The ETF Rule Proposal: Key Takeaways

In the coming months the SEC is planning to launch the 'ETF Rule' (6c-11), which will bring a purpose built regulatory framework to the ETF industry. Currently, ETFs are generally subject to the 1940s Securities Act with exemptive orders to handle certain 'ETF-specific' characteristics, particularly surrounding the creation/redemption process. Because of this bespoke nature, launching an ETF takes about seven months and costs on average $100,000.

The new rules aim to expand and standardize disclosure to investors. Part of the regulatory intent is to reduce the time-to-market for ETFs and lower the barrier to entry for newer and smaller issuers. To some extent these new regulations will also influence the volume and type of ETFs that we begin to see moving forward. The ETF rule will supersede existing exemptive reliefs for any eligible ETFs (approximately 200 of the 300 current existing orders) as of one year after the rule officially goes live.

Below are the key takeaways that investors should understand about the ETF Rule, as well as some notes on how IHS Markit can assist in all areas with our ETF offering. All of the details are based on the SEC proposal dated June 28th.

Custom Baskets have been formally approved

Under the new proposal, custom baskets have been approved as alternatives for creation/redemption. This is to ensure that there is enough basket flexibility to tighten spreads and ensure that the arbitrage mechanism is efficient, as well as removing a barrier to entry for new ETFs. The conditions for a custom basket are simple; they must detail when and how the ETF will use representative sampling and how changes will be replicated to the ETFs portfolio holdings through rebalancing events and reconstitutions. They must also specify the roles of employees of the ETF's investment advisor that are required to review each basket. A basket is defined as custom if it fits one of the below two conditions:

1. Any basket that are composed of a non-representative selection of the portfolios holdings
    a. Not a pro-rata reflection of the portfolio holdings OR;
    b. Not a representative sample of the portfolio holdings OR;
    c. Not reflecting changes due to a rebalancing event or reconstitution.
2. Different baskets used in transactions on the same business day; for example a basket that has substituted cash in lieu for a portion of the basket for a single authorized participant.

Any custom baskets do not need to be disclosed publicly, but an internal record must be kept for 5 years post-trade.

IHS Markit can assist in this process using our pre-trade custom basket environment, which facilitates the creation and approval of baskets from both sides of the transaction with a risk and pricing assessment available without the need for emergency constructs or spreadsheets.

Standardized Data Disclosure Rules

The proposal outlines a set of disclosure rules designed to benefit investors. There is a concerted effort to take into account changes in the ETF industry since the initial launches and to set a level of standardization across the market. The new disclosures are:

- Disclosures on public website (free of charge)
  - Portfolio holdings
    - These must be disseminated prior to the market open of the primary listing exchange of the ETF share and prior to the ETF accepting orders
    - Must include all portfolio holdings that form the basis of the ETF’s NAV calculation and fit a pre-described format
  - Median bid-ask spread for the most recent fiscal year
  - NAV per Share
  - Market Price
    - The most suitable of the official closing price OR the midpoint price of the best bid and best offer
  - Premiums/Discounts
    - Current premium/discount
    - Historical information surrounding premiums and discounts
      - A table and a line graph for the most recent completed calendar year and most recently completed quarters of the current year (or lifetime for new issues)
    - Any premium/discount greater than 2% for 7 consecutive trading days must post this information on its website, alongside with a discussion of factors that are reasonably believed to have materially contributed to this premium/discount.
      - This data must be published on the preceding day after the provision is triggered
      - This data must be maintained on the website for at least one year.
  - Interactive Calculator
    - Interactive calculator that allows the user to customize calculations for round trip costs with a customized value of transaction and number of trips
- Indicative Intraday Value (IIV) no longer needs to be disclosed
  - In the current process the IIV needs to be disseminated every 15 seconds for domestic ETFs, or 60 seconds for internationals
  - It has been considered that market makers generally calculate their own IIV today taking into account their own pricing and models, and these are more accurate than the ones calculated by the issuers.

For issuers, IHS Markit houses all of the data available to fit the current requirements and can facilitate a centralized build for data accuracy and cost-saving purposes.

No differentiation between active and passive ETFs

The SEC ruled that there will be no differentiation in the rule set between active and passively managed ETFs. While they considered different treatment for passive ETFs (with specific data disclosure rules around tracking error being touted for passive funds), the SEC decided against it. This was a deliberate move by the SEC, as there is a proliferation of highly customized and methodologically complex indices that have rendered the difference between actively and passively managed ETFs irrelevant in their eyes. In the past, it was typically more difficult to obtain approval for actively managed ETFs due to perceived increased investment risk, so this change could lead to growth in active management.

Leveraged ETFs, Unit Investment Trusts, Master-Feeder Funds and Share Class ETFs are not included

At this point, the SEC has ruled not to accept certain ETF 'types' as part of the core regulation. These will continue to be handled within the 1940s Securities Act with exemptions required. This will make launches these ETFs more difficult than standard open-ended funds under the new regulations.

- Leveraged ETFs
  - Leveraged funds are defined as "providing returns that have a specified multiple or an inverse relationship to the performance of a market index over a fixed period of time"
    - Includes any fund indirectly seeking to replicate a leveraged return, such as embedding inverse leverage in the underlying index
  - These instruments are considered too complex and high-risk to be included in 6c-11.
- Unit Investment Trusts (UITs)
  - The UIT structure differs from open-ended funds as it is managed by a trust indenture rather than an investment advisor. This means that, unlike an open-ended fund, it cannot be actively managed, participate in securities lending or invest in derivatives.
    - Popular UIT ETFs include SPY and QQQ, two of the largest ETFs
  - The SEC has ruled that this need not be included as there have been no new UITs launched since 2002 and the structure is only in existence of for legacy ETFs.
- Master-Feeder Funds
  - Master-Feeder funds have one master fund with an onshore feeder and an offshore feeder. This allows the consolidation of multiple portfolios into one to allow for economies of scale benefits.
  - These have been excluded as, if baskets differ (e.g: in kind vs in cash) then all feeder fund shareholders would bear costs associated the cash transactions
- Share-Class ETFs
  - Most ETF issuers operate their funds as discrete asset pools, but there are some ETFs (Vanguard) that are operating as share classes of existing mutual funds.

- The SEC has ruled that these should not be included within the ETF rule, which is intended to address broadly the common type of relief that most ETFs have sought. Instead these should be handled by exemptions
  - For example, an ETF share class that transacts with authorized participants on an in-kind basis may have different costs to a mutual fund share class that transacts on a cash basis. The protections in place should be included in the exemptive relief.

If you would like to discuss the proposed ETF Rule, or for more information on how IHS Markit can help issuers and investors work with the proposed rulings, please contact sam.barber@ihsmarkit.com