

October 7, 2019

# SEC Adopts New ETF Rule and Related Form Amendments and Issues Exemptive Order

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## SUMMARY

On September 26, 2019, the Securities and Exchange Commission unanimously adopted new rule 6c-11 and related form amendments under the Investment Company Act of 1940 (the Investment Company Act) that are intended to modernize the regulatory framework for most exchanged-traded funds (ETFs). Under the rule, ETFs that satisfy certain conditions will be permitted to operate within the scope of the Investment Company Act and participate in the market without applying for individual exemptive orders from the SEC. The conditions in the rule are generally consistent with the conditions in existing exemptive orders. Rule 6c-11 will replace hundreds of individualized exemptive orders and, in order to level the playing field among most ETFs and to protect ETF investors, the SEC will rescind exemptive relief previously granted to ETFs that are able to rely on the rule.

In conjunction with new rule 6c-11, the SEC voted to issue an exemptive order granting a conditional exemption from section 11(d)(1) of the Securities Exchange Act of 1934 and Exchange Act rules 10b-10, 15c1-5, 15c1-6 and 14e-5 for broker-dealers and certain other persons that engage in certain transactions in securities of ETFs that rely on the new rule and satisfy certain diversification requirements in an effort to reduce the complexities and burden that may otherwise be associated with the ETF creation and redemption process.

The SEC states in the adopting release that it adopted new rule 6c-11 to establish a “consistent, transparent, and efficient regulatory framework for ETFs” and to facilitate “greater competition and innovation among ETFs.”<sup>1</sup> The SEC adopted the new rule and form amendments largely as proposed in June 2018, but with certain modifications to reflect public comments received by the SEC.

Under the rule and form amendments, ETFs that satisfy certain conditions will be permitted to operate without obtaining an exemptive order from the SEC. Some highlights of the new rule and form amendments are as follows:

- **Rule 6c-11.** The rule is intended to create a consistent regulatory framework for ETFs by eliminating certain conditions that the SEC has previously included within its numerous individualized exemptive orders and by eliminating historical distinctions between actively managed and index-based ETFs.
- **Rescission of Certain ETF Exemptive Relief.** The SEC will (i) rescind exemptive relief previously granted to an ETF if the ETF is able to rely on rule 6c-11; (ii) rescind exemptive relief permitting an ETF to operate in a master-feeder structure if it is not currently relying on that relief; and (iii) grandfather existing master-feeder arrangements involving ETF feeder funds while preventing the formation of new ones.
- **Amendments to Forms N-1A and N-8B-2.** The adopted amendments will require ETFs to provide additional information on Form N-1A (the form for open-end management investment companies) and Form N-8B-2 (the form for unit investment trusts) to investors who purchase and sell ETF shares in the secondary markets, such as the bid-ask spread, and premiums and discounts from the ETF’s net asset value (NAV); the information requirements will apply equally to all ETFs, whether structured as registered open-end management investment companies or as unit investment trusts (UITs).

### A. BACKGROUND

The SEC first granted relief to permit an ETF to operate in 1992; today, there are approximately 2,000 SEC-registered ETFs with aggregate net assets of \$3.32 trillion, approximately 16% of the total net assets of all registered investment companies.<sup>2</sup> ETFs have characteristics of both mutual funds, which issue redeemable securities, and closed-end funds, which generally issue shares that are not redeemable and that are listed on a national securities exchange and trade at market-determined prices. The creation and redemption processes of an ETF together with the secondary market trading in ETF shares provide arbitrage opportunities designed to maintain the market price of ETF shares at or close to the NAV per share of the ETF.

ETFs currently operate as investment companies under the Investment Company Act in reliance on case-by-case exemptions from certain provisions thereof.<sup>3</sup> The SEC has granted over 300 exemptive orders to date.<sup>4</sup> The SEC first proposed a rule in 2008 to permit ETFs to form and operate without the need to obtain individual exemptive relief; however, the SEC never acted on the 2008 proposal. In June 2018, the SEC proposed for comment a revised form of rule 6c-11.

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## B. RULE 6c-11

### 1. Scope

Rule 6c-11 defines an ETF as a registered open-end management investment company that (i) issues and redeems creation units to and from authorized participants in exchange for a “basket” (as defined in the rule) of “securities, assets or other positions” and a cash balancing amount, if any; and (ii) issues shares that are listed on a national securities exchange and traded at market-determined prices.<sup>5</sup>

The rule applies only to certain types of ETFs:

Type of ETF	Within Scope of Rule 6c-11?
<i>ETFs organized as Open-End Management Investment Companies</i>	Yes
<i>ETFs organized as UITs</i>	No, but existing UIT ETFs will continue to rely on their existing exemptive orders
<i>Index-Based ETFs</i>	Yes
<i>Actively Managed ETFs</i>	Yes
<i>Leveraged/Inverse ETFs</i>	No, but existing leveraged/inverse ETFs will continue to rely on their existing exemptive orders, and new leveraged/inverse ETFs may apply for an exemptive order
<i>Share Class ETFs</i>	No, but existing share class ETFs will continue to rely on their existing exemptive orders, and new share class ETFs may apply for an exemptive order
<i>Master-Feeder ETFs</i>	No, but existing master-feeder ETFs will continue to rely on their existing exemptive orders
<i>Non-transparent ETFs</i>	No

#### a. Open-End Management Investment Companies

The rule applies only to ETFs organized as open-end management investment companies, and not to those organized as UITs “given the limited sponsor interest in developing ETFs organized as UITs” and the different regulatory framework required by the unmanaged nature of UITs.<sup>6</sup> The SEC notes that most ETFs today are open-end management investment companies rather than UITs. ETFs organized as UITs will continue to operate under the terms and conditions in their existing exemptive orders.

#### b. Index-Based ETFs and Actively Managed ETFs

Rule 6c-11 provides exemptions for both index-based ETFs and actively managed ETFs, which the SEC considers to be similar in respect of operational matters despite their different investment objectives or

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strategies.<sup>7</sup> The SEC believes that permitting index-based and actively managed ETFs to operate under the same rule will provide “a level playing field among those market participants” and a more consistent and transparent regulatory framework.<sup>8</sup>

### **c. Leveraged/Inverse ETFs**

The rule will not be available for leveraged ETFs that “seek to amplify the returns of an underlying index by a specified multiple or to profit from a decline in the value of an underlying index over a pre-determined period of time using financial derivatives” and that typically require a rebalancing of their portfolios on a daily basis.<sup>9</sup> The SEC states that this daily reset feature and the effects of compounding leveraged returns may result in performance significantly different from some investors’ expectations.

### **d. Share Class ETFs**

Rule 6c-11 does not cover an ETF “structured as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio.”<sup>10</sup> Hence, the rule does not provide any relief from section 18(f)(1) or 18(i) of the Investment Company Act, nor does it expand the scope of rule 18f-3 under the Investment Company Act, which provides a limited exemption from sections 18(f)(1) and 18(i) by permitting registered open-end management investment companies or series or classes thereof to issue more than one class of voting stock.

ETFs seeking relief from section 18(f)(1) or 18(i) are expected to do so through the SEC’s exemptive application process, where the SEC can continue to weigh policy considerations in the context of the facts and circumstances of a particular applicant.

### **e. Master-Feeder ETFs**

Although the SEC’s exemptive orders previously have provided relief allowing ETFs to operate as feeder funds in a master-feeder structure, due to the lack of market interest in this structure, the SEC will rescind the master-feeder relief granted to ETFs that did not in fact rely on the relief as of the date of the rule proposal (*i.e.*, June 28, 2018).<sup>11</sup> The SEC will grandfather existing master-feeder arrangements involving ETF feeder funds but prevent the formation of new ones by amending relevant exemptive orders.

## **2. Exemptive Relief Under Rule 6c-11**

Consistent with prior exemptive orders, rule 6c-11 provides exemptions to ETFs within its scope from certain provisions of the Investment Company Act. Specifically, the rule permits an ETF meeting its conditions to:

- classify its shares as “redeemable securities” within the meaning of section 2(a)(32) of the Investment Company Act;
- issue shares to be purchased and sold at market prices rather than at NAV per share;
- engage in in-kind transactions with certain affiliates; and

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- in certain limited circumstances, pay authorized participants the proceeds from the redemption of shares in more than seven days.

### **a. Treatment of ETF Shares as “Redeemable Securities”**

Under the rule, an ETF will be considered to issue “redeemable securities” within the meaning of section 2(a)(32) of the Investment Company Act and will, accordingly, be regulated as an open-end fund within the meaning of section 5(a)(1) of the Investment Company Act.<sup>12</sup> Therefore, rules under the Exchange Act that apply to redeemable securities will apply to ETFs relying on rule 6c-11; such ETFs will be eligible for (i) the “redeemable securities” exceptions under rules 101(c)(4) and 102(d)(4) of Regulation M and rule 10b-17(c) under the Exchange Act in connection with secondary market transactions in ETF shares and the creation or redemption of creation units, and (ii) the exemption for a “registered open-end investment company” in rule 11d1-2 under the Exchange Act.<sup>13</sup>

### **b. Trading of ETF Shares at Market-Determined Prices**

Section 22(d) of the Investment Company Act prohibits investment companies from selling a redeemable security to the public at a price different from the current public offering price in the prospectus. Rule 22c-1 requires dealers to sell, redeem or repurchase a redeemable security only at a price based on the security’s NAV.

Consistent with prior exemptive orders, rule 6c-11 provides exemptions from section 22(d) and rule 22c-1 to allow investors to purchase and sell individual ETF shares on the secondary market at market-determined prices that may be different from the price in the prospectus or based on NAV.<sup>14</sup> The SEC believes exemptions from these provisions are appropriate because the arbitrage mechanism already addresses the concerns of shareholder dilution and unjust discrimination behind these provisions.

### **c. Affiliated Transactions**

Section 17(a) of the Investment Company Act prohibits purchases and redemptions of creation units of an ETF by affiliated persons of that ETF.<sup>15</sup>

Consistent with prior exemptive orders, rule 6c-11 provides an exemption from sections 17(a)(1) and 17(a)(2) of the Investment Company Act with regard to the deposit and receipt of baskets by persons who are affiliated persons of an ETF “solely by reason of: (i) holding with the power to vote 5% or more of an ETF’s shares; or (ii) holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF.”<sup>16</sup>

This relief is intended to promote the arbitrage mechanism and reduce concentration risk by allowing a greater pool of market participants to engage in arbitrage using in-kind baskets. However, in light of the fact that the rule will provide additional flexibility by allowing an ETF to use custom baskets (*see infra* Section I. B.3.e), thereby increasing the possibility of different treatments for affiliates and non-affiliates in terms of an ETF’s receipt and delivery of baskets, the SEC decided that the relief will continue to cover

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transactions with persons deemed affiliates solely by reason of 5% or more shareholdings, but will not cover additional types of affiliated relationships, such as broker-dealers affiliated with an ETF's investment adviser.<sup>17</sup>

### d. Additional Time for Delivering Redemption Proceeds

Section 22(e) of the Investment Company Act prohibits open-end funds from paying redemption proceeds more than seven days after the tender of their shares for redemption.

Rule 6c-11 grants relief from section 22(e) to permit an ETF to delay satisfaction of a redemption request if “a local market holiday, or series of consecutive holidays, or the extended delivery cycles for transferring foreign investments to redeeming authorized participants, or the combination thereof prevents timely delivery of the foreign investment included in the ETF's basket.”<sup>18</sup> An ETF relying on the exemption will need to deliver foreign investments as soon as practicable, but not later than 15 days after the tender to the ETF of one or more creation units of its shares for redemption.

Unlike the proposed rule, rule 6c-11 as adopted does not include a sunset provision to limit the relief from section 22(e) to 10 years from the rule's effective date.

### 3. Conditions for Reliance on Rule 6c-11

ETFs will be required to comply with various specified conditions in order to rely on the exemptive relief provided by rule 6c-11. These conditions are generally consistent with those in prior exemptive orders, which the SEC believes have “effectively accommodated the unique structural and operational features of ETFs while maintaining appropriate protections for ETF investors.”<sup>19</sup>

#### a. Issuance and Redemption of Shares

Consistent with prior exemptive orders, rule 6c-11 requires ETFs to “issue (and redeem) creation units to (and from) authorized participants in exchange for baskets and a cash balancing amount (if any).”<sup>20</sup> The SEC intends for this condition to promote the ETF share issuance and redemption process that is important for the arbitrage mechanism.

- **Authorized Participant.** The rule defines an “authorized participant” as “a member or participant of a clearing agency registered with the [SEC] that has a written agreement with the ETF or one of its service providers that allows the authorized participant to place orders for the purchase and redemption of creation units.”<sup>21</sup>
- **Creation Units.** The rule defines “creation unit” as “a specified number of ETF shares that the ETF will issue to (or redeem from) an authorized participant in exchange for the deposit (or delivery) of a basket and a cash balancing amount (if any).”<sup>22</sup> Under the rule, an ETF generally may issue and redeem shares only in creation unit aggregations, but will be permitted to sell or redeem individual shares in limited circumstances, such as on the day of consummation of a reorganization, merger, conversion or liquidation, and is not limited to transacting with authorized participants in these limited circumstances.

- **Suspension of Issuance and Redemption.** The rule allows an ETF to suspend the redemption of creation units only in accordance with section 22(e) of the Investment Company Act, and to charge transaction fees on these redemptions only in accordance with rule 22c-2, which limits such fees to 2% of the value of the shares redeemed.<sup>23</sup> The SEC believes that an ETF may suspend the issuance of creation units “only for a limited time and only due to extraordinary circumstances,” such as market closures, and that it should not be able to set transaction fees so high as to effectively suspend the issuance of creation units.<sup>24</sup>

### b. Listing on a National Securities Exchange

Consistent with prior exemptive orders, rule 6c-11 covers only ETFs that issue shares “listed on a national securities exchange and traded at market-determined prices.”<sup>25</sup> Listing shares for trading on a national securities exchange is a fundamental characteristic of ETFs. This definition excludes an ETF that is suspended or delisted from a national securities exchange. The SEC clarified that an ETF will be considered no longer listed on an exchange “as of the effective date of the removal of the ETF’s shares from listing pursuant to rule 12d2-2 under the Exchange Act.”<sup>26</sup> Therefore, special circumstances such as a trading suspension, a trading halt or receipt of a temporary non-compliance notice from the listing exchange will not constitute a “delisting” for purposes of rule 6c-11.<sup>27</sup>

### c. Intraday Indicative Value

Departing from exchange listing standards and prior exemptive orders, rule 6c-11 does not require the dissemination of an ETF’s intraday estimate of its NAV per share, or intraday indicative value (IIV).<sup>28</sup> The SEC believes that the IIV is not used by market participants when conducting arbitrage trading, and may not represent the actual value of an ETF’s shares in many cases. The rule instead conditions its relief on the daily disclosure of portfolio holdings.

### d. Daily Portfolio Transparency

The SEC believes that daily portfolio transparency is important for the operation of the arbitrage mechanism of ETFs. The SEC’s prior exemptive orders have generally required ETFs to provide either full or partial portfolio transparency, yet the SEC observes in the release that as a practical matter all ETFs provide full portfolio transparency.<sup>29</sup>

- **Website Disclosure.** Rule 6c-11 requires an ETF to “disclose prominently on its website ... the portfolio holdings that will form the basis for each calculation of NAV per share” to be made “each business day before the opening of regular trading on the primary listing exchange of the ETF’s shares.”<sup>30</sup> Unlike the proposed rule, rule 6c-11 as adopted does not require an ETF to “disclose its portfolio holdings before it starts accepting orders for the purchase or redemption of creation units.”<sup>31</sup> Moreover, departing from the 2008 proposal, the SEC adopted transparency requirements for all ETFs without distinguishing between index-based ETFs and actively managed ETFs.
- **Disclosure of Securities, Assets or Other Investment Positions.** The rule requires an ETF to disclose on its website all portfolio holdings forming the basis of the ETF’s next calculation of NAV per share, intended to cover an ETF’s securities, assets or other positions including its cash holdings, short positions and written options.<sup>32</sup> Unlike the proposed rule, the SEC will not require this information to be presented and contain information in the manner prescribed within Article 12 of Regulation S-X. The rule will require ETFs to disclose for each portfolio holding on a daily basis

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(1) the ticker symbol; (2) the CUSIP or other identifier; (3) a description of the holding; (4) the quantity of each security or other asset held; and (5) the percentage weight of the holding in the portfolio.<sup>33</sup>

### e. Baskets

Rule 6c-11 requires ETFs within its scope to “adopt and implement written policies and procedures” that cover the methodology used to construct and accept baskets.<sup>34</sup> The rule will also give ETFs flexibility to use custom baskets, provided that they adopt further policies and procedures with detailed parameters for such baskets.<sup>35</sup>

- **Basket Flexibility.** Exemptive orders since approximately 2006 have required that an ETF’s basket generally correspond *pro rata* to its portfolio holdings with limited exceptions. However, rule 6c-11 will provide certain additional basket flexibility and will apply the same standards to all ETFs relying on the rule.<sup>36</sup> Moreover, in light of the increased risks presented by custom baskets, the rule requires an ETF using custom baskets to establish policies and procedures to (i) set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interest of the ETF and its shareholders, including any processes for revisions to, or deviation from, those parameters, and (ii) specify the titles or roles of the employees of the ETF’s investment adviser who review such baskets for compliance purposes.<sup>37</sup> The SEC believes that the ETF’s board of directors’ oversight of the ETF’s compliance policies and procedures, as well as its general oversight of the ETF, will provide an additional layer of protection.
- **Posting of a Published Basket.** Rule 6c-11 as proposed would have required an ETF to prominently disclose on its website at the beginning of each business day information relating to one published basket that it would exchange for orders to purchase or redeem creation units. However, after reviewing the comments received, the SEC did not include this basket publication requirement in the final rule.<sup>38</sup>

### f. Website Disclosure

Rule 6c-11 requires an ETF to disclose certain information on its website. These requirements differ from those in the proposed rule in certain aspects. Specifically, under the rule as adopted, the following information must be disclosed publicly and prominently on the ETF’s website:<sup>39</sup>

- the ETF’s daily NAV per share, market price, and premium or discount, each as of the end of the prior business day;<sup>40</sup>
- a table showing the number of days the ETF’s shares traded at a premium or discount for the most recently completed (i) calendar year and (ii) calendar quarters of the current year;<sup>41</sup>
- a line graph showing the premium or discount for the most recently completed (i) calendar year and (ii) calendar quarters of the current year;<sup>42</sup>
- the median bid-ask spread for the ETF’s most recent 30 calendar days;<sup>43</sup> and
- historical information regarding the ETF’s premiums and discounts if over 2% for more than seven consecutive trading days, and a discussion of the factors reasonably believed to have materially contributed to the premium or discount.<sup>44</sup>

## **g. Marketing**

Rule 6c-11 does not contain requirements relating to the marketing of ETFs that have been a condition of ETF exemptive orders; for example, there is no requirement that an ETF identify itself in sales literature as an ETF that does not sell or redeem individual shares, or that the ETF explain that investors may purchase or sell individual ETF shares through a broker via a national securities exchange.<sup>45</sup>

## **4. Recordkeeping**

Rule 6c-11 expressly requires an ETF relying on the rule to preserve and maintain copies of all written agreements between the ETF (or its relevant service provider(s)) and authorized participants permitted to purchase or redeem creation units directly from the ETF, as well as any information regarding the baskets exchanged with authorized participants, for at least five years (the first two years in an easily accessible place).<sup>46</sup>

## **C. EFFECT ON PRIOR EXEMPTIVE ORDERS**

One year following the effective date of rule 6c-11, the SEC will rescind “those portions of [its] prior ETF exemptive orders that grant relief related to the formation and operation of an ETF,” including certain relief for master-feeder ETFs.<sup>47</sup> The SEC will not rescind relief from section 12(d)(1) or sections 17(a)(1) and (a)(2) under the Investment Company Act related to fund of funds arrangements involving ETFs (given the pending rulemaking on such arrangements) and will not rescind any exemptive relief of ETFs that are unable to rely on rule 6c-11.<sup>48</sup> In order to allow time for ETFs to transition to the new rule, the SEC will amend those existing ETF exemptive orders, which by their terms were to expire on the effective date of any SEC rule providing relief to ETFs, to provide that the relief contained in those orders will not terminate until one year following the effective date of rule 6c-11.

## **D. AMENDMENTS TO FORM N-1A, FORM N-8B-2 AND FORM N-CEN**

The SEC adopted various conforming revisions to Form N-1A, Form N-8B-2 and Form N-CEN to reflect rule 6c-11.

## **E. NEW EXEMPTIVE ORDER FOR SECTION 11(d)(1)(A) OF THE EXCHANGE ACT AND CERTAIN EXCHANGE ACT RULES**

In conjunction with rule 6c-11, the SEC has issued an exemptive order (the ETF Order) granting a conditional exemption from section 11(d)(1) and rules 10b-10, 15c1-5, 15c1-6 and 14e-5 under the Exchange Act for broker-dealers and certain other persons that engage in certain transactions in securities of ETFs relying on rule 6c-11 and meeting the diversification requirement applicable to a regulated investment company in Internal Revenue Code section 851(b)(3)(B).<sup>49</sup>

## **1. Exchange Act Rule 10b-10**

Exchange Act rule 10b-10, which requires broker-dealers to send their customers confirmations of trades, generally requires a broker-dealer that engages in in-kind creation and redemption transactions in

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component securities of an ETF on behalf of a customer to send to the customer a written confirmation disclosing certain information including the identity, price, and number of shares or units (or principal amount) of each component security involved (Exempt Information). The ETF Order grants an exemption from rule 10b-10 to permit a broker-dealer effecting an in-kind creation or redemption transaction on behalf of a customer to confirm the transaction without providing contemporaneous confirmations relating to the component securities. A broker relying on this exemption must meet the following additional conditions:

- confirmations of issuance and redemption transactions in ETF shares must contain all of the information specified in rule 10b-10(a) other than Exempt Information;
- any confirmation of an issuance or redemption transaction in ETF shares that omits Exempt Information will contain a statement that such omitted Exempt Information will be provided to the customer upon request; and
- all such requests will be fulfilled in a timely manner in accordance with rule 10b-10(c), *i.e.*, within five business days of receipt of the request, or within 15 business days of a request pertaining to a transaction effected more than 30 days prior to the date of the request.<sup>50</sup>

### **2. Exchange Act Rule 15c1-5 and Rule 15c1-6**

Exchange Act rules 15c1-5 and 15c1-6 require a broker-dealer effecting a transaction to disclose any control relationship with an issuer of, or any participation or interest in a primary or secondary distribution of, a component security that it purchases for or sells to a customer. The ETF Order exempts broker-dealers transacting in ETF shares from this requirement upon the conditions that they provide any information to which a customer is entitled under rule 15c1-5 or 15c1-6 upon request and fulfill such requests in a timely manner.<sup>51</sup>

### **3. Exchange Act Section 11(d)(1)**

Exchange Act section 11(d)(1) generally prohibits a person that is both a broker and a dealer from extending or maintaining credit to or for a customer on securities that are part of a distribution of a new issue of securities in which the broker-dealer participated for 30 days after such participation is completed. As broker-dealers effecting creation and redemption transactions on behalf of customers (Broker-Dealer APs) may participate in the distribution of new issue securities with respect to ETF shares for an indefinite period, the 30-day period in section 11(d)(1) may never commence. The ETF Order notes that section 11(d)(1) issues can also arise for broker-dealers who effect only secondary market transactions (Non-AP Broker-Dealers).

#### **a. Broker-Dealer APs**

A Broker-Dealer AP that has entered into a contractual arrangement with an ETF (or one of its service providers) that permits the Broker-Dealer AP to place orders for the purchase or redemption of creation units is not normally compensated by ETFs in connection with the creation or redemption of ETF shares.<sup>52</sup> The ETF Order grants an exemption from the new issue lending restriction under section 11(d)(1) to Broker-Dealer APs provided they do not:

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- directly or indirectly receive from the “fund complex”<sup>53</sup> any payment, compensation, or other economic incentive to promote or sell the ETF shares to persons outside the fund complex, other than certain limited forms of non-cash compensation; and
- extend, maintain or arrange for the extension or maintenance of credit to or for a customer on ETF shares before 30 days have passed from the date that the shares initially commence trading.

### **b. Non-AP Broker-Dealers**

Non-AP Broker-Dealers effect ETF securities transactions solely on the secondary market, whether for themselves or on behalf of their customers, and do not enter contractual arrangements to effect creation or redemption transactions with the ETF or its service providers. Thus, Non-AP Broker-Dealers generally do not receive any compensation from the ETFs or their affiliates for selling ETF shares, other than limited forms of non-cash compensation in certain cases. For these reasons, Non-AP Broker-Dealers may reasonably be considered not to be participating in the distribution of new issue securities within the meaning of section 11(d)(1). However, “to remove any ambiguity about the circumstances when Non-AP Broker-Dealers may offer margin on ETF securities,” the ETF Order grants an exemption from section 11(d)(1) to Non-AP Broker-Dealers that offer margin on ETF securities on the condition that they do not, directly or indirectly, receive from the fund complex any payment, compensation, or other economic incentive to promote or sell the ETF shares to persons outside the fund complex, other than certain limited forms of non-cash compensation.<sup>54</sup>

### **4. Exchange Act Rule 14e-5**

Exchange Act rule 14e-5 would prohibit an ETF, the legal entity of which the ETF is a series, and authorized participants who are broker-dealers and acting as a dealer-manager in tender offers from purchasing any securities that are the subject of a tender offer involving an ETF’s component securities. The ETF Order grants an exemption from rule 14e-5 for such persons or entities subject to the following conditions:

- no purchases of securities made by a broker-dealer acting as the dealer-manager of a tender offer would be effected for the purpose of facilitating a tender offer; and
- if there is a change in the composition of an ETF’s portfolio of component securities, and a broker-dealer acting as a dealer-manager of a tender offer is unable to rely on the exception found in rule 14e-5(b)(5) for basket transactions because (i) the basket of such securities contains fewer than 20 securities or (ii) such securities make up more than 5% of the value of the basket, then any purchases of an ETF component security by such dealer-manager during a tender offer will be effected for the purpose of adjusting a basket of securities in the ordinary course of its business and not for the purpose of facilitating a tender offer.<sup>55</sup>

### **5. Exchange Act Section 13(d) and Section 16**

The SEC declined to follow the suggestion of some commenters that it exempt ETF insiders and large shareholders of ETFs from certain reporting requirements under sections 13(d) and 16 of the Exchange Act, beyond the conditions set forth in several no-action letters, including the condition that there be no material deviation between the secondary market price and NAV per share of the ETF. The SEC noted

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that the exemptions under rule 6c-11 are based on the close tie between market price and NAV per share, and stated that such suggested action would be inconsistent with the rule.<sup>56</sup>

### F. EFFECTIVE AND COMPLIANCE DATES

Rule 6c-11, related amendments to Form N-1A, Form N-8B-2 and Form N-CEN and the exemptive order will become effective on the date that is 60 days after the publication of the Rule 6c-11 adopting release in the *Federal Register*. The compliance date for the form amendments will be the date that is 425 days<sup>57</sup> after the publication in the *Federal Register* or one year following the amendments' effective date.

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## ENDNOTES

- 1 Securities and Exchange Commission, Release No. IC-33646; File No. S7-15-18, *Exchange Traded Funds* (September 26, 2019) (“ETF Release”), at 5.
- 2 *Id.*
- 3 *Id.*, at 9 (explaining that ETFs have historically been organized as open-end funds or UITs under the Investment Company Act). See 15 U.S.C. § 80a-5(a)(1) (defining the term “open-end company”) and 15 U.S.C. § 80a-4(2) (defining the term “unit investment trust”).
- 4 *Id.*, at 5.
- 5 *Id.*, at 18, citing rule 6c-11(a). Under the rule, the term “basket” is defined to mean the securities, assets or other positions in exchange for which an ETF issues (or upon return of which it redeems) creation units. The term “exchange-traded fund” includes ETFs that transact on an in-kind basis, on a cash basis or both.
- 6 *Id.*, at 20. A UIT is defined as an investment company organized under a trust indenture or similar instrument that issues redeemable securities, each of which represents an undivided interest in a unit of specified securities. A UIT has a fixed life – a termination date for the trust is established upon its creation. *Id.*, at 17.
- 7 *Id.*, at 22.
- 8 *Id.*, at 23.
- 9 *Id.*, at 26.
- 10 *Id.*, at 122.
- 11 *Id.*, at 128.
- 12 *Id.*, at 34.
- 13 *Id.*, at 35. The SEC clarified that all ETFs, including those that are not eligible to rely on rule 6c-11, such as ETFs organized as UITs or share class ETFs, are still eligible for the redeemable securities exemptions in rules 101(c)(4) and (102)(d)(4) of Regulation M and rule 10b-17(c) under the Exchange Act in connection with secondary market transactions in ETF shares and the creation or redemption of creation units and the exemption in rule 11d1-2 under the Exchange Act for securities issued by a registered open-end investment company or unit investment trust. *Id.*, at 36.
- 14 *Id.*, at 39.
- 15 *Id.*, at 43, citing 15 U.S.C. § 80a-2(a)(3)(A), (B) and (C). An affiliated person of an ETF includes, among others: (i) any person directly or indirectly owning, controlling or holding with power to vote, 5% or more of the outstanding voting securities of the ETF; (ii) any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled or held with power to vote by the ETF; and (iii) any person directly or indirectly controlling, controlled by or under common control with the ETF.
- 16 *Id.*, at 42. The SEC believes that persons that are affiliated with an ETF by virtue of holding more than 25% of the ETF’s shares or more than 25% of the shares of an investment company that is an affiliated person of the ETF need not be expressly referenced in the rule’s section 17(a) relief, on the basis that such over-25% holders are already captured by having share ownership greater than 5%. *Id.*, at 45.
- 17 *Id.*, at 46. The SEC clarified that it may still consider exemptions for broker-dealers affiliated with ETFs or an ETF’s investment adviser in the SEC’s regular exemptive application process.
- 18 *Id.*, at 47, citing 17 CFR § 240.15c6-1. A “foreign investment” under rule 6c-11 is defined as “any security, asset or other position of the ETF issued by a foreign issuer (as defined by rule 3b-4 under the Exchange Act), and that is traded on a trading market outside of the U.S.” *Id.*, at 49. Unlike the proposed rule, the adopted rule does not define “foreign investment” as an investment for which

## ENDNOTES (CONTINUED)

- there is no “established U.S. public trading market.” *Id.*, at 50. The relief from the requirements of section 22(e) will not affect any obligations arising under rule 15c6-1 under the Exchange Act, which requires that most securities transactions be settled within two business days of the trade date. *Id.*, at 47 n.141, citing 17 CFR § 240.15c6-1.
- 19 *Id.*, at 51-52.
- 20 *Id.*, at 52, citing rule 6c-11(a).
- 21 *Id.*, at 55, citing rule 6c-11(a). This definition differs from the definition of “authorized participant” in the SEC’s exemptive orders and Form N-CEN because “it does not include a specific reference to an authorized participant’s participation in [Depository Trust Company (DTC)], as DTC is itself a clearing agency.” The SEC is amending Form N-CEN to make the definition of authorized participant therein consistent with the definition in rule 6c-11. *Id.* at 52-53.
- 22 *Id.*, at 55-56, citing rule 6c-11(a). While the SEC recognizes that creation unit sizes are important, the rule “will not mandate a maximum or minimum creation unit size or otherwise place requirements on creation unit size.” *Id.*
- 23 *Id.*, at 57.
- 24 *Id.*, at 57-58.
- 25 *Id.*, at 59, citing rule 6c-11(a).
- 26 *Id.*, at 61.
- 27 *Id.*
- 28 *Id.*
- 29 *Id.*, at 67-68.
- 30 *Id.*, at 68, 70, citing rule 6c-11(c)(1)(i). In addition, the rule requires the portfolio holdings that form the basis of the calculation to be the ETF’s portfolio holdings as of the close of business on the prior business day. *Id.*, at 79.
- 31 *Id.*, at 73.
- 32 *Id.*, at 74, citing rule 6c-11(c)(1)(i).
- 33 *Id.*, at 76-77.
- 34 *Id.*, at 80.
- 35 *Id.* Rule 6c-11 defines two types of “custom baskets”: (i) baskets that are composed of “a non-representative selection of the ETF’s portfolio holdings,” and (ii) any basket that differs from the initial basket that is “used in transactions on the same business day.” *Id.*, at 91-92, citing rule 6c-11(a)(1).
- 36 *Id.*, at 84-86.
- 37 *Id.*, at 86.
- 38 *Id.*, at 94.
- 39 *Id.*, at 97, citing rule 6c-11(c)(1).
- 40 Rule 6c-11 defines the term “market price” to mean: (i) the official closing price of an ETF share; or (ii) if a more accurate reflection of the market price of an ETF share as of the time the ETF calculates current NAV per share, the price that is the midpoint of the national best bid and national best offer as of the time of that calculation. *Id.* at 99.
- 41 *Id.*, at 100-02, citing rule 6c-11(c)(1)(ii)-(iv).

## ENDNOTES (CONTINUED)

- 42 *Id.*
- 43 *Id.*, at 97. Unlike the proposed rule which would have required disclosure of the median bid-asked spread for the most recent fiscal year on the ETF's website and in its prospectus, the rule requires disclosure of that information for the most recent 30 calendar days only on the website. Further, the rule requires the use of the national best bid and best offer in calculating median bid-ask spread. *Id.*, at 112.
- 44 *Id.* Rule 6c-11 requires the disclosure for at least one year following the first day the information is posted. *Id.*, at 107.
- 45 *Id.*, at 115.
- 46 *Id.*, at 118-21. Specifically, the rule requires an ETF to maintain records setting forth the following information for each basket exchanged with an authorized participant: (i) the ticker symbol, the CUSIP or other identifier, a description of the holding, the quantity of each holding, and the percentage weight of each holding composing the basket exchanged for creation units; (ii) if applicable, an identification of the basket as a "custom basket" and a record stating that the custom basket complies with the ETF's custom basket policies and procedures; (iii) cash balancing amounts (if any); and (iv) the identity of the authorized participant conducting the transaction. *Id.* at 119-20, citing rule 6c-11(d)(2).
- 47 *Id.*, at 129-33.
- 48 *Id.*
- 49 Exemptive Order, at 9. IRC Section 851(b)(3)(B) provides that a "regulated investment company" must have:
- not more than 25 percent of the value of its total assets [ ] invested in— (i) the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, (ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary [of the Treasury], to be engaged in the same or similar trades or businesses or related trades or businesses, or (iii) the securities of one or more qualified publicly traded partnerships (as defined in subsection (h)).
- 50 *Id.*, at 11.
- 51 *Id.*, at 12-14.
- 52 Broker-dealers may become authorized participants for various reasons, including for their proprietary trading, to facilitate customer trades, to hedge or otherwise manage their own risk, or to arbitrage differences between the market price and NAV per share of the ETF. *Id.*, at 15.
- 53 *Id.* For the purpose of the order, a "fund complex" is the issuer of the ETF shares, any other issuer of ETF shares that holds itself out to investors as a related company for purposes of investment or investor services; any investment adviser, distributor, sponsor or depositor of any such issuer; or any "affiliated person" (as defined in section 2(a)(3) of the Investment Company Act) of any such issuer or any such investment adviser, distributor, sponsor or depositor.
- 54 *Id.*, at 17.
- 55 *Id.*, at 17-19.
- 56 ETF Release, at 38-39.
- 57 The ETF Release provides 425 days, although in practice this may be 426 days as 2020 is a leap year.

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