K&L GATES

2020 ETF Think Tank
Hosted on: Wednesday, September 30, 2020

K&L Gates ETF Think Tank 2020

On September 30, 2020, the Exchange Traded Fund (ETF) Practice Group at K&L Gates LLP hosted its annual ETF Think Tank conference in a virtual format. The conference was structured around four panel sessions each of which lasted approximately 50 minutes. The panels were moderated by partners of the ETF Practice Group and each panel's speakers were knowledgeable ETF industry veterans representing ETF sponsoring firms, stock exchanges, ETF governing boards and ETF service providers. Topics of discussion were drawn from recent major developments - regulatory and business - that are of interest to ETF industry participants and firms thinking of starting an ETF business. The following is a summary of the principal points raised during each session.

Session I: ETF Rule 6c-11 Implementation, Listing Rules

- Moderator: Stacy Fuller, K&L Gates LLP
- Speakers: Irma Bribiesca, DeltaShares ETFs; Paul Kim, Simplify ETFs; Frank Koudelka, State Street Corporation; Kyle Murray, Cboe; and Andrew Serowik, Exchange Traded Concepts

The U.S. Securities and Exchange Commission (SEC) recently adopted Rule 6c-11 (the ETF Rule) to permit registered advisers to launch ETFs without first obtaining individualized exemptive relief. Historically, such relief has been required because the Investment Company Act itself, as adopted in 1940, does not contemplate their structure. The adoption of the ETF Rule is intended to streamline the market entry process for existing and would-be ETF issuers and reduce related costs in order to promote competition.

Rule 6c-11's "basket" provisions are the heart of the ETF Rule. Pursuant to these provisions, ETF sponsors have flexibility to use "custom baskets," including negotiated baskets, on a daily basis for creations and redemptions. "Baskets" are the in-kind securities that an ETF accepts in creations and delivers for redemptions. Historically, certain ETF sponsors were limited to using baskets that were pro rata slices of the fund portfolio, while others had exemptive relief to use custom baskets (i.e., non-pro rata slices). Custom baskets have largely been used by ETF sponsors to enhance their ETFs' tax efficiency. Accordingly, the ETF Rule is expected to result in a greater number of ETFs being able to operate in a tax-efficient manner, which will benefit ETF investors.

The ability to use custom baskets will affect communications between authorized participants (APs) and market makers on the one hand and ETF sponsors on the other hand. Generally speaking, however, APs and market makers are expected to embrace any changes. In particular, they are expected to welcome the ability to interface with all ETF sponsors to negotiate custom baskets in lieu of having to consider different ETF sponsors' individual exemptive orders.

Another key enhancement to the ETF regulatory regime coming out of Rule 6c-11 was the approval by the SEC of updated generic listing standards for ETFs. Listing standards are referred to as "generic" in this context if they can be used by more than one ETF sponsor. Prior to the SEC's adoption of the ETF Rule, the exchanges' generic listing standards uniformly imposed various diversification and liquidity requirements on ETFs. These requirements hamstrung ETF sponsors' ability to offer new products in various asset classes, such as nonagency MBS. The updated standards remove the diversification and liquidity restrictions and invite product development as, under the standards, the main criterion an ETF must meet is compliance with the ETF Rule. Due to the standards' simplicity, they are expected to reduce listing costs for ETFs and shorten the timeline from product conception to market. Product sponsors in more esoteric asset classes, however, will need to consider market makers' and APs' continued need to hedge any position in an ETF's shares in order to trade them efficiently, given that the cost of hedging affects the bid-ask spread and premium-discount in the ETF's shares.

Session II: The Brave New World of Semi-Transparent Active ETFs

- Moderator: Peter Shea, K&L Gates LLP
- Speakers: Tony Baker, Investment Innovations LLC; Darlene DeRemer, Grail Partners; Sonia Kurian, T. Rowe Price; Jim Simpson, ETP Resources; Adina Taylor, Fidelity Investments; and Doug Yones, NYSE Arca

Over the past two decades, the market for active ETFs has drastically increased. Recent investor product selection indicates that interest in active ETFs shows no signs of slowing down. Utilization of the ETF wrapper permits portfolio managers to market their strategies while also benefiting from the substantial benefits realized in the ETF context, including lower operational costs, tax advantages, high liquidity, and global distribution channels. However, portfolio managers have historically been wary of marketing their proprietary active strategies through a typical ETF wrapper due to the full transparency requirements. Semitransparent active ETFs permit portfolio managers to protect their intellectual property while also realizing the many benefits inherent in the ETF structure that are important to investors. There are two general classes of semitransparent active ETFs: (1) those utilizing proxy portfolios (instead of disclosing actual holdings, a substitute basket (the "proxy portfolio") is provided to the market place); and (2) those that rely on the Precidian Investments process (a verified indicative value is posted to the marketplace, with the actual holdings known only to an authorized participant representative).

A predominant benefit of utilizing semitransparent active ETFs is the ability to deliver to investors the *alpha* potential of active management within the beneficial ETF wrapper. An investor's main concerns are identifying strategies that are appropriate given the investor's investment goals and risk limitations and selecting a portfolio management team that the investor is confident can achieve the product's investment objective. Although the semitransparent active ETFs do result in less transparency than a fully transparent ETF, the increase in active strategy options and continued realization of the substantial benefits gained through the ETF structure outweigh the loss of transparency for most investors. Semitransparent active ETFs, all of which currently operate in accordance with conditions set forth in SEC orders, contain conditions that in many respects reflect the conditions of the ETF Rule 6c-11 applicable to fully transparent ETFs. Accordingly, any operational changes are not expected to deter interest in semitransparent active ETFs from either portfolio managers or investors.

Session III: What's New & What's Next?

- Moderator: Trayne Wheeler, K&L Gates LLP
- Speakers: Brandon Clark, Federated Hermes; Nancy Davis, Quadratic Capital Management; Steve Oh, Nasdaq; Rich Powers, The Vanguard Group; and Bob Tull, Procure ETFs

ESG (environmental, social, and corporate governance) investing is highly topical, with a recent survey showing that 90% of financial advisors are being asked by their clients about ESG. ESG is integrated into investment management in various ways. For passively managed index ETFs, ESG is most often used as a screen to exclude certain industries or companies based upon undesirable ESG characteristics. For actively managed ETFs, ESG typically is used as part of the investment process to identify companies that have long-term sustainable business plans or that effectively integrate ESG factors in their business strategies. ESG is also used to identify exceptional companies from an ESG perspective or rule out companies with high ESG risks. The growth of various different ESG product styles reflect the diversity of investor needs and perspectives. There may be a tension between investment return versus ESG impact—doing *well* versus doing *good*. Current investment returns data is inconclusive because of the broad diversity of ESG approaches. Whether ESG achieves *alpha* (superior investment return) often depends on specific investment strategies and their *beta* (risk) profiles. ESG factors are important in both asset management and in exchange-traded operating companies, with the NASDAQ seeing increased focus on ESG trends and developments. Overall, more ESG-related products are launching into the market, bringing different ESG concepts to investors, with accelerating levels of ESG assets under management.

Alternative investments play an important role in both ESG investing and in ETF investing overall. ETFs are often thought of in terms of equities and fixed-income-investment exposure only, but very significant options- and derivatives-based strategies exist and can be harnessed in ETF products. Accessing such strategies had been limited to institutional investors, but ETFs are making these strategies more accessible for retail investors. Such alternative investments can enable investors to manage market correlation, interest rate, and other risks in their portfolios. The rise of actively managed semitransparent ETFs may significantly increase this area of product development in the future.

The role of artificial intelligence has continued to grow, being used to generate more sophisticated indexing methodologies, as well as being harnessed for sophisticated data analysis. AI has been an increasingly important tool for the exchanges' market analysis and for passive and active ETF management and new product development. Investor outreach and education regarding ETF investing will play a critical role, especially regarding the benefits to long-term investment goals that ETFs provide. Market turmoil during the pandemic highlighted the importance of investor education and the role ETFs could play in investment solutions. Broader public education about and investment in ETFs is s an important area of emphasis for the industry going forward.

Session IV: Marketing and Distributing ETFs in the Age of COVID-19

- Moderator: Rich Kerr, K&L Gates LLP
- Speakers: Dave LaValle, Alerian; Luke Oliver, DWS; Ben Slavin, BNY Mellon; Chris Sullivan, Macmillan Communications; and Susan Thompson, State Street Global Advisors.

The age of COVID-19 has highlighted the importance of technology and digital marketing in the marketing and distribution of ETFs. While remote working due to COVID-19 has resulted in higher engagement between internal and external wholesalers, greater partnership between asset managers and their service providers (including index providers), and a generally closer relationship with clients, there has also been more difficulty in reaching out to new prospects during this time. Despite the generally smooth transition to remote working, there were some difficulties and costs, including requirements to upgrade software and hardware for remote access, create cross office integration without travel, and increase communication with clients and partners to ensure seamless delivery of service during the transition and during social distancing. During these unprecedented times, ETF issuers and their service providers have focused their marketing and distribution efforts on (i) communicating with customers, developing best practices, and broader distribution strategies; (ii) developing and making use of new data and analytics; and (iii) continuing to innovate and develop more sophisticated ETF products. These efforts have resulted in clients turning more to such issuers for additional support and information.

The year 2020 has been difficult for the United States not only because of the global pandemic, but also as a result of civil unrest due to racial injustice and a presidential election cycle that has shed a light on stark divisions in U.S. society. Marketing and distribution in such circumstances faces significant headwinds, as there is a risk that pure sales activity may create a backlash from a public focused on these bigger picture issues. As a result, ETF issuers have shifted their public relations and brand positioning efforts to focus on strengthening relationships with the media and other content providers and are seeking to provide with content that demonstrates an understanding of the broader environment and that is tailored around these national issues.

Not surprisingly, digital marketing and communication through social media and other avenues has continued to grow in importance during 2020 amid clients' increasing demand for data in the ETF space. Issuers, both large and small, have invested heavily in delivering content via social media with differing results. This focus on digital marketing and social media may have helped level the playing field between small issuers and large issuers. While large issuers have significantly more resources and have invested in teams of data scientists to identity distribution targets and analyze trade data to determine where and how to communicate, some smaller issuers have proven to be more nimble and agile in their use of social media, as they have greater flexibility and fewer internal hurdles in disseminating their message.

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Stacy Fuller (Washington, DC), Peter Shea (New York), Trayne Wheeler (Boston) and Richard Kerr (Boston) as well as K&L Gates speakers Mary Burke Baker (Tax Policy), Joel Almquist (Tax Law) and Rob Sichel (ERISA) extend their thanks to the panelists and all attendees. We earnestly hope to have our next K&L Gates ETF Think Tank again hosted in our offices in 2021. If you have any questions about the K&L Gates ETF Think Tank or about the ETF business, please reach out to our ETF Practice Group (www.klgates.com). We can help!