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ETFs in 2020: One Board or Two (or More)?

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The recent advent of non-transparent, semi-transparent, and other actively managed exchange traded funds (ETFs) within existing mutual fund complexes raises the issues discussed below that the boards of mutual funds in such complexes currently face. Non-transparent, semi-transparent, and other actively managed ETFs often are essential or actual "clones" of existing mutual funds, which suggests strongly that a unitary board structure is appropriate for these new types of products. This dominant preference exists even if a board separate from the mutual fund board already oversees passively managed, transparent ETFs within the complex, as these are fundamentally different products from mutual funds and actively managed ETFs.

ETFs entered the markets nearly 30 years ago and after a slow start have gained increasing momentum for the last 10, now accounting for close to 20 percent of total net assets managed by investment companies. The first ETFs pursued passive and transparent index-based strategies, attracting investors with lower fees than traditional mutual funds. While passive ETFs still abound, actively managed ETFs are absorbing an increasing share of investor assets.

Many actively managed ETFs are sponsored by mutual fund advisers looking to enter or expand their footprint in the ETF landscape. With the initial wave of ETF launches, ETFs' novel structure and operations often led mutual fund advisers to establish a separate ETF board. But the emergence of standardized ETF operating conditions and non-transparent, semi-transparent, and other actively managed ETFs presents the question anew and, in the context of ETFs that are basically well-worn affiliated mutual fund strategies in a different wrapper, more sharply.

In this piece we review recent market and regulatory developments involving ETFs, discuss the shared and distinct responsibilities of mutual fund and ETF boards, and suggest factors that advisers and boards should consider when questioning whether or not to employ a unitary[1] board as ETFs are introduced alongside existing mutual fund offerings. In fund complexes where separate ETF and mutual fund boards already exist, advisers launching new actively managed ETFs should also consider these factors when proposing whether the new ETFs will be overseen by the ETF board or the mutual fund board.

From Active to Passive and Back Again

Much has been said about the ongoing flow of investor assets away from actively managed mutual funds towards index-based ETFs and other passive products. Yet as we move into the sixth month of the COVID-19 pandemic in the United States, it is actively managed ETFs that are making headlines. So far in 2020, 68 actively managed ETFs have

launched, eking out passive ETF launches for the first time in 20 years.[2]

> Amid continued volatility spurred by a resurgence in coronavirus cases and an uncertain earnings season, some investors are favoring active management. Those [ETFs] have attracted more than $5.3 billion in both May and June, and another $2.5 billion so far in July, data compiled by Bloomberg show. That brings their total assets to a record of $122 billion.[3]

While this represents a relatively small percentage of the over $4 trillion ETF industry, the data shows that actively managed ETFs are increasingly popular, combining a desire for active management with the lower cost and tax advantages of the ETF wrapper.

The popularity and performance of funds pursuing social impact or environmental, social and governance (ESG) focused strategies also have driven the ballooning of actively managed ETFs.[4] ESG-focused ETFs reportedly gathered over $15 billion in the first half of 2020, with BlackRock reporting in July that "sustainable ETFs in its iShares suite had gathered $11 billion so far in 2020, more than doubling the $5 billion of inflows in the full year 2019."[5]

This growth in actively managed ETFs, including ETFs that are managed as identical or similar "clones" of an adviser's mutual funds, has been fueled in part by three actions taken by the Securities and Exchange Commission (SEC) last year.

Non-Transparent ETFs

In May 2019 the SEC approved the first "non-transparent" actively managed ETFs[6] that, under a bevy of conditions, are permitted to disclose their holdings on a quarterly instead of daily basis.[7] Precidian, the recipient of the long-anticipated non-transparent exemptive order, argued that daily transparency subjected its ETFs to substantial costs and other harms as it exposed the ETFs to the risk of "free riding" and "front running" by other investors and managers. Precidian holds several business process patents relating to the new ETF model and even before the exemptive order was released its competitors had announced confidential licensing arrangements with Precidian. A handful of asset managers have reportedly obtained such a license and are moving forward with a series of non-transparent ETF launches.[8]

Rule 6c-11

In September 2019, after years of backlog and delay in its processing of ETF exemptive applications, the SEC adopted Rule 6c-11 under the Investment Company Act of 1940 (the 1940 Act), allowing certain qualifying ETFs to operate for the first time without obtaining an exemptive order from the SEC.[9] Rule 6c-11 is available only to ETFs organized as open-end management investment companies (that is, not unit investment trusts), only to those pursuing actively managed or passive index-based strategies (that is, not leveraged or inverse ETFs) and only to those providing daily portfolio holdings disclosure (that is, not non-transparent ETFs). The rule streamlines the organization process and codifies five core compliance requirements for existing ETFs,[10] thereby significantly reducing the time and financial commitments required of advisers to sponsor new ETFs.

In sum, ETFs now need not obtain exemptive relief to:

- Issue (and redeem) shares in creation units to (and from) authorized participants in exchange for a basket of securities and any cash balance;
- Allow their shares to be purchased and sold at market price rather than NAV;
- Engage in in-kind transactions with affiliates (other funds and authorized participants) to deposit and receive baskets; and
- Deliver redemption proceeds to authorized participants in more than seven days.[11]

Rule 6c-11 also:

- Allows ETFs that have not received exemptive orders to enter into fund-of-fund arrangements subject to the same conditions set forth in existing ETF exemptive orders permitting fund-of-fund investments beyond the limits of Section 12(d)(1) of the 1940 Act; and
- Standardizes and codifies the compliance requirements for existing ETFs falling within the scope of the rule.

In late 2020 (one year following the effective date of Rule 6c-11), the SEC will rescind, as no longer necessary, the exemptive orders for any existing ETF that falls within the scope of Rule 6c-11.

Semi-Transparent ETFs

In December 2019, the SEC issued four exemptive orders allowing the first semi-transparent ETFs to launch, many of which have come to market closely tracking the strategies of existing affiliated mutual funds.[12] Each of these active management ETF models has unique variations, but unlike Precidian's non-transparent ETFs, the semi-transparent models provide some degree of daily transparency (with full transparency on a quarterly or monthly basis) typically through a "proxy portfolio" that resembles but does not exactly mirror a fund's actual holdings and generally is composed using artificial intelligence, algorithms, and other mathematical tools.

As SEC Commissioners explained when giving notice in November of the exemptive applications, the proxy portfolio gives authorized participants of semi-transparent ETFs "enough information to keep the fund's price in line with asset values. Each fund's portfolio will only include securities that trade on an exchange, and the fund will establish thresholds for tracking error and bid-ask spreads, with the board taking needed action if the thresholds are crossed."[13] Semi-transparent ETFs allow advisers to protect their proprietary strategies and are already "further boosting the profile of actively-managed ETFs,"[14] with the likes of Fidelity Investments now offering the products.[15]

Many asset managers of course have well-established ETF complexes to which they might add based on these regulatory developments. Still, others are in the process of offering ETFs for the first time. As of June 30, 2020, reportedly 30 percent of advisers with $100 billion or more in long-term mutual fund assets did not have an ETF family and approximately half of mutual fund advisers with between $50 billion and $100 billion did not.[16]

As advisers face competitive pressures to launch ETF strategies, a threshold issue is whether to create a separate board to oversee the ETF products or to combine the ETFs with an existing board, either by issuing the ETFs as a separate series of an existing trust or creating a new trust to be governed by an existing board. Again, this question is particularly important when the ETFs are intended to replicate the strategies of existing actively managed funds in the same fund complex.

Shared Fundamentals

Regardless of whether they oversee mutual funds or ETFs, directors have substantially similar duties and responsibilities under the state and federal securities laws.

The familiar fiduciary duties of loyalty and care, creatures of common law, are basically the same for mutual fund and ETF directors.[17] Also, under the "business judgment rule," mutual fund and ETF directors generally are afforded great deference in their decisionmaking.

At the federal level, the 1940 Act imposes a number of specific duties on mutual fund and ETF directors. In what is widely viewed as a restatement of state level fiduciary duties, Section 36(a) of the 1940 Act establishes fiduciary duties for mutual fund and ETF directors and empowers the SEC to enforce them. Section 15(c) of the 1940 Act requires mutual fund and ETF boards to request and evaluate information that is reasonably necessary to evaluate

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the terms of the funds' investment advisory contracts. Courts have long applied the standard set out in *Gartenberg* in evaluating whether the Section 15(c) duty has been met.[18] In assessing whether the advisory fees approved by fund boards are excessive in cases brought under Section 36(b) of the 1940 Act, courts also have been influenced by the degree of directors' conscientiousness and independence.[19]

While ETF directors are responsible for overseeing the unique aspects of ETFs—their purchase and redemption process,[20] organizational structure,[21] national exchange listing requirements[22] and need to comply with applicable exemptive orders,[23] no-action relief,[24] and SEC rules[25]—importantly, ETF directors do not assume any heightened liability or fiduciary duty over that assumed by directors of traditional mutual funds.

Directors of both mutual funds and ETFs are required to:

- Monitor fund performance and expenses and the adviser's allocation of portfolio brokerage costs, if any;
- Oversee the process for the valuation of fund holdings and the pricing of fund shares, and determine the time for the pricing of shares;
- Oversee the process for preparation, filing and delivery of shareholder reports, prospectuses and proxy statements;
- Discuss with fund auditors accounting issues arising from the annual audit or otherwise;
- Determine the amount of the funds' fidelity bond;
- Monitor the services provided to the funds, including by the adviser, distributor, administrator, custodian and any others;
- Designate a chief compliance officer (CCO) for the funds and oversee the CCO's activities;
- Monitor the funds' compliance with applicable law and their policies and procedures; and
- Review periodic compliance reports from the CCO, including the annual written report pursuant to Rule 38a-1 under the 1940 Act.

ETF Particulars

Although the unique characteristics of ETFs extend the focus areas of their directors to topics that differ from those overseen by traditional mutual fund directors, these additional focus areas spring from the fundamental oversight and governance responsibilities and best practices of mutual fund boards.

As a preliminary matter, ETF directors must understand and oversee ETFs' purchase and redemption process, structure, national exchange listing obligations and requisite compliance with applicable exemptive orders, no-action relief, and SEC rules. This typically requires some additional knowledge concerning the operation of capital markets. In addition:

- In overseeing ETF performance and expenses generally, and specifically in the context of the Section 15(c) annual contract renewal process, ETF directors must bear in mind that:
  - ETFs typically charge a single service fee that is shared among the adviser and other service providers, as opposed to the advisory fees paid to a mutual fund's adviser that are only one component of the fund's overall expense ratio;
  - Even when an ETF has adopted a plan of distribution pursuant to Rule 12b-1 under the 1940 Act, ETFs rarely actually charge Rule 12b-1 fees or sales loads as authorized participants typically cover these costs in connection with creation units and investors in the secondary market cover them through transaction fees charged by the financial intermediaries through which they purchase the ETF;
  - The performance of passive index-based ETFs is driven primarily not by the skill of investment analysts but by how well the ETF minimizes transaction costs and how closely the ETF tracks its index, the composition of which may be licensed from a third-party provider;[26] and

  - — The performance of non-transparent and semi-transparent ETFs may be impacted by the transaction costs of, respectively, contracting with multiple financial intermediaries (both authorized participants and AP Representatives) to sell and redeem shares and additional trading required to sell proxy portfolio securities received from authorized participants in order to maintain the desired actual portfolio construction.
- ETF directors must establish a fair valuation process that reflects ETFs' arbitrage mechanism.
- Along with the service providers that ETFs share with mutual funds (investment advisers, distributors, administrators, and custodians) ETF directors necessarily oversee their funds' listing exchanges and authorized participants (and AP Representatives for non-transparent ETFs) as well as the associated contracts. Moreover, given the resources required to operate ETFs in compliance with applicable conditions, ETF directors must continuously monitor the adequacy of resources of the adviser and other service providers.
- ETF directors typically receive regular reporting on, without limitation, trading volume, premium/discount trading data, bid/ask spreads, creation unit transactions, activities with authorized participants and tracking error. With non-transparent and semi-transparent ETFs, the board also must monitor and potentially take action if the fund crosses established premium/discount, bid/ask spread and tracking error thresholds.
- The oversight of affiliated transactions governed by Section 17 of the 1940 is somewhat heightened with respect to ETFs as authorized participants often own 5 percent or more of an ETF's shares, and sometimes own upwards of 25 percent. The respective affiliate and control relationships that would exist under Section 17 if not for the adoption of Rule 6c-11 and/or the terms of ETF's exemptive relief must be closely monitored by the CCOs and overseen by the directors of ETFs.
- Other continuous compliance monitoring and oversight are required of ETF directors with respect to, among other things: applicable exemptive orders and exchange listing requirements; the daily composition and disclosure of proxy portfolios for semi-transparent ETFs; the daily compilation and disclosure of portfolio holdings and creation unit composition for traditional ETFs; restrictions on index composition for passive index-based ETFs, including, for example, minimum trading volume thresholds and market capitalization and concentration limits; requisite website disclosure; and, as applicable, the calculation and dissemination of interval (typically every 15 seconds) and estimated intraday indicative value throughout the business day.
- ETF directors' oversight of the liquidity risk management program required by Rule 22e-4 under the 1940 Act generally is more complicated than that of traditional mutual fund directors. For example, in-kind ETFs are not typically required to classify their portfolios into liquidity buckets or to comply with the highly liquid investment minimum requirements of Rule 22e-4, but are required to incorporate other factors in their liquidity risk management programs, including the relationship between an ETF's shares and its portfolio liquidity and the effect of the ETF's deposit or redemption basket for creation units on its overall portfolio liquidity. An in-kind ETF's liquidity risk management program must also address the fund's ability to meet in-kind redemptions under all market conditions and the circumstances under which redemptions can be made in cash.
- ETF directors must pay close attention to market and regulatory developments pertaining to ETFs and their advisers.[27]

The Unitary Board

There are many reasons that an adviser might elect to propose that an existing board assume the

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additional oversight of ETFs, particularly where the ETFs are managed similarly to existing mutual funds. In general, these dovetail with the reasons that nearly 90 percent of fund complexes have unitary board structures today.[28] It is simply easier to administer a single board than to duplicate reporting across multiple boards and respond to the different information requests and viewpoints of multiple boards. A single board also provides a single arbiter on a multitude of matters that boards decide, thus eliminating different standards and resolution of conflicts that may be difficult to administer or explain to regulators or in a litigation context. Along these lines, as reasons for adopting a unitary board approach the registration statements of mutual funds and ETFs with a shared board often point to:

- The fact that the funds are similarly governed by the 1940 Act and often face common and overlapping issues thereunder;
- The fact that the funds share fundamental activities, such as compliance, risk management, maintenance of portfolio liquidity, securities valuation, trading, and financial reporting;
- The belief that a unitary board promotes efficiency and consistency and reduces financial and administrative costs in the governance and oversight of all funds in the complex;
- The fact that funds in the same complex generally share service providers, officers and personnel; and
- Significantly, the belief that a unitary board reduces and mitigates the possible conflicts of interest that may go unchecked with multiple boards, including by enhancing the board's oversight of the funds' adviser and other affiliated service providers; this is especially important with respect to ETFs that are clones of, or managed in a similar manner as, existing mutual funds in the same fund complex, an arrangement that is becoming increasingly prevalent due to the recent SEC relief orders permitting non-transparent and semi-transparent ETF structures discussed above.

In addition to the factors highlighted above, advisers and boards should consider the following in weighing whether or not to utilize a unitary board:[29]

- In today's environment, with many ETFs' portfolio management more closely paralleling that of mutual funds, are the business lines distinct? What is the degree of overlap? For example, are any ETF strategies closely similar to or identical clones of mutual fund strategies in the fund complex? Do the ETF products utilize the same staff and resources as the mutual funds?
- With retail and institutional investors alike gravitating to ETFs and garnering assets from former mutual fund shareholders, are there differences in the approach to marketing the funds? Do the same third-party financial intermediaries serve as distribution partners for the mutual funds and authorized participants for the ETFs? What role do revenue sharing payments made by the adviser and its affiliates to such third-party intermediaries play with respect to the funds? Is there a risk of cross-subsidization that is best overseen by a single board with visibility into both product lines?
- To what extent does the adoption of Rule 6c-11 simplify the legal and operational issues and compliance oversight of ETFs sponsored by the adviser?
- Is the mutual fund board already responsible for applying different valuation methodologies (for example, fair valuation of domestic and foreign equity securities)? Can the directors' experience in this regard and general financial acumen be applied to ETF valuation methodologies, particularly given the prevailing practice of boards delegating day-to-day valuation responsibilities to the fund adviser that the SEC has recently proposed to codify?[30]

- It is standard practice, following the US Supreme Court's decision in *Jones v. Harris*,[31] for mutual fund boards to consider the fees charged by the funds' adviser for all comparable advisory services in the annual Section 15(c) process. This includes fees charged to separate accounts or sub-advised funds with comparable strategies. As the portfolio management of ETFs looks more and more like that of mutual funds and the fees paid by passive index-based and/or actively managed ETFs increasingly appear in mutual fund boards' Section 15(c) materials, the board of mutual funds managed by an adviser must understand and differentiate the advisory contracts of ETFs sponsored by the adviser even if there are separate boards. Would the annual Section 15(c) advisory contract renewal negotiations be streamlined and better serve shareholder interests by the utilization of a unitary board?
- If new ETFs are being established through a mutual fund conversion or merger,[32] would a proxy solicitation be necessary to establish a new board? What are the potential costs of that and why is it preferable to the existing mutual fund board?
- "Conflicts of interest that arise might be easier to govern with a consolidated board, such as the allocation of resources between the ETF and mutual fund complexes, the potential for disintermediation of assets from mutual funds when similar ETFs are launched, and trading conflicts that arise from [ETF] seeding arrangements."[33] How will these and other conflicts, particularly with respect to ETFs cloned from mutual funds, be eliminated or appropriately mitigated if separate mutual fund and ETF boards are maintained?[34] What conflicts might not be as easily identified by separate boards, and would the CCO's duties in this regard be streamlined with a unitary board?
- Does the adviser retain greater leverage and control through the creation of separate boards?[35]

Conclusion

Despite the outflows they have suffered in recent years, mutual funds aren't going anywhere anytime soon.[36] And, the line between ETFs and mutual funds is blurring with both the introduction of non-transparent, semi-transparent, and other actively managed ETFs, whether through wholly new and/or cloned ETF launches or the transformation of mutual funds into ETFs through conversion or merger, and increasing similarities between passively managed mutual fund and index-based and leveraged ETFs.[37] The consideration that advisers sponsoring ETFs must give to the structure of the board(s) overseeing the funds they manage is heightened in this context.

The directors of a mutual fund board likely would need to be educated by independent counsel in order to take on oversight of ETFs sponsored by the funds' adviser in a unitary board structure. Directors should, however, be up to the task, having in recent years tackled the complexities of alt strategies, smart beta, derivatives, cybersecurity, distribution-in-guise and liquidity risk management, just to name a few. While a unitary board might not be right for all complexes with both mutual funds and ETFs, it may provide for streamlined reporting and a more uniform approach to conflicts. A review of the conflicts of interest and other factors discussed above suggests strongly that where non-transparent, semi-transparent, and other actively managed ETFs are twin clones or close replicas of existing affiliated mutual funds, the unitary board approach is most appropriate, even if a separate board overseeing passively managed or dissimilar ETFs already has been established.

In all events, in making this governance determination, advisers to mutual funds and similarly managed active ETFs should work closely with counsel to address the considerations discussed above. Directors of existing mutual funds should also seek the advice of their independent counsel as to whether they wish to undertake the oversight of ETFs.

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NOTES

1 Typically, fund complexes have either a unitary or cluster board structure. In a unitary structure, one board oversees all funds at the complex. In a cluster structure, separate clusters of funds are overseen by different boards. While technically a board could oversee a cluster of both mutual funds and ETFs, for the purposes of this discussion, we use the term unitary board to refer to a board that oversees both ETFs and mutual funds within the same complex.

2 Claire Ballentine, "Active ETF Launches Are Outstripping Passive for First Time," *Bloomberg* (July 16, 2020), available at *https://www.bloomberg.com/news/articles/2020-07-16/active-etf-launches-are-outstripping-passive-for-first-time*.

3 *Id.*

4 *Id.*

5 Andrea Riquier, "Sustainable-investing flows have smashed records in 2020. What's going on?," *Market Watch* (July 16, 2020), available at *https://www.marketwatch.com/story/sustainable-investing-flows-have-smashed-all-records-in-2020-whats-going-on-2020-07-07* (citing data from research provider ETF Flows).

6 *Precidian ETFs Trust, et al.*, Inv. Co. Act. Rel. Nos. 33440 (April 8, 2019) (notice) and 33477 (May 20, 2019) (order) (*Precidian*), available at *https://www.sec.gov/rules/ic/2019/ic-33477.pdf*. Precidian is using the "ActiveShares" brand for its non-transparent ETFs.

7 Previously, exemptive orders granted to actively managed ETFs allowed authorized participants to directly purchase "creation units" or redeem "baskets" of securities at the net asset value (NAV) of the actively managed ETF through contractual agreements with the ETF. By contrast, retail investors purchase or redeem ETFs shares on an exchange at market price (*see infra* n.20). According to the SEC, this "arbitrage" mechanism is designed to keep a "close tie" between an ETF's NAV and its market price and serves as the "foundation" that allows retail investors and authorized participants to buy and sell the ETF's shares at a similar price and NAV, respectively. As pricing is a critical component of this arbitrage mechanism, the SEC historically required all ETFs to provide daily transparency of their portfolio holdings. In lieu of daily disclosure, Precidian proposed that: authorized participants would purchase and redeem creation units from the ETF through a confidential brokerage account unaffiliated with the ETF (the AP Representative); the AP Representative would have daily access to the "identity and weightings of the basket securities" exchanged for ETF shares in the creation unit process on behalf of the particular authorized participant; and the AP Representative would act pursuant to a separate contract with the ETF and be subject to confidentiality restrictions limiting disclosure of the basket. Along with standard ETF operating conditions (*see infra* n.21), the *Precidian* order includes additional conditions: providing specific disclosures to investors regarding the differences between the ActiveShares ETFs and traditional ETFs and the related risks and costs; including additional legends on all offering and marketing materials and websites; refraining from "selective disclosure of any material nonpublic information;" taking remedial action if the ActiveShares ETFs do not function as intended; and periodically providing the SEC Staff with certain "metrics and other such information" upon request. Notably, Precidian also agreed that during the first three years' of each ActiveShares ETF's life, Precidian would call a meeting of the board if, for 30 days or more in any quarter, or 15 days in a row, the difference between the market closing price or bid/ask price, on one hand, and the NAV, on the other, exceeded 1.0 percent, or if the bid/ask spread exceeded 1 percent. In addition, Precidian agreed to report to the board and recommend remedial measures if an ActiveShares ETF crosses the "premium/discount and spread" thresholds, at which point the board would "consider the continuing viability of the…ETF, whether shareholders are being

harmed, and what, if any action would be appropriate." Precidian further agreed that ActiveShares ETFs would have the verified intraday indicative value (VIIV) of their portfolio holdings calculated and disseminated "every second during the trading day, rather than every 15 seconds like existing ETFs," and that Precidian would have a standardized calculation process in place across the ActiveShares ETFs. Precidian also agreed that the ActiveShares ETFs would only invest in securities that simultaneously trade with the ETF on a US exchange. These provisions address criticism that the arbitrage mechanism for ETFs would not work with a blind portfolio when indicative value is disseminated at 15-second intervals because market participants could hedge the blind portfolio; according to Precidian, when VIIV is disseminated more frequently, market participants can use the ETF's registration statement, prior holdings, and the VIIV to create dynamic hedges.

8 Annie Massa and Claire Ballentine, "BlackRock Files To License Active Non-Transparent ETF Structure," *Financial Advisor* (June 4, 2020), available at *https://www.fa-mag.com/news/blackrock-files-to-license-active-semi-transparent-etf-structure-56115.html. See also*, Virtus Investment Partners, "Virtus Investment Partners Announces Agreement to License Precidian's ActiveShares Exchange-Traded Fund Structure," (Dec. 24, 2019), available at *https://ir.virtus.com/news/news-details/2019/Virtus-Investment-Partners-Announces-Agreement-to-License-Precidians-ActiveShares-Exchange-Traded-Fund-Structure/default.aspx*; American Century Investments, "American Century Investments First to Launch Semi-Transparent Active Exchange Traded Funds," (Apr. 2, 2020), available at *https://corporate.americancentury.com/content/corporate/en/newsroom/press/press-center/semi-transparent-active-exchange-traded-funds.html;* Darell Oliver, Legg Mason, "Legg Mason and Clearbridge Investments Launch Semi-Transparent ETF Using Precidian Investments' Innovate ActiveShares Technology," (May 28, 2020), available at *https://www.leggmason.com/content/dam/legg-mason/documents/en/corporate-press-releases/financial-release/2020/release-cb-precidian-cfcv-launch.pdf.*

9 *Exchange-Traded Funds*, Sec. Act Rel. No. 10695 and Inv. Co. Act Rel No. 33646 (Sept. 26, 2019), available at *https://www.sec.gov/rules/final/2019/33-10695.pdf.*

10 Thomas Ahmadifar, Alexandra Kambouris Alberstadt and Todd P. Zerega, "The SEC Issues its Long-Awaited ETF Rule (Part 1)—What Made the Cut," *Asset Management ADVocate* (Sept. 27, 2019), available at *https://www.assetmanagementadvocate.com/2019/09/the-sec-issues-its-long-awaited-etf-rule-part-1-what-made-the-cut/* (explaining that in order to rely on Rule 6c-11 to launch without first seeking exemptive relief, an ETF must: (i) issue and redeem its shares in the form of creation units to and from authorized participants in exchange for baskets of securities (and any cash balance); (ii) list its shares, which must trade at market-determined price, on a national securities exchange; (iii) disclose on its Website daily the portfolio holdings that will form the basis for the ETF's next NAV calculation (Rule 6c-11 relatedly requires that any changes in an ETF's holdings of portfolio securities be reflected on a T+1 basis); (iv) adopt and implement written policies and procedures governing the construction of baskets and the process for accepting baskets (Rule 6c-11 allows an ETF to use "custom baskets" instead of pro rata baskets, which can make ETFs more efficient from an arbitrage or tax perspective, and also allows that some ETFs could satisfy redemption orders in cash, instead of having to deliver securities that might be hard to replace); and (v) disclose on its Website, which must be publicly available and free, (a) before the opening of trading, the composition of the portfolio required for a creation unit, plus any cash balancing amount, (b) the ETF's NAV, market price, and premium or discount of the market price from the NAV, each as of the end of the prior business day, (c) detailed information about the ETF's bid-ask spreads, (d) historical information regarding premiums and discounts and (e) specific disclosures when an ETF's premium or discount was greater than 2

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percent for more than seven consecutive trading days).

[11] Thomas Ahmadifar, Alexandra Kambouris Alberstadt, and Todd P. Zerega, "The SEC Issues its Long-Awaited ETF Rule (Part 2)—What was Omitted," *Asset Management ADVocate* (Sept. 30, 2019), available at *https://www.assetmanagementadvocate.com/2019/09/the-sec-issues-its-long-awaited-etf-rule-part-2-what-was-omitted/*.

[12] *T. Rowe Price Associates, Inc. et al.*, Inv. Co. Act Rel. Nos. 33685 (Nov. 14, 2019) (notice) and 33713 (Dec. 10, 2019) (order); *Fidelity Beach Street Trust et al.,* Inv. Co. Act Rel. Nos. 33683 (Nov. 14, 2019) (notice) and 33712 (Dec. 10, 2019) (order); *Blue Tractor ETF Trust et al.*, Inc. Co. Act. Rel. Nos. 33682 (Nov. 14, 2019) (notice) and 33710 (Dec. 10, 2019) (order); and *Natixis Advisors, L.P., et al.*, Inv. Co. Act Rel. Nos. 33684 (Nov. 14, 2019) (notice) and 33711 (Dec. 10, 2019) (order).

[13] Public Statement of SEC Commissioners Robert J. Jackson, Jr. and Allison Herren Lee, "Statement of Commissioners Jackson and Lee on Non-Transparent Exchange Traded Funds," (Nov. 15, 2019), available at *https://www.sec.gov/news/public-statement/statement-jackson-lee-2019-11-15#_ftn2.*

[14] Ballentine, *supra* n.2.

[15] James Lord, "Fidelity debuts semi-transparent ETFs with triple launch," *ETF Strategy* (June 8, 2020), available at *https://www.etfstrategy.com/fidelity-debuts-semi-transparent-etfs-with-triple-launch-95487/*.

[16] Jackie Noblett, "The Fund Shops Still Sitting on the ETF Sidelines," *Ignites!* (July 23, 2020) (citing data from the Morningstar Direct platform).

[17] Under state law, ETF directors are also typically bound by a duty of obedience to the ETF and its shareholders that requires them to carry out their duties in compliance with the terms of the ETF's governing documents, exemptive order conditions and applicable law.

[18] Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F. 2d 923 (2d Cir.). The *Gartenberg* factors typically, among other things, include considerations of (i) the nature, extent and quality of services provided by the investment adviser and its affiliates, (ii) the costs of and benefits to the investment adviser and its affiliates in providing these services, (iii) the extent to which the investment adviser realizes economies of scale and shares them with the investment company, (iv) the rates charged by other investment advisers to similar investment companies and (v) the independence, expertise, care and conscientiousness of the board in evaluating adviser compensation. Although no case law has yet addressed these factors in the context of an ETF, it is to be expected that the same standards would apply.

[19] *See, e.g.,* Mary Ann Sivolella v. AXA Equitable Life Insurance Company and AXA Equitable Funds Management Group, LLC and Sanford et al. v. AXA Equitable Funds Management Group, LLC (Civ. Act. Nos. 3:11-cv-4194 and 3:13-cv-312 (D.N.J.).

[20] Unlike mutual funds, which do not trade on national exchanges and are generally available directly to the public for investment at NAV (either through the funds' transfer agent or an omnibus account sponsored by a third-party financial intermediary), with restrictions on investor eligibility applicable at the share class level, most investors cannot access ETFs directly. Rather, only "authorized participants," such as broker/dealers and other financial intermediaries, may directly buy and sell ETF shares in large blocks (creation units) by engaging in a contractual relationship with the ETF sponsor. Authorized participants purchase creation units by depositing a basket of assets that generally reflects the underlying portfolio composition of the ETF and redeem creation units for redemption baskets holding the ETF's assets. Retail investors may buy and sell ETF shares, at market price, only on the national stock exchange(s) on which the shares are listed and only through broker/dealers. The purchase and redemption of ETF creation units is designed to be driven largely by investor arbitrage of an ETF's secondary market price and its NAV. Accordingly, an ETF's sales and redemptions of creation units generate positive or negative flows depending on whether the secondary market

price is at a premium or discount to NAV per share. Certain ETFs, known as "in-kind ETFs," sell and redeem creation units through in-kind transfers of securities and other portfolio assets, apart from a de minimis amount of cash.

21 Like mutual funds, ETF typically are organized as SEC-registered open-end investment companies on Form N-1A. Certain disclosures required by Form N-1A are modified for ETFs, including, for example, those at: Item 3 relating to fees and expenses; Item 6(c) relating to purchase and sale of shares; and Item 11 relating to share pricing. ETFs must also make a Form 8-A filing with the SEC in order to trade on a national exchange. In order to commence operations, ETFs must be able to comply with the conditions of Rule 6c-11 or if unable to do so (as is the case for ETFs organized as unit investment trusts, leveraged/inverse ETFs, ETFs with multiple share classes and non-transparent and semi-transparent ETFs) submit to the SEC an application for exemptive relief from various sections of the 1940 Act, including, for example: the provisions of Section 5(a)(1) and Section 2(a)(32) relating to "redeemable securities;" Section 22(d) and Rules 22c-1 relating to share price; Section 17 relating to affiliated transactions given that authorized participants buying and selling creation units may own 5 percent or more of the ETF's shares; and the Section 22(e) seven-day redemption satisfaction requirement for ETFs holding foreign securities. ETFs also typically seek exemptive relief to permit funds-of-funds to acquire shares of the ETF in excess of the limits in Section 12(d)(1) of the 1940 Act and must also seek exemptive relief from certain provisions of Securities Exchange Act of 1934 and the rules thereunder, which the SEC has generally granted as self-executing, subject to certain conditions.

22 The SEC has approved standard exchange listing requirements for ETFs that do not require prior SEC approval and typically "contain quantitative criteria with respect to components included in the ETF's underlying or reference index or benchmark…[such as] minimum thresholds regarding trading volume, market capitalization, number of index components, and index concentration limits." *See, e.g.,* Sec. Exch. Act Rel No. 42787 (May 15, 2000) and Sec. Exch. Act Rel. No. 34-78396 (July 22, 2016). For ETFs that cannot rely on these generic listing standards, national exchanges wanting to list the ETF must file a proposed rule change with the SEC indicating certain conditions and representations and await SEC approval before listing the ETF.

23 In addition to the core conditions now codified at Rule 6c-11, ETF exemptive orders granted by the SEC have included conditions that, among others: prohibit marketing the ETF as a mutual fund; require daily disclosure on the ETF's website of its portfolio holdings, prior business day NAV, market closing price (or bid/ask price) and the premium or discount of the market price (or bid/ask price) against the NAV; require that the ETF's intraday indicative value (an estimate of an ETF's NAV per share) be publicly disseminated at least every 15 seconds during regular trading hours for domestic ETFs and every 60 seconds for international ETFs.

24 *See e.g.,* In Re Stradley Ronon Stevens & Young, LLP (June 24, 2019) (indicating that the SEC Staff would not recommend enforcement action, under certain conditions, against an index-based mutual fund or ETF exceeding the diversification limits of Section 5(b)(1) of the 1940 Act), available at *https://www.sec.gov/investment/stradley-062419.*

25 *See, e.g.*, Rule 6c-11 *supra* n.10.

26 Amy Doberman, "ETF Boards Need to Apply Gartenberg Differently," *Learning Curve* (June 2017).

27 For example, early in 2020 an asset manager settled with the SEC on suitability allegations that the firm failed to properly train and supervise its employees regarding the risks associated with single-inverse and other non-traditional ETF products recommended to advisory clients and brokerage customers with limited knowledge of complex financial investment products. Single-inverse ETFs seek investment results that are the opposite of the performance of an index for a stated trading period, typically a single

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day. During the relevant period, the SEC claimed that the firm's clients sustained millions of dollars of losses in single-inverse ETF investments. The settlement entailed payment of a $35 million civil penalty. *In the Matter of Wells Fargo Clearing Services, LLC* and *Wells Fargo Advisors Financial Network, LLC*, Sec. Exch. Act Rel No. 88295 and Inv. Adv. Act Rel. No. 5451 (Feb. 27, 2020), available at *https://www.sec.gov/litigation/admin/2020/34-88295.pdf*.

28 The Independent Directors Council (IDC) and the Investment Company Institute (ICI) report that since 1994 most mutual fund complexes have had a unitary board structure, with 89 percent of complexes participating in the IDC/ICI survey employing a unitary board. "IDC and ICI Overview of Fund Governance Practices, 1994-2018" (Oct. 2019), available at *https://www.idc.org/pdf/19_pub_fund_governance.pdf*.

29 As noted above, advisers considering whether to launch actively managed ETFs under the supervision of an ETF or mutual fund board in a complex where both already exist should also consider these factors. For such advisers, an additional consideration is whether the separate board approach continues to make sense as actively managed ETFs come to the shelf. That is, should certain new ETFs, like non-transparent or semi-transparent ETFs that are managed similarly or identically to existing mutual fund in the fund complex, be launched under the mutual fund board that already oversees the mutual fund that ETF will substantially or fully replicate?

30 *Good Faith Determinations of Fair Value*, Inv. Co. Act Rel. No 33845 (Apr. 21, 2020), available at *https://www.sec.gov/rules/proposed/2020/ic-33845.pdf*.

31 Jones v. Harris, 559 U.S. 335 (2010).

32 *See e.g.,* Claire Ballentine, "Push to Convert Mutual Funds Into ETFs Is Quietly Gathering Pace," *Bloomberg* (Aug. 11, 2020), available at *https://www.bloomberg.com/news/articles/2020-08-11/push-to-convert-mutual-funds-into-etfs-is-quietly-gathering-pace*. The potential benefits of reorganizing an existing mutual fund as an ETF, versus launching a new ETF, include potentially portable performance history and continuous tax status as a "regulated investment company" under Subchapter M of the Internal Revenue Code. A mutual fund can convert to an ETF, with the approval of its board, through various amendments to the fund's registration statement and agreement or declaration of trust (if it does not already contemplate ETF operations); such a conversion may also require shareholder approval under the 1940 Act and/or direction of the board. The merger of a mutual fund into a "shell" ETF established in the same trust or an affiliated trust of the mutual fund can be effectuated with the approval of the mutual fund's board; if the board determines that the conditions of Rule 17a-8 under the 1940 Act are met, no shareholder approval would be technically required, although the board may deem it desirable and/or appropriate. With both conversions and mergers, unless the resulting ETF is able to fully rely on Rule 6c-11, an exemptive order from the SEC would of course also be required. All ETFs operating with no transparency or semi-transparency must have obtained exemptive relief in order to do so.

33 Amy Doberman, "Efficiency at What Cost? Advantages of a Separate Board for ETFs," *The Investment Lawyer*, Vol. 24. No. 2 (Feb. 2017), at n.25.

34 *See* Nick Ravo, "ETFs Get All the Buzz, but Mutual Funds Still Dominate. There's a Reason.," *Wall Street Journal* (Oct. 6, 2019), available *at https://www.wsj.com/articles/etfs-get-all-the-buzz-but-mutual-funds-still-dominate-theres-a-reason-11570414020* (observing that it "is clear that mutual funds and ETFs both have advantages and drawbacks…The availability of automatic investment and dividend reinvestment plans makes incremental mutual-fund purchases less expensive than buying ETFs over time. Those who buy ETFs incrementally incur commissions and transaction fees with each purchase that can substantially reduce gains, or increase losses, especially if an investor is dollar-cost averaging, or buying the same dollar amount of an investment on a regular basis.").

35 In its 2005 Task Force Report, the IDC opined that "the practice of having a board oversee multiple

funds or portfolios that is prevalent within the mutual fund industry is not an historical accident. Rather, it is a logical approach to corporate governance, derived from the unique features of mutual funds…The members of the Task Force are of the unanimous view that a unitary or cluster board structure is the most efficient structure for a mutual fund family, and that any arbitrary limit on the number of funds within a complex that could be overseen by a director would be counterproductive and harmful to fund shareholders." "Director Oversight of Multiple Funds," IDC Task Force Report (May 2005), available at *http://ungersand.a2hosted.com/images/DirResPDFs/IDC_OS_of_Multiple_Funds.pdf*.

36 Ravo, *supra* n.34 (citing ICI data and explaining that "mutual funds in the U.S. remain a monolithic presence," with $19.93 trillion in assets under management as of Aug. 31, 2019 versus $19.49 trillion a year earlier, "suggesting that any shrinkage will come glacially," and noting that "more mutual funds were launched last year (345) than ETFs (247)," 80 percent of the 56 million households owning mutual funds buy them through employer-sponsored retirement plans and "there are far more mutual funds available to investors than ETFs," with 8,009 US mutual funds and 2,053 ETFs trading domestically as of August 2019).

37 *Id.* (noting that "ETFs are often simple, passively managed index funds, though some are double- or triple-leveraged or perform inversely, to some degree, from an underlying instrument" and "mutual funds offer the same type of indexed investing options (although their leverage is limited by law to 33 percent), as well as a broad variety of passively and actively managed options").

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