Blogs
November 12, 2019
Asset Management ADVocate

The SEC Issues its Long-Awaited ETF Rule (Part 3) – The ETF Exemptive Order

In our previous posts, we reviewed the new Rule 6c-11 (the "ETF Rule") from the U.S. Securities and Exchange Commission ("SEC"), which provides relief to exchange traded funds ("ETFs"). The SEC also issued a complementary exemptive order (the "ETF Exemptive Order") primarily providing relief to broker-dealers that distribute ETFs. ETFs distribute their shares by issuing a block of shares (known as a "creation unit") to certain broker-dealers (referred to as "Authorized Participants") in exchange for a basket of the ETF's underlying securities. Authorized Participants then sell these ETF shares on exchanges. Only Authorized Participants may redeem the ETF's shares for the basket of underlying securities (or the cash equivalent) and only in amounts corresponding to a creation unit. This process could cause Authorized Participants and ETFs to run afoul of the provisions of the Securities Exchange Act of 1934 (the "Exchange Act") discussed below. Prior to adoption of the ETF Rule, the SEC included relief from these Exchange Act provisions in the exemptive order issued to the ETF's sponsor. The ETF Exemptive Order supersedes these previous exemptive orders and covers any ETF that: (a) relies on the ETF Rule and (b) satisfies the diversification requirement for regulated investment companies in Subchapter M of the Internal Revenue Code.

The ETF Exemptive Relief

The four items of relief in the ETF Exemptive Order are:

- **Exchange Act Rule 10b-10:** Rule 10b-10 generally requires a broker-dealer to send its customer a written confirmation of each trade disclosing certain information, including among other items, the identity of the security, price, and number of shares ("Trade Information"). The ETF Exemptive Order allows an Authorized Participant that is effecting an in-kind creation or redemption transaction with an ETF to confirm the transaction without providing this Trade Information for the basket of underlying securities. This relief is subject to conditions, including that the confirmation will contain all of the other information required by rule 10b-10 and that the Trade Information will be available upon the customer's request.
- **Exchange Act Rules 15c1-5 and 15c1-6:** Rules 15c1-5 and 15c1-6 require a broker-dealer to disclose to its customer any control relationship with an issuer of a security, or its interest in a primary or secondary distribution of a security, that it purchases for or sells to the customer. The securities delivered in an in-kind creation or redemption transaction with an ETF on behalf of a customer may be subject to these rules. The ETF Exemptive Order allows an Authorized Participant to omit rules 15c1-5 and 15c1-6 disclosures regarding these underlying securities except upon the customer's request.
- **Exchange Act Section 11(d)(1):** Section 11(d)(1) generally prohibits a person that is both a broker and a dealer from extending credit to a customer on a security which was part of a new issue of securities in which the broker-dealer participated. The ETF Exemptive Order grants relief to an Authorized Participant that provides credit on ETF shares based on two conditions: (1) it does not accept compensation from an ETF to promote or sell the ETF's shares outside the ETF complex, other than non-cash compensation permitted by FINRA regulations; and (2) it does not extend credit on shares of an ETF until thirty days after the ETF's shares have commenced trading on an exchange. The SEC does not consider broker-dealers who are not Authorized Participants to be participating in the distribution of new issue ETF shares. For some ETFs, the relief provided under the ETF Exemptive Order with respect to section 11(d)(1) is narrower than the relief provided in their current exemptive orders.

- **Exchange Act Rule 14e-5:** Rule 14e-5 prohibits "covered persons" from directly or indirectly purchasing securities that are the subject of a tender offer ("subject securities") or any securities that could become subject securities ("related securities") except as part of such tender offer. The ETF Exemptive Order permits in-kind creation and redemption transactions with ETFs to include subject and related securities even if the Authorized Participant or ETF is a covered person. This exemption would apply, for example, when an Authorized Participant acts as dealer-manager in a tender offer for a subject security. This relief is premised on several conditions, including that purchases of subject securities or related securities by Authorized Participants would not be effected for the purpose of facilitating a tender offer and that if an ETF's basket composition changes during a tender offer, any transactions in that security will be because of the basket composition change and not the tender offer.

What's Next?

The ETF Rule will go into effect on December 23, 2019. Funds that currently operate pursuant to an exemptive order but fall within the scope of the ETF Rule will see their exemptive relief rescinded on December 23, 2020.

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