Id.* at 12.

25 *Id*. at 15. The SEC noted that market makers do not rely on IIV currently and instead calculate their own NAV per share with proprietary algorithms that are based on daily portfolio transparency. *See* id. at 14.

26 *See* Precidian ETFs Trust, *et al.*, SEC File No. 812-14405 (Dec. 22, 2014).

27 The revised proposal states that the ETFs will adopt procedures that ensure that any extraordinary expenses that would be taken in account in calculating the NAV (*i.e.*, expenses that are infrequent, unusual and material in size) will be included in the VIIV for that day.

28 According to the application, if there is a material discrepancy between the two data streams, the ETF's listing exchange will have the ability to temporarily halt trading.

29 *See Fidelity Beach Street Trust, et al.*, *supra* n.11.

30 *See T. Rowe Price Equity Series, Inc., et al.*, *supra* n.11.