

SEC Adopts Rule to Modernize ETF Regulation

September 27, 2019

On September 26, 2019, the Securities and Exchange Commission (the “**Commission**”) adopted new **rule 6c-11** (the “**Rule**”) under the Investment Company Act of 1940, as amended (the “**Investment Company Act**”), as well as form amendments designed to “modernize the regulation of exchange-traded funds (“**ETFs**”), by establishing a clear and consistent framework for the vast majority of ETFs operating today.” Additionally, the Commission voted to issue an **exemptive order** intended to further harmonize related relief for broker-dealers.

As noted in the Commission’s **press release** and fact sheet issued in connection with the adoption of the Rule (the “**Press Release**”), the Rule and form amendments are intended to “facilitate greater competition and innovation in the ETF marketplace, leading to more choice for investors.” According to the Press Release, “ETFs relying on the [R]ule and related exemptive order will have to comply with certain conditions designed to protect investors, including conditions regarding transparency and disclosure.” The Press Release further notes that “one year after the effective date of the [R]ule, the Commission is rescinding exemptive relief previously granted to certain ETFs, including those that will be permitted to operate in reliance on the [R]ule.”

The Press Release states that the Rule will “permit ETFs that satisfy certain conditions to operate within the scope of the [Investment Company Act] and come directly to market without the cost and delay of obtaining an exemptive order[.]” which, according to the Press Release, “should facilitate greater competition and innovation in the ETF marketplace by lowering barriers to entry.” Additionally, the Press Release notes that the disclosure amendments “will provide investors who purchase and sell ETF shares on the secondary market with new information.”

Scope of the Rule

The Rule will be available to ETFs organized as open-end funds, but not to those ETFs organized as unit investment trusts, leveraged or inverse ETFs, ETFs structured as a share class of a multi-class fund and non-transparent ETFs.

Conditions for Reliance on the Rule

In order to rely on the Rule, ETFs will be required to comply with certain conditions, including:

- *Transparency.* Under the Rule, an ETF will be required to provide daily portfolio transparency on its website.
- *Custom basket policies and procedures.* An ETF relying on the Rule will “be permitted to use baskets that do not reflect a pro-rata representation of the fund’s portfolio or that differ from the initial basket used in transactions on the same business day[.]” as long as the ETF has adopted written policies and procedures that set forth “detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders.” The Rule also contains related recordkeeping requirements.
- *Website disclosure.* Under the Rule, an ETF will be required to disclose certain information on its website, including “historical information regarding premiums and discounts and bid-ask spread information[.]” intended to help inform investors about the “costs of investing in ETFs and the efficiency of an ETF’s arbitrage process.”

Rescission of Certain ETF Exemptive Relief

According to the Press Release, one year following the effective date of the Rule, the Commission will be rescinding exemptive relief previously granted to ETFs permitted to rely on the Rule, as well as exemptive relief permitting ETF master-feeder structures (though the Commission is “grandfathering certain existing master-feeder arrangements and preventing the formation of new ones, by amending relevant exemptive orders”). The Press Release further notes that the Commission is not rescinding exemptive relief permitting ETF fund of funds arrangements. Further, the Press Release states that “ETFs relying on [the Rule] that do not already have their own exemptive relief may enter into fund of funds arrangements as set forth in recent ETF exemptive orders, provided that they satisfy the terms and conditions for [the relief] in those orders, until such time as the Commission issues a rule governing fund of funds arrangements.” In this regard, the Commission proposed a rule governing fund of funds arrangements in December 2018. It is unclear when the Commission will adopt this rule. For more information on this proposed rule, please see the January 22, 2019 Davis Polk Client Memorandum, [SEC Proposes Rule Changes for Fund of Funds Arrangements](#).

Form Amendments (Form N-1A and Form N-8B-2)

The Commission has also adopted certain amendments to Form N-1A (the form used by ETFs structured as open-end funds to register under the Investment Company Act), as well as to Form N-8B-2 (the form used by ETFs structured as unit investment trusts to register under the Investment Company Act). The Press Release states that the amendments are intended to “provide more useful, ETF-specific information to investors who purchase ETF shares on an exchange.”

Related Exemptive Relief and Interpretations under the Securities Exchange Act of 1934

The Commission is also issuing an exemptive order that “harmonizes certain related relief” under the Securities Exchange Act of 1934 (the “**Exchange Act**”), providing relief to broker-dealers and other persons “from certain requirements under the Exchange Act with respect to relying on [the Rule].”

According to the Press Release, the Rule and form amendments will be effective 60 days after publication in the Federal Register. However, there will be a one-year transition period for compliance with the form amendments.

Davis Polk is currently preparing a client memorandum that will more fully describe the Rule and form amendments, as well as the related exemptive relief.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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