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Reflecting Back on the 30th Anniversary of ETFs:

Regulatory History Frames Current Issues for ETF Industry

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Introduction

Pearls have long been considered the traditional gift for a 30th anniversary. This seems particularly appropriate when looking back at the past 30 years of the U.S. exchange traded fund (ETF) industry. While historically pearls were rare and alluring, today they are widely available and commonly featured in retail jewelry. Similarly, the first ETFs were novel and intriguing, while today, they are an integral - and increasingly impactful - part of the investment management industry. ETFs have evolved to touch the global retail and institutional markets and even the crypto industry.

The "ETF story" may be relatively brief compared to other investment vehicles, but, nonetheless, contains a variety of evolutions. In this paper, we summarize some of the key milestones in the last 30 years, such as the introduction of actively-managed and semi-transparent funds, as well as explore recent changes and future developments, such as those relating to funds offering exposure to spot bitcoin and ETF share classes. We also review the key themes of the "ETF story", including the approach of the U.S. Securities and Exchange Commission (SEC) to approving the initial ETF and all modifications to that initial model. These themes are likely going to guide the continuing evolution of ETFs, which will have many more anniversaries to celebrate in the future.

Key Highlights

» January 22, 1993 – World's first ETF launched: SPDR S&P 500 Trust ETF

» As of August 31, 2023, global ETFs account for approximately $10.70 trillion in assets under management

The Industry & Its Regulator

A regulatory pattern was introduced in 1993 and continues today - and at each stage, the SEC employed the same process: consider the impact and "success" of what has already been approved and the existence of the arbitrage mechanism in what was proposed.

A key component to ETFs is the arbitrage function. The SEC has been concerned about net asset value (NAV) versus market price, making the ETFs' arbitrage mechanism key to their success where the activities of market participants corrects trading prices to ETF NAV.

1990s

The first ETFs were unit investment trusts, which did not have portfolio management. Therefore, intraday indicative values (IIVs) requirements were imposed. The SEC was concerned that the activities of an investment manager would distort information transparency. As a guard rail, only U.S. domestic equity indexed portfolios (highly liquid underlying securities) were allowed.

1993

First international equity indexed ETF – The SEC was concerned that the arbitrage function would be impaired:

a. Foreign securities trading closes at a time different from when ETF share trading closes.

b. Settlements can be delayed due to foreign exchange holidays being non-synchronous with U.S. market holidays.

2001

Actively Managed ETF Concept Release.

2002

First fixed income indexed ETF – The SEC was concerned that the arbitrage function would be impaired when fixed income securities do not price daily or are priced infrequently and there is no consolidated tape of such prices.

2006

First leveraged ETF.

2008

First fully transparent, actively managed ETF – The SEC was concerned that active management would distort information transparency.

2019

The SEC adopts the "ETF Rule" (**Rule 6c-11)** and approves generic listing rules for exchanges.

» Single most important condition: daily transparency to the ETF's portfolio and other daily metrics via ETF website posting.

2019

SEC approves exemptive relief for non-transparent, actively-managed ETFs.

» Relief conditioned upon availability of a robust transparency substitute.

» Again, the SEC was concerned that the activities of an investment manager would distort information transparency. Therefore, as a guard rail, only U.S. equity portfolios permitted.

The ETF Ecosystem

This brings us to the current ETF landscape:

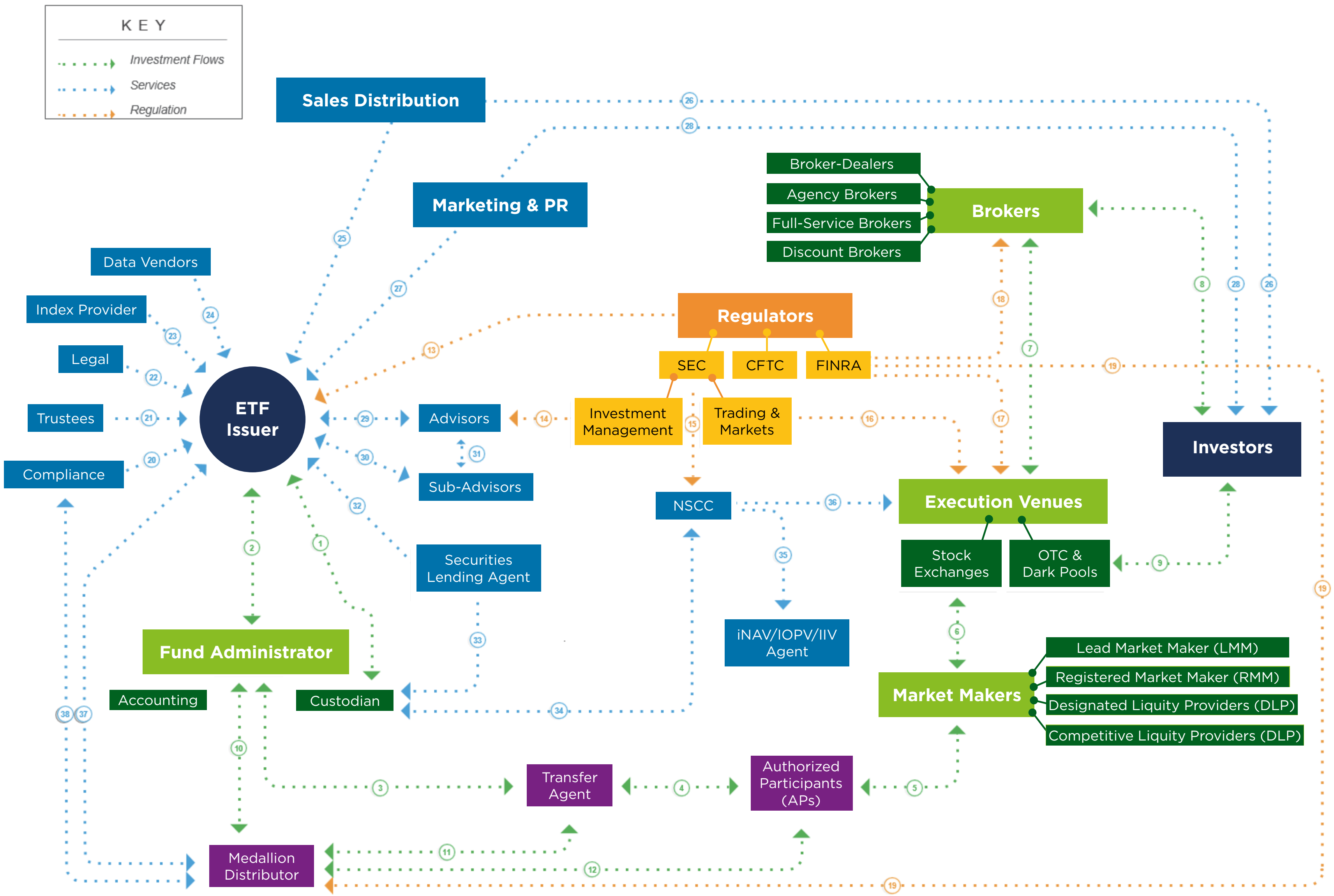

Figure 1

Produced by Arro Financial Communications in collaboration with ACA Foreside and ETF Trends.

Corresponding key with glossary available at end of this paper on page 13.

Themes to Look Forward to

Mutual Fund to ETF Conversions

There has been growing interest in active strategies since 2021, and the regulatory latitude granted to reorganizations of financial products into ETFs since the 2019 ETF Rule adoption have spurred increasing mutual fund to ETF conversions. All conversions to date are structured as mutual fund series mergers into new ETF series of the same trust, or a new trust with the same board. The ETF survives the merger, which is a tax-free event, allowing for the continuity of fund performance history, and avoiding a need for shareholder voting on the reorganization itself.

However, these conversions are not without their drawbacks, as the SEC is scrutinizing these transactions. An SEC examination priority focus is on board considerations for the adoption of Rule 12b-1 distribution sales load plans for the ETF where one or more mutual fund classes had no such Rule 12b-1 plan in effect before the conversion. SEC guidance is driving the timing of suspension of sales loads through the SEC's conversion registration process.

Conversions are a complicated undertaking that require commitment across an organization. The first course of business is to set a realistic timeframe that reaches beyond regulatory approval to manage this in-depth event. The below Conversion Framework will help you organize your understanding of the various considerations and assess whether converting a mutual fund to an ETF makes sense for your firm.

Strategic Analysis

- Determine if the investment strategy can be supported in an ETF. Assess if transparency of an active ETF is acceptable for the strategy, or if there are concerns around immediate disclosure of intellectual property that is prompting the need to evaluate exemptive relief options utilizing a semi-transparent ETF wrapper.
- Understand if an ETF wrapper makes sense for the type of investors or programs the mutual fund is in to alleviate loss in transition.
- Review the requirements of onboarding and ongoing support of ETF products at intermediaries (secondary market).
- Acknowledge that ETFs do not soft or hard close. The creation/redemption mechanism is required to confirm that the arbitrage mechanism works. Evaluate the capacity constraints of contemplated strategies.
- Review the share class structure of the mutual fund to determine if collapse of multiple classes into one is the best process to move forward.

Governance

- Conversion mechanism - Think through which type of conversion mechanism to use: either reorganize the existing mutual fund or merge it into an ETF.
- Determine when to file a registration statement update disclosing the date that the fund will be offered as an ETF or that the merger will occur. When considering mergers, decide whether to fold the mutual fund into a new shell ETF or an existing one.
- Governing documents - Review governing documents to determine if your trust/corporation permits you to offer ETFs and to understand if a shareholder vote is necessary.
- Board approval – Keep your board fully informed throughout the entire process regarding how the conversion will impact shareholders.

Compliance and Operational Considerations

- Comply with ETF-specific rules, such as the SEC's ETF Rule for active transparent ETF structures or conditions of that relief for a semi- or non-transparent structure.
- Ensure the ETF's compliance program addresses new entities that the fund encounters in the ETF ecosystem, such as authorized participants, website vendors, and ETF-specific data providers.
- Fractional shares – ETFs are measured in units, but mutual funds are measured in dollars.
- Shareholder accounts – ETFs are held in a brokerage account. For any mutual fund direct clients, a brokerage account would need to be established.
- Focus on new and existing service provider relationships.
- Changing intermediary relationships - Although the traditional mutual fund dealer agreement ecosystem does not apply to ETFs, the relationship between the ETF asset manager and former mutual fund intermediaries still exist.

Weaving this altogether, the ETF Rule and regulatory guidance have laid the foundation for mutual fund to ETF conversions. Continued investor adoption and market flows in ETFs are signaling that timing might be right for firms looking to enter the market with a conversion, which allows firms with existing products to bring assets and a track record into the ETF structure. The ETF ecosystem requires a cultural shift for firms that requires embracing new roles, implementing new workflows, and educating stakeholders. Implementation of the Conversion Framework will provide the necessary infrastructure to evaluate if a conversion makes sense.

ETF Share Classes; ETFs in Retirement Accounts; and Active ETFs

ETF share classes offer a variety of benefits to mutual fund managers. They provide various types of investors (e.g., individual, institutional, insurance, and retirement investors) with flexibility and choices within a single-fund product. However, self-directed retirement plans, for instance, are often not equipped to allow continuous ETF share trading and only permit mutual fund once-a-day trades. Thus, not all investors want an ETF wrapper.

An ETF share class can improve mutual fund shareholders' tax and cost exposures. Mutual funds usually sell and redeem their shares for cash. ETFs can engage in in-kind creation and redemption transactions to benefit the mutual fund to manage the tax effects and mitigate portfolio transaction costs of the whole fund. ETF class launches occur immediately and leverage the existing mutual fund track record and asset base, avoiding cannibalization of the existing fund with a separate ETF using the same strategy as well as investor objections to a cloned or "diluted" strategy ETF.

However, the ability to use an ETF share class faces impediments and concerns. The primary obstacle is the need for SEC exemptive relief. The SEC's concern seems centered on the entire fund structure being fundamentally fair to all share classes and the structure polices itself. The operational complexities include the cash drag on performance from mutual fund liquidity needs, the ability of the fund's strategy to be scalable (since the ETF cannot close), and the liquidity of the portfolio to be sufficiently liquid for efficient ETF interaction with capital markets. The administrative complexities include proper allocation of costs and tax effects among classes, and possible imposition of swing pricing on mutual fund classes by the SEC.

New approaches have developed for ETF structures that have received SEC approval, including semi-transparent ETFs. These new ETFs selectively disclose portfolio holdings information to the public on a schedule similar to traditional actively managed mutual funds, while still striving to maintain market and NAV parity. This is accomplished through the use of alternative methods of signaling the value of an ETFs portfolio to the market.

Since actively managed ETFs seek to generate alpha - outperform a benchmark – through security selection and innovative weighting schemes, many money managers have been reluctant to adopt the traditional ETF structure because it demands a transparency that could expose proprietary security selection and weighting methodologies to the public. Moreover, since most ETFs' holdings are disclosed each trading day, and their rebalances occur on a regular basis, transparent ETFs open themselves up to "front running," a scheme where traders bid up the price of an ETF's underlying holdings with the foreknowledge that the ETF itself will need to purchase those shares for a rebalance.

For asset managers who wish to harness the advantages of the ETF structure – including tax efficiency and intraday tradability – but want to avoid some of the transparency pitfalls, semi-transparent ETFs may offer a solution. With a few minor exceptions, semi-transparent ETFs utilize all the same structures and relationships as fully transparent ETFs. However, they are mostly distinguished from fully transparent ETFs by the methods utilized to signal the value of the ETFs underlying portfolio.

Semi-transparent Licensing Models

The table below outlines the various semi-transparent solution licensing models that have received SEC approval and are available in the marketplace.

Model	Method	Approach
Blue Tractor	Shielded Alpha	» Disclose holdings and weightings, but disclosed weightings deviate 10% from actual weightings.
Fidelity	Tracking Basket	» Discloses a Tracking Basket designed to closely track the daily performance of the ETF's actual holdings and weightings, which are shielded from public view.
New York Stock Exchange/ Natixis	Proxy Portfolio	» Discloses a Proxy Portfolio designed to recreate the daily performance of the actual portfolio using a factor model analysis of the ETF's actual portfolio. The ETF's actual holdings and weightings are shielded from public view.
Precidian	ActiveShares	» Trusted agents, also known as Authorized Participants Representatives, use confidential accounts to execute creations and redemptions for Authorized Participants.
T. Rowe Price	Proxy Portfolio	» Disclose a Proxy Portfolio to the public with holdings that exhibit a high correlation to the fund's true underlying holdings.

Crypto ETFs

The ETF industry marched in fits and starts to a bitcoin spot exposure product (ETP). In January 2024, SEC approved a limited number of bitcoin spot ETPs - which are not registered investment companies - for listing on a major U.S. exchange. How we got there:

Oct 2021

The SEC permits managed bitcoin futures ETFs to rely on the ETF Rule and generic listing standards. Managed futures ETFs can only invest up to 25% in a controlled foreign corporation that has bitcoin futures exposures.

Apr 2022

The SEC permits exchange-traded commodity pools that have up to 100% exposure to bitcoin futures.

Aug 2023

Spot bitcoin ETPs receive a boost when the DC Circuit Court of Appeals reverses SEC denial of a listing rule for a spot bitcoin grantor trust ETP as arbitrary and capricious.

Dec 2023

Rather than appeal the court ruling, the staff of the SEC engaged with proposed spot bitcoin ETP sponsors to discuss parameters necessary for approval, including the inclusion of additional disclosure and other requirements to provide for investor protection. Among the requirements insisted upon were that the ETPs effect sales and redemptions of ETP creation units solely in cash (rather than in-kind) and hardcoding of key service providers (including bitcoin custodians) into the listing rule.

Jan 2024

The SEC approved all listing rule applications simultaneously, in an effort to prevent a single ETP from having a first mover advantage, and declared effective many bitcoin ETP registered offerings thereafter.

Spot Exposure Bitcoin ETP

To date, the SEC has only granted approval to ETPs investing in bitcoin, and it is unclear whether it will be receptive to products investing in other crypto assets.

Issuers wishing to offer similar products with other digital asset investments will need to undergo a comprehensive review process, and ultimate approval is not guaranteed. Moreover, future ETPs seeking to invest directly into other cryptocurrencies or digital assets may have to demonstrate a depth of market similar to that of the current bitcoin market and satisfy a correlation test similar to that which was relied on by the SEC in approving the current bitcoin products.

ETFs wishing to add bitcoin to their portfolios may not look to the recent ETP approvals as a source of confirmation that such investments would be permissible. Approvals were limited to products that were not registered investment companies (i.e., not traditional ETFs).

Current bitcoin ETPs are engaged in a rapid race to the bottom of fees because the ETP ecosystem is bracing for broader acceptance of these products.

Cash creation and redemption prevents all current bitcoin ETPs from being considered “grantor trusts” that would enable them to be pass-through tax entities, Bitcoin ETP sponsors next battle is with IRS to allow application of grantor trust status to currently offered ETPs.

Over the last 30 years, the ETF has evolved from a novel and intriguing structure to an integral and increasingly impactful part of the investment management industry. The key milestones shared throughout highlight the products evolution in the marketplace from first launch, expansion through the years and the key themes of the first 30 years of the ETF story. As we embark on the next 30 years of ETF growth we look forward to the continued growth and innovation in the marketplace and to celebrating the next 30 year milestone anniversary, the “diamond”, or 60th.

ACA Foreside, part of ACA Group, works with asset management firms throughout the world to facilitate compliance and product distribution through legal underwriting, registered representative licensing, and DTCC/NSCC fund sponsorship. We have experience working with all types of pooled investment vehicles such as mutual funds, exchange traded funds (ETFs), alternative products, closed-end interval funds, business development companies (BDCs) and private placements.

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Our Asset Management and Investment Funds practice has over 50 years of experience in the financial services industry and comprises more than 150 lawyers across the United States, Asia, Europe and Australia. Clients benefit from the practice's highly specialized experience, offering superior legal knowledge and practical real-world advice. The breadth and depth of our experience arms clients with the resources of a global, multi-disciplinary team. Our superior client service is consistently cited as our greatest strength and competitive advantage.

Key and Glossary

1 The **ETF issuer** communicates the fund's market trades as well as details of the creation/redemption basket to the **Custodian**, who in turn provides safekeeping of the assets, as well as providing the ETF Issuer with an aggregate snapshot of the portfolio.

2 The **ETF Issuer** and **Accounting/Custody** work together to process and settle creation/redemption activity when there are orders.

3 When a creation or redemption order is processed, **Accounting/Custody** processes the underlying basket and the transfer agent processes the ETF shares.

4 In some operating models, the **Authorized Participant** places orders on the **Primary Market** with the **Transfer Agent** instead of directly with the **Distributor**.

5 **Authorized Participants** may buy or sell excess shares to the market through market participants. **Market Makers** may engage **Authorized Participants** to facilitate creations or redemptions.

6 **Market Makers** provide ETF liquidity by posting double-sided quotes on the national **Stock Exchanges**.

7 **Brokers** who wish to buy or sell retail quantities of ETF shares will facilitate these transactions on the **Secondary Market** through one of the national **Exchanges**.

8 **Investors** who wish to invest in ETFs will engage with a **Broker**, who buys or sells shares on their behalf.

9 Large **Institutional investors** may buy or sell ETF shares on the **Secondary Market** through alternative trading venues such as **OTC (Over-the-Counter) and Dark Pools**.

10 When a creation or redemption order is processed, the **Medallion Distributor** approves the order and provides final order details to **Accounting/Custody**.

11 The **Medallion Distributor** provides the **Transfer Agent** with creation/redemption activity for record keeping, and the **Transfer Agent** maintains this data for the use of the **Medallion Distributor** in shareholder communications.

12 **Authorized Participants** initiate creation and redemption activity on the **Primary Market** through **Medallion Distributor** systems, and the Medallion Distributor provides confirmations to Authorized Participants.

13 ETF Issuers operate under various rules and regulations including the **SEC** for asset management activities, **FINRA** for sales activities, and the **CFTC** when certain derivatives are involved.

14 The **Investment Management** division of the **SEC** monitors the **Investment Advisor** to ensure compliance with multiple federal regulations.

15 The **NSCC (National Securities Clearing Corporation)** is regulated by the **SEC**.

16 The **Trading and Markets Division** of the **SEC** monitors and works alongside **Execution Venues** to ensure efficient, transparent markets, as well as overall capital market integrity.

17 **FINRA** regulates member **brokerage** firms and **exchanges**.

18 **FINRA** monitors **Brokers** to ensure federal regulations are being followed. It also seeks to protect **Investors** from unscrupulous sales tactics.

19 As a FINRA-member broker-dealer, the **Medallion Distributor** interacts with FINRA on behalf of the **ETF Issuer**.

20 **Compliance** monitors the **ETF issuer** and funds for compliance with regulations, policies, and procedures.

21 The **Trustees** monitor vendors and the general management of the trust to ensure shareholders' rights and interests are being protected.

22 The **Legal** team assists the **ETF Issuer** with contracts and provides general counsel. It also sets the agenda for regular and special meetings of **Trustees**.

23 The **Index Provider** transmits daily index constituents to the **ETF** for the purpose of tracking the portfolio.

24 **Data Vendors** communicate various data points such as securities pricing, corporate action information, and website informatics to the **ETF Issuer** and its service providers.

25 The **Sales Distribution** team of an ETF issuer is usually in-house, but can be outsourced to a 3rd party.

26 The **Sales Distribution** team works to sell the ETF to **Investors**.

27 **Marketing and PR** sets messaging strategy as well as methods of communicating the **ETF Issuer's** products to investors.

28 **Marketing and PR** communicates key information about the ETF to **Investors** by shaping branding, educational content, and messaging, as well as arranging media opportunities and appearances.

29 The investment **Advisor** monitors and manages the day-to-day operations of the **ETF** and its other service providers.

30 A **Sub-advisor**, if engaged, manages all or part of the investment portfolio of the **ETF**.

31 A **Sub-advisor** may be engaged on behalf of the primary investment **advisor** to manage some, or all, of the portfolio's assets.

32 The **Securities Lending Agent** acts as agent of the **Fund** to manage the lending of portfolio securities. This service generally does not start until the fund has some scale.

33 The **Custodian** and **Securities Lending Agent** work in tendem to facilitate the borrowing of securities with proper record-keeping

34 The **Custodian** transmits creation/redemption baskets nightly to the **NSCC** (National Securities Clearing Corporation) who then disseminates it to all member firms including back to the custodian.

35 The **NSCC** (National Securities Clearing Corporation) transmits ETF constituents to the **IOPV** (Indicative Optimized Portfolio Value) calculation agent each morning to generate estimated intra-day share price

36 The **NSCC** (National Securities Clearing Corporation) transmits official creation/redemption basket to **Exchanges** for public dissemination.

37 The **ETF Issuer** appoints the **Medallion Distributor** as a Service Provider of the Trust.

38 The **Medallion Distributor** is a function of the **ETF Issuer's Compliance**, as it is tasked with reviewing and approving all ETF marketing materials prior to use for compliance with **SEC** and **FINRA** advertising rules.