April 29, 2019

SEC Set to Approve Non-Transparent ETFs

SUMMARY

On April 8, 2019, the Securities and Exchange Commission ("SEC") issued a notice (Release No. IC-33440) of its intention to grant Precidian Funds LLC and associated trusts ("Precidian") exemptive relief from the provisions of the Investment Company Act of 1940 (the "Act") for the launch of actively managed exchange-traded funds ("ETFs") that would not publicly disclose their portfolio holdings on a daily basis as required for traditional ETFs. Unless the SEC grants a hearing, which must be requested by May 3, 2019, the SEC will grant the requested relief on the basis of the conditions set out in Precidian's exemptive application.

BACKGROUND

Because they create and redeem their shares only in large aggregations, and their shares trade in the secondary market at negotiated prices, ETFs operate under SEC exemptive relief from various provisions of the Act and the rules thereunder. As a principal condition to granting relief, the SEC has required that ETFs have mechanisms to enable market participants to cause the market price of ETF shares to be kept at or close to the net asset value ("NAV") per share of the ETF. To date, the main such mechanism has been daily portfolio transparency, which provides market participants a method to value an ETF's portfolio on an intraday basis and to identify market arbitrage opportunities, with the result that ETF shares tend to trade at prices close to the NAV per share.

Although there are a number of actively managed fixed-income ETFs, many investment advisers, especially investment advisers of equity strategies, are reluctant to provide the level of transparency required for actively managed ETFs under existing orders, reasoning that such ETFs could be reverse engineered to reveal trading strategies, or could lead to "front running" and "free riding" at a cost to the ETFs and their shareholders.

In a previous exemptive application for their new ETFs, Precidian had proposed prospectus disclosure, quarterly disclosure of portfolio holdings, and disclosure of the indicative intraday value as substitute mechanisms for daily disclosure of portfolio holdings. The SEC states in the notice that Precidian's prior proposal "did not provide an adequate substitute for full portfolio transparency in facilitating effective arbitrage."

DISCUSSION

Precidian's latest application for exemptive relief proposed the following for its ETFs ("Precidian ETFs"):

- **Authorized Participant Representatives**. The Precidian ETFs would sell and redeem their shares in creation units to "authorized participants" only though an unaffiliated broker-dealer acting on an agency basis ("AP Representative"). The Precidian ETFs would disclose daily to the AP Representative, on a confidential basis, the basket of securities constituting the creation or redemption units of the respective funds, thereby allowing the AP Representative to then promptly execute such creation and redemption transactions upon receiving orders from authorized participants, either purchasing the underlying basket of shares upon receipt of funding from an authorized participant to create shares, or receiving a basket of shares from a fund and liquidating it to effect a redemption. This contrasts with the creation and redemption practices of existing ETFs, which generally involve authorized participants depositing (in the case of creations) or receiving (in the case of redemptions) a basket of securities published by the ETF on a daily basis.
- **Verified Intraday Indicative Value**. Each Precidian ETF would disclose a "verified intraday indicative value" ("VIIV") reflecting the value of its portfolio holdings which would be calculated every second during the trading day, as opposed to the typical intraday indicative value calculated every 15 seconds for existing ETFs. Further, the funds would adopt precise and uniform procedures and parameters for calculating the VIIV, with the adviser bearing responsibility for overseeing the calculation and dissemination of the VIIV including conducting periodic (no less than annual) reviews of that process. This disclosure is intended to permit market participants to assess whether the fund is trading at a premium or discount to NAV, and provide a level of current information that should facilitate effective arbitrage.
- **ETF Portfolio Holdings**. The Precidian ETFs would invest only in certain securities that trade on a national exchange during the same hours as the fund shares, allowing prompt creation or redemption transactions and providing reliable price inputs for the VIIV calculation. To the extent portfolio holdings do not have readily available market quotations, the Precidian ETFs would publicly disclose such securities and their weightings in the VIIV.
- **Regulation Fair Disclosure**. The Precidian ETFs would comply with Regulation Fair Disclosure, which by its terms does not apply to ETFs. Regulation Fair Disclosure prohibits selective disclosure of any material non-public information.
- **Remedial Actions**. The Precidian ETFs and their adviser would establish certain preset thresholds based on their levels of premiums/discounts and bid-ask spreads, which must be no greater than 1%. If a threshold is exceeded, the board of directors of the relevant fund would meet promptly and consider the continuing viability of the funds, whether shareholders are being harmed, and what, if any, remedial action would be appropriate. Further, for the first three years of each of the funds, the board of directors would conduct the same evaluation on an annual basis regardless of whether the threshold is exceeded. Lastly, the funds would periodically disclose certain metrics and information to the SEC upon request to facilitate monitoring and the effective operation of the funds.
- **Protective Conditions**. In addition to those conditions included in prior ETF exemptive orders, the Precidian ETFs would comply with certain additional conditions that include providing certain public

disclosures to investors (i) explaining their differences from traditional ETFs and informing investors that their bid-ask spreads and premiums/discounts may be larger than those for traditional ETFs due to the lack of transparency, thus making them more expensive to buy and sell, (ii) cautioning that market participants may attempt to reverse engineer the funds' trading strategies, to the detriment of the funds and their shareholders, and (iii) including a legend (included in the notice) on the front of the prospectus, on its website, and in any marketing materials explaining the differences.

The notice indicates that Precidian contemplates that registered investment advisers of open-end management investment companies seeking to launch new series that rely on the relief granted to the Precidian ETFs enter into license agreements with Precidian and apply to the SEC for separate exemptive orders that would incorporate by reference all the terms and conditions of any final SEC order in respect of the Precidian ETFs.

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