

Unique Oversight Considerations for ETFs

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Regulation

- ETFs are required to adhere to the rules set by the Securities and Exchange Commission. If they are operating in jurisdictions other than the United States, they would have to abide by the regulatory requirements in place by those jurisdictions.

Regulation – ETF Rule

- Rule 6c-11 allows transparent ETFs that meet certain criteria to come directly to market without the cost or expense of obtaining an exemptive order.
- Available only to fully transparent ETFs.
- ETFs relying on the rule are permitted to use baskets that do not reflect pro-rata representations of the fund's portfolio if the ETF adopts written policies and procedures detailing parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders.

Creation and Redemption Process

- An authorized participant system is used to create and redeem shares of an ETF.
- Creation – issuing new shares
- Redemption – removal of existing shares

Custom Basket Transactions

- Deviation from the standard, pro-rata in-kind process
- More tailored selection of assets that may not include all the securities in the ETF

ETF Redemptions in Kind

Internal Revenue Code Section 852(b)(6):

Section 311(b) shall not apply to any distribution by a regulated investment company to which this part applies, if such distribution is in redemption of its stock upon the demand of the shareholder.

ETF Redemptions in Kind

History of Section 852(b)(6):

- Enacted in 1969 to give relief to mutual funds if they had to make in-kind distributions
- *General Utilities* doctrine was repealed, and law was modified by the Tax Reform Act of 1986

ETF Redemptions in Kind

Enter: the ETF Industry

- First ETF launched in January 1993 (SPDR SPY)
- 30 years later, ETFs boast trillions of dollars of AUM
- Thousands of ETFs on the market offering broad range of investment exposure

ETF Redemptions in Kind

How it Works:

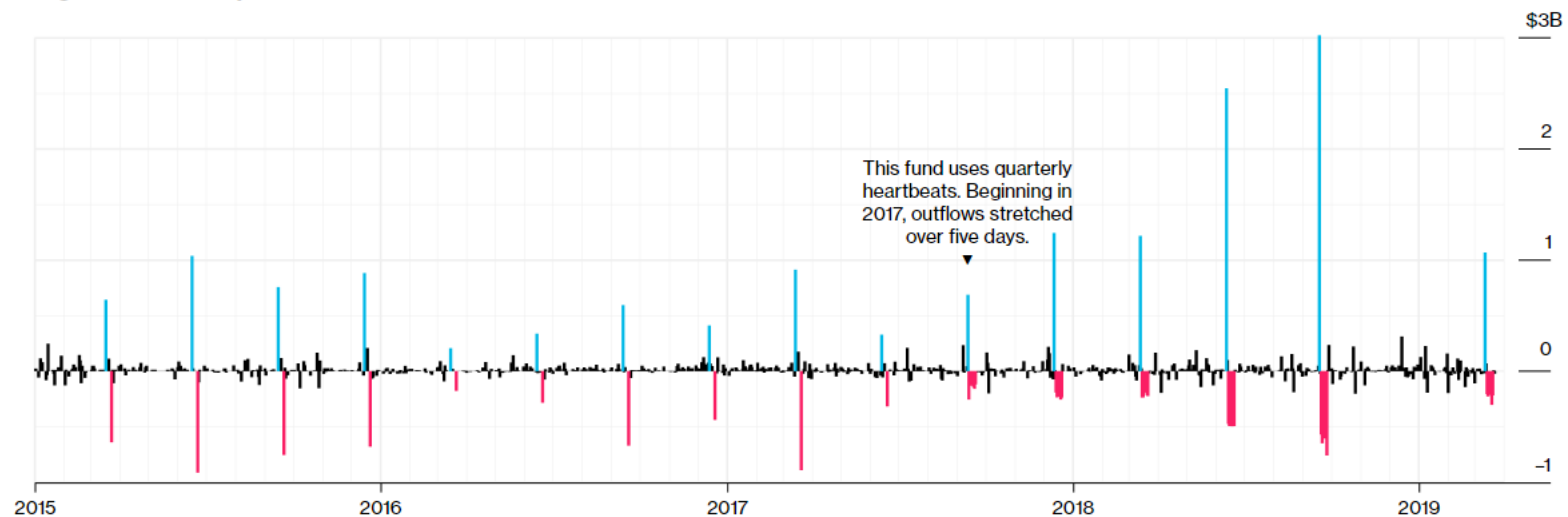
- Authorized Participant (AP) contributes basket of low-cost lot stocks (“creates” or “creation unit”) to ETF in exchange for shares
- AP sells ETF shares to customers
- AP redeems shares and receives basket of stocks from the ETF

ETF Redemptions in Kind

Heartbeat Trades

- Term likely originated in a 2017 FactSet article by Elisabeth Kashner – “The Heartbeat of ETF Tax Efficiency.”

Vanguard Small-Cap ETF



Graphic source: Bloomberg

IRC Section 852(b)(6)

Will it Last?

- Senator Wyden, chairman of the U.S. Senate Committee on Finance, proposed to strike 852(b)(6) in 2021.
- Joint Committee on Taxation estimates that repealing this section could raise over \$200 billion.
- For now, the ETF industry & lobby remains strong and outpaces mutual funds in new fund launches.

Market Makers

- Transactions on the stock exchange are facilitated by Market Makers.
- Liquidity in the secondary market is provided by Market Makers.
- Relationships with Market Makers are integral in maintaining the liquidity of an ETF.

Index Tracking

- Many ETFs track specific indexes.
- Regular rebalancing and effective portfolio management ensure accurate tracking.

Custody and Safekeeping of Assets

- A qualified custodian is required to hold the underlying assets of the Fund.
- A crucial element for protecting the ETFs assets is a reliable custodian.

Portfolio Management

- Asset allocation decisions must be made by Portfolio Managers.
- An essential element of achieving the objectives of the ETF is efficient portfolio management.

Fee Structure

- An important operational consideration of an ETF is the fee structure.
- Traditional vs. Unitary fee structure

Communication and Marketing

- Effective shareholder communication provides transparent information about an ETF's holdings, objectives and performance.
- Attracting new investors and maintaining liquidity are important results of effective marketing.

Distribution Channels

- Collaboration with brokerage firms and market makers is required for distribution of ETFs.
- A crucial aspect of a successful ETF is establishing and maintaining relationships with these entities.

Mutual Fund Conversions to ETFs

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Mutual Fund Conversions to ETFs

Typically Structured as Shell Reorganizations

- Should qualify for tax-free treatment
- Must meet continuity of business enterprise requirement
 - › Acquiring Fund must continue the line of business of the Target Fund's historic business
- Significant non-tax considerations

In Kind Seeding

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In-Kind Seeding

General Rule: Internal Revenue Code Section 351(a)

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control...of the corporation.

In-Kind Seeding

Exception: Internal Revenue Code Section 351(e)(1)

This section shall not apply to a transfer of property to an investment company.

This exception does not apply if:

- Shareholder does not achieve diversification on such transfer to the investment company (i.e. contributes an already diversified portfolio)

In-Kind Seeding

In Practice

- Seek a tax opinion that provides for:
 - › 80% control test
 - › No shareholder achieves diversification as a result of the transfer
- Evaluate for portfolio continuity after transfer

In-Kind Seeding

Additional Considerations

- Intermediary/authorized participant involvement
- RIC Qualification
 - › Asset diversification tests
 - › Gross Income Test
- Failure to meet tax-free status

Questions?

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