Morgan Lewis

ETF ROUNDUP

Welcome to the latest issue of *ETF Roundup*, our guide to recent legal and regulatory developments affecting the exchange-traded fund (ETF) industry. We hope you find this newsletter useful. If you have any questions, or if there are any topics you would like us to address in future issues, please email us at **etfroundup@morganlewis.com** or contact any of the Morgan Lewis lawyers listed on page 10.

UPDATE ON CRYPTO ASSETS IN ETFS

In 2018, the US Securities and Exchange Commission's Division of Investment Management staff penned a letter to the Investment Company Institute and the Securities Industry and Financial Markets Association titled "Engaging on Fund Innovation and Cryptocurrency-related Holdings" (letter) that acknowledged the growing interest in cryptocurrencies and cryptocurrency-related products and sought input on five substantive areas implicated by investment companies' potential investment in cryptocurrencies or cryptocurrency-related products.[1] On May 11, 2021, in the first substantive staff guidance since the letter, the staff issued a *Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market* (statement).[2] The goals of the statement were twofold. First, the staff strongly encouraged investors interested in investing in a mutual fund with exposure to the Bitcoin futures market to carefully consider the associated risks, including the volatility of Bitcoin and the Bitcoin futures market. Second, the staff clarified its views on the appropriateness of Bitcoin-related strategies for investment companies. At a high level, the staff expressed greater comfort with the Bitcoin futures market, noting that it has continued to develop since the Letter was published, has consistently produced a reportable Bitcoin price, and that the

1 Division of Investment Management, Engaging on Fund Innovation and Cryptocurrency Related Holdings, Jan. 18, 2018, https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm.

2 Division of Investment Management Staff, Staff Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market, May 11, 2021, https://www.sec.gov/news/public-statement/staff-statement-investing-bitcoin-futures-market#_ftn2.

ISSUE 7

TABLE OF CONTENTS

www.morganlewis.com

cash-settled futures do not present the custody concerns associated with other cryptocurrency-related investments. The staff then stated that it believed that investments in the Bitcoin futures market should be pursued only by closed-end funds and mutual funds. The staff did not directly address why investments in the Bitcoin futures market are not appropriate for ETFs, but implied ETFs cannot offer appropriate strategies to support Bitcoin futures and address potential liquidity challenges in the Bitcoin futures market. Three days after the staff issued its statement, a Bitcoin futures mutual fund registration statement was filed, and on July 28, 2021, it became the first actively offered Bitcoin futures mutual fund.[3]

ETF investments in Bitcoin remained stalled until August 3, 2021, when Gary Gensler, Chairman of the US Securities and Exchange Commission (SEC), referenced Bitcoin futures ETFs in a speech given before the Aspen Security Forum covering a broad range of cryptocurrency issues.[4] Chairman Gensler stated that he "anticipate[s] that there will be filings with regard to [ETFs] under the Investment Company Act" and that he "look[s] forward to the [s]taff's review of such filings, particularly if those are limited to these CME-traded Bitcoin futures." While the disconnect between the staff's guidance in the statement and Chairman Gensler's open invitation to Bitcoin futures strategy ETFs did not go unnoticed in the industry, Chairman Gensler's comments were all the encouragement needed to motivate several fund complexes, some of which had previously tried unsuccessfully to register similar strategies, to register Bitcoin futures strategy ETFs. On the day following Chairman Gensler's speech, two registration statements were filed for Bitcoin futures strategy ETFs and during the week of October 18th, the first two Bitcoin futures strategy ETFs launched.[5]

Despite the successful registration of these early Bitcoin futures strategy ETFs, the SEC staff remains very cautious with respect to Bitcoin-related strategies and has done its best to narrowly define which strategies and Bitcoin-related investments will be permitted in an ETF. While certain of the limitations imposed by the staff have been communicated entirely through the comment-and-response process in the course of its review of a registration statement, such as its position that an ETF's investment in certain investment vehicles that provide exposure to Bitcoin may not, in the aggregate, exceed 15% of the ETF's assets, other limitations have been made more public, such as the staff's request that recently filed inverse and leveraged Bitcoin futures strategy ETFs withdraw their registration statements.[6]

We also think it is interesting that Bitcoin futures strategy mutual funds and ETFs registered under the Investment Company Act of 1940 (1940 Act) have now made their debut while their cousins registered under the Securities Act of 1933 ('33 Act) remain stagnant, with little sign of future regulatory relief. That said, the introduction of the Bitcoin futures strategy mutual funds and ETFs could help to stimulate the further development of the Bitcoin futures market and provide the assist needed to get the '33 Act Bitcoin exchange-traded products (ETPs) through their remaining regulatory hurdles, most notably the staff's concern about the vulnerability of the Bitcoin markets to fraud and manipulation.

The staff's views on Bitcoin and other cryptocurrency investments are clearly still evolving, and we are confident that there is much more to come.

TAX PROPOSALS MAY AFFECT ETFS

On September 10, 2021, US Senate Finance Committee Chairman Ron Wyden (D-OR) released draft tax legislation (the Wyden Draft), which included provisions that, if enacted, would affect ETFs registered under the Investment Company Act of 1940 that are taxed as regulated investment companies (RICs) and ETFs subject to rules applicable to publicly traded partnerships (PTPs) (often referred to more broadly as "exchange-traded products" or ETPs). Subsequently, on September 15, the House Ways and Means Committee announced the completion of its markup of draft tax legislation (the Ways and Means Draft) that could have inadvertently affected ETPs treated as "grantor trusts" for US federal income tax purposes. The relevant provisions involving grantor trusts and the proposal from the Wyden Draft, however, are not contained in the Build Back Better Act (H.R. 5376), which passed the House on November 19, 2021. It is unclear whether the proposals in the Wyden Draft will make their way into another piece of legislation; however, industry participants should continue to track the progress of such proposals. The proposals in the Wyden Draft could have a significant effect on ETFs and ETPs.

3 Bitcoin Strategy ProFund, Form N-1A Registration Statement (as filed July 27, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/1039803/000168386321004281/pf-20210727.htm.

4 Gary Gensler, Remarks Before the Aspen Security Forum, https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03#_ftnref5.

5 ProShares Bitcoin Strategy ETF, Form N-1A Registration Statement (as filed Oct. 15, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/1174610/000168386321006052/f10028d1.htm; Valkyrie Bitcoin Strategy ETF, Form N-1A Registration Statement (as filed Oct. 20, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/1877493/000138713121010113/valk-n1aa_102021.htm.

6 Direxion Shares ETF Trust, Request for Withdrawal of Post-Effective Amendment to Trust's Registrant Statement on Form N-1A for Direxion Bitcoin Strategy Bear ETF, https://www.sec.gov/Archives/edgar/data/1424958/000119312521316915/d254494daw.htm; Valkyrie ETF Trust II, Form AW – Request for Withdrawal of Post-Effective Amendment No. 1. for Valkyrie XBTO Levered BTC Futures ETF, https://www.sec.gov/Archives/edgar/data/0001877493/000138713121010552/valk-aw_102921.htm; Investment Managers Series Trust II, Request for Withdrawal of Post-Effective Amendment for AXS Short Bitcoin Strategy ETF, https://www.sec.gov/Archives/edgar/data/0001587982/000139834421020752/fp0069926_aw.htm.

ETFs Taxed as RICs

Currently, Section 852(b)(6) of the Internal Revenue Code of 1986, as amended (the Code), permits a RIC to distribute appreciated property to a shareholder without recognizing gain. However, proposed changes in the Wyden Draft would repeal Section 852(b)(6), causing RICs to recognize any gain on in-kind distributions of appreciated property. Because RICs are required to distribute their income and gains each year to avoid entity-level tax, a repeal of Section 852(b)(6) would likely cause an ETF that generates gains from the distribution of appreciated securities, pursuant to redemption requests, to sell securities in the market for the purpose of generating the cash needed to satisfy its annual distribution requirements. Such sales may increase transaction costs and may generate additional capital gains, further increasing the ETF's distribution requirements.

Commodity Pools Taxed as PTPs

Current law generally treats PTPs as C corporations unless certain exemptions are met. One such exemption applies if 90% or more of a PTP's gross income consists of "qualifying income" within the meaning of Section 7704(d) of the Code, and the Treasury Regulations thereunder (the Qualifying Income Exemption). The Wyden Draft would eliminate the Qualifying Income Exemption, which would cause many PTPs to be subject to entity-level tax as C corporations.

In contrast, the Build Back Better Act proposes to expand the types of "qualifying income" permitted by the Qualifying Income Exemption to include certain income from the generation of electric power or thermal energy and from certain renewables, among other energy sources.

Whether either proposal becomes law is currently unclear. It is important to note that many industry groups, including the Investment Company Institute, strongly oppose the proposed legislation affecting RICs.

SEC COMMISSIONERS ISSUE STATEMENTS RELATING TO COMPLEX ETPS

On October 4, 2021, SEC Chairman Gensler announced that he had directed the SEC staff to study the potential risks associated with complex financial products that are traded on exchanges. In conjunction with this new directive, he also requested that the staff present recommendations to the SEC with respect to potential rulemakings to address such risks, which is part of a broader examination of ETPs. In his statement, Chairman Gensler noted that complex ETPs, such as leveraged ETFs and inverse ETFs, present risks beyond those of typical ETFs, which invest in portfolios of stocks and bonds, and that such risks can have systemic effects when the products operate in unanticipated ways during periods of market stress.

In a joint statement released simultaneously with Chairman Gensler's, Commissioners Allison Herren Lee and Caroline Crenshaw echoed the Chairman's call for additional regulation, outlining three key principles that they believe should guide the establishment of a new regulatory framework with respect to complex ETPs. Specifically, the Commissioners asserted that:

- The new regulatory framework should establish strong, consistent regulatory oversight of all complex ETPs and specifically limit opportunities for regulatory arbitrage with respect to ETPs that are not required to be registered under the 1940 Act.
- The SEC should take a consistent, holistic approach to the review and listing process for ETPs, taking into account the potential for such products to cause risk in the financial system.
- The new regulatory framework should provide heightened protections with regard to investors' trading of complex ETPs.

SEC EXAMINATION STAFF OUTLINES OBSERVATIONS OF REGISTERED FUND COMPLIANCE RISKS

On October 26, 2021, the Division of Examination staff of the SEC published its latest risk alert, which mainly focused on ETFs and mutual funds and, more specifically, on compliance areas that may impact retail investors. The staff highlighted deficiencies and weaknesses in almost every area of fund and fund adviser compliance obligations. Specifically, the SEC noted that it had observed deficiencies with respect to firms' compliance programs and practices relating to the following nonexhaustive list of activities:

- Investment guideline monitoring (including compliance with investment restrictions, limitations on investments in derivatives, and Rule 35d-1, i.e., the Names Rule).
- The operation of a fund's liquidity risk management program.
- Trading practices, including trade allocation and aggregation, principal transactions, cross-trading, and use of soft dollars.
- Fund valuation processes, including the oversight of pricing vendors and the involvement of investment personnel in the valuation process.
- Engagement of third-party service providers, including index providers, financial intermediaries, and providers of shareholder services.
- Fee calculations and expense allocations.

- Review of marketing and advertising literature, especially back-tested index returns.
- Annual fund contract renewal processes.
- Annual fund compliance review processes.
- Incomplete fund disclosures covering almost every necessary disclosure required under Form N 1A (the registration form used by ETFs).

We describe the alert in more detail in our **LawFlash** and highlight practices that ETFs and their advisers can undertake to stay compliant.

SEC APPROVES NYSE ARCA RULE CHANGE PERMITTING MERGERS OF AFFILIATED INVESTMENT COMPANIES WITHOUT SHAREHOLDER APPROVAL

On May 14, 2021, the SEC issued an **order** approving a rule change (the Merger Rule Change) that exempts ETFs and certain other investment companies from obtaining shareholder approval pursuant to New York Stock Exchange (NYSE) Arca Rule 5.3-E(d)(9) (the Merger Rule) when the ETF acquires the stock or assets of an affiliated investment company in a transaction that (i) complies with Rule 17a-8 under the 1940 Act and (ii) does not otherwise require shareholder approval under the 1940 Act. Before the Merger Rule Change, the Merger Rule generally required ETFs that acquired other affiliated investment companies to obtain shareholder approval of the acquisition. As a result of the Merger Rule Change, such approval by the acquiring ETF's shareholders often is no longer required. Acquiring ETFs should still consider whether shareholder approval of an affiliated merger is otherwise required under state law or the acquiring ETF's governing documents. Further, the Merger Rule Change does not alter whether approval of the affiliated merger is required by the shareholders of the fund being acquired.

The Merger Rule Change became effective immediately on May 14. On September 30, 2021 and October 29, 2021, the SEC issued notices of filings and immediate effectiveness of similar rule changes for Cboe BZX Exchange Inc. Rules 14.10(e)(1)(A) and (E)[7] and Nasdaq Rules 5615(a)(1) and (5).[8]

SEC APPROVES FIRST CONVERSIONS OF MUTUAL FUNDS INTO ETFS

A significant evolution for the ETF industry took place in March with the conversion of two mutual funds sponsored by Guinness Atkinson Asset Management into ETFs. Interest in such conversions appears to be strong, with similar conversions taking place soon afterwards for four mutual funds sponsored by **Dimensional Fund Advisors**, one mutual fund sponsored by **The Nottingham Company**, and one mutual fund sponsored by **Mutual Fund Administration, LLC/UMB Fund Services, Inc.**

The conversions follow the SEC's **adoption of semi-transparent active ETF models**, which allow active ETFs to operate without having to disclose their portfolios on a daily basis. Fund sponsors that provide active strategies, many of which have until now opted to limit their involvement in the ETF space because of the requirement for daily transparency, may now be more likely to consider converting their existing mutual funds into ETFs. Such funds would be able to take advantage of the benefits associated with the ETF structure, including the possibility of greater tax efficiency and decreased operational costs and fund expenses.

In addition to regulatory, board, and tax considerations, sponsors that wish to convert their existing mutual funds into ETFs should take into account operational and structural challenges, which the SEC has focused on in their review of such proposed conversions. For example, the SEC is focused on how a firm will move direct mutual fund shareholders into brokerage accounts necessary for ETF ownership, as well as how a firm will handle fractional shares of mutual funds, given that ETFs are issued in whole shares. In remarks provided to the Investment Company Institute, Peter Driscoll, then Director of the SEC's Division of Examinations, noted that the staff would be closely monitoring such conversions, focusing among other things on issues related to illiquid security holdings and valuation, as well as on the listing process for newly converted ETFs.

THE SEC DIVISION OF EXAMINATIONS RELEASES ESG RISK ALERT

In a **Risk Alert** issued on April 9, 2021, by the SEC's Division of Examinations, the SEC staff provided observations made during recent examinations of investment advisers and funds (both registered and private) engaged in ESG investing. The Risk Alert highlights certain deficiencies and

7 Cboe BZX Exchange, Inc., File No. SR 2021-059, Form 19b-4 (Sept. 30, 2021), https://www.sec.gov/rules/sro/cboebzx/2021/34-93218.pdf.

8 The Nasdaq Stock Markets LLC, File No. SR-NASDAQ-2021-083, Form 19b-4 (Oct. 29, 2021), https://www.sec.gov/rules/sro/nasdaq/2021/34-93467.pdf.

internal control weaknesses observed by the staff, as well as observations regarding what the staff viewed as effective practices related to the management and oversight of ESG investing activities. We describe those observations in more detail in our LawFlash. The Risk Alert follows an **Investor Bulletin** released in February 2021 by the SEC Office of Investor Education and Advocacy to educate retail investors on investing in ESG funds and the establishment of a **Climate and ESG Task Force** within the SEC's Division of Enforcement in March 2021.

COMPLIANCE DATE APPROACHES FOR NEW FUND OF FUNDS RULE

On October 7, 2020, the SEC adopted Rule 12d1-4 (the Fund of Funds Rule) under the 1940 Act and related amendments that are collectively designed to provide a more consistent and efficient regulatory framework for funds that invest in other funds (so-called "fund of funds" arrangements). The SEC also rescinded Rule 12d1-2 under the 1940 Act,[9] rescinded most exemptive orders granting relief from certain provisions of Section 12(d)(1) of the 1940 Act, and withdrew certain no-action letters related to Section 12(d)(1) that fall within the scope of the Fund of Funds Rule.

The Fund of Funds Rule is available to registered funds, including ETFs, and business development companies (BDCs) seeking to invest in other registered funds and BDCs beyond the limits currently imposed by Section 12(d)(1) of the 1940 Act. Unregistered funds, such as private funds and foreign investment companies, are not permitted to rely on the Fund of Funds Rule.

Section 12(d)(1)(A) prohibits a registered fund from (i) acquiring more than 3% of another fund's outstanding voting securities, (ii) investing more than 5% of its total assets in any single fund, or (iii) investing more than 10% of its total assets in funds generally. In the past, however, the SEC has adopted rules and issued various exemptive orders permitting fund of funds arrangements in excess of these limits. The SEC believes that the existing mix of exemptive rules and exemptive relief, as well as two statutory exceptions to the Section 12(d)(1)(A) limits, led to a regulatory regime with a variety of different fund of funds arrangements subject to a wide variety of conditions. In adopting the Fund of Funds Rule and related amendments, the SEC sought to "eliminate the existing overlapping and potentially inconsistent conditions for funds of funds and to harmonize conditions across different fund arrangements."

The Fund of Funds Rule permits a fund (acquiring fund) to acquire the shares of another fund (acquired fund) in excess of the Section 12(d)(1)(A) limits described above. The Fund of Funds Rule also provides affiliated transactions relief from Section 17(a) of the 1940 Act necessary to effectuate a fund of funds arrangement. To rely on the rule, funds must comply with conditions that generally (1) limit control and voting on the part of acquiring funds; (2) require advisers of acquiring and acquired funds to make certain evaluations and findings, and report those evaluations and findings to their respective funds' boards; (3) require acquiring funds and acquired funds to enter into fund of funds investment agreements that contain certain terms; (4) limit the ability to establish three-tier fund of fund structures; and (5) require acquiring and acquired funds to maintain and preserve certain written records.

The Fund of Funds Rule and the related amendments went into effect on January 19, 2021. The rescission of Rule 12d1-2 and the applicable existing exemptive orders, and the withdrawal of the applicable no-action letters, will take place on the compliance date for the Fund of Funds Rule—January 19, 2022. Funds of funds that are currently relying on affected exemptive orders or Rule 12d1-2 will have until that time to amend their compliance programs and transition to the Fund of Funds Rule. Funds entering into participation agreements between now and January 19, 2022, in reliance on an exemptive order should consider the implications of the Fund of Funds Rule on such agreements.

For more detailed information on this topic, read our **LawFlash** or check out our **Compliance Checklist**.

NEW SEC RULE WILL REGULATE REGISTERED FUND INVESTMENTS IN DERIVATIVES

On October 28, 2020, the SEC voted to **adopt** Rule 18f-4 (the rule) under the 1940 Act, which replaces decades-old SEC and staff guidance with an updated, comprehensive framework for use of derivatives[10] by registered funds, including ETFs. For more information on the rule please consult our **White Paper** and **Compliance Checklist**.

Specific to ETFs, new leveraged or inverse funds[11] will be subject to the rule, including the Value at Risk–based (VaR) limit on funds' leverage risk. As a result, the limit of leveraged or inverse funds' targeted daily return will be limited to 200% of the return (or inverse of the return) of the funds'

9 Rule 12d1-2 under the 1940 Act permits a fund that invests in acquired funds within the same group of investment companies in reliance on Section 12(d)(1)(G) to also invest in other types of securities.

10 Although the rule does not define "derivative," it defines "derivative transactions" as "(1) any swap, security-based swap, futures contract, forward contract, or option; any combination of the foregoing; or any similar instrument ('derivatives instrument'), under which a Fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; (2) any short sale borrowing; and (3) for applicable Funds, any reverse repurchase agreement or similar financing transaction if the applicable Fund elects to treat them as such."

11 The Proposing Release defines "leveraged/inverse funds" to include funds "that seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time."

underlying index. Leveraged and inverse funds in operation as of October 28, 2020, that seek an investment return in excess of 200% VaR will be permitted to continue their current operations and will not have to comply with the VaR requirement, subject to certain conditions. In connection with the adoption of the rule, the SEC also amended Rule 6c-11 under the 1940 Act to permit ETF sponsors to offer products with leverage exposures at or below 200% without the need to obtain an exemptive order, provided that such ETFs also comply with the applicable provisions of the rule. The parallel amendment to Rule 6c-11 represents a significant market opportunity for new product offerings in the ETF space.

Notably, the SEC did not adopt the proposed exception for leveraged and inverse funds from the leverage risk limits or sales practice rules that would have applied to intermediaries recommending leveraged and inverse funds to retail investors, as proposed in the November 2019 **Proposing Release**.

SEC MODERNIZES FRAMEWORK FOR FUND VALUATION PRACTICES

On December 3, 2020, the SEC adopted Rule 2a-5 under the 1940 Act.[12] Rule 2a-5 is intended to be an updated fair valuation regulatory framework for registered investment companies, including ETFs and BDCs. For more detailed information on the new Rule 2a-5, please consult our **White Paper** and **Compliance Checklist**.

CBOE ISSUES UPDATED ETP LISTING COMPLIANCE GUIDE

On March 1 and June 1, 2021, the Chicago Board Options Exchange (Cboe) published updated versions of its **Cboe ETP Listings Compliance Guide** (the Compliance Guide). As outlined below, the updated Compliance Guide includes several changes from the previous version of the Compliance Guide.

Rule 6c-11 Compliance – March 1, 2021 Update

Reflecting the SEC's adoption of Rule 6c-11 (the ETF Rule) under the 1940 Act, the Compliance Guide was updated to note that ETFs, as such term is defined by the ETF Rule, must comply with all conditions included therein. ETFs that had previously been listed as Index Fund Shares and Managed Fund Shares are no longer subject to the generic listing requirements of these classifications. Additionally, ETFs that had previously been approved through Rule 19b-4 product filings are no longer subject to the representations contained in their respective Rule 19b-4 product filing.

In addition to the requirements of the ETF Rule, listed ETFs must continue to meet all applicable listing standards.

Deficiency Proceedings – March 1, 2021 Update

The updated Compliance Guide now notes that upon a Cboe staff determination that an ETP is deficient with a listing requirement, such ETP will be included on the Below Listing Standards page of the Cboe listings website. Further, the Cboe staff will update such ETP's financial status to "Below Listing Standards." Each ETP's financial status is reflected on the Securities Information Processor. The ETP's inclusion on the Below Listing Standards Page and corresponding changes to its published financial status will remain in effect until the Cboe staff has determined that the ETP is in compliance with all applicable listing requirements.

The updated Compliance Guide also clarifies existing guidance with respect to the cure period,[13] noting explicitly that "at any point during the Cure Period, the issuer may provide data to the staff evidencing compliance with the listing requirement that the ETP was deemed deficient with."

Material News Disclosures – March 1, 2021 Update

The Cboe listing standards require an ETP issuer to "promptly disclose, through any method compliant with Regulation Fair Disclosure (Regulation FD), material information that would reasonably be expected to affect the value of an ETP or influence investors['] decisions." The Compliance Guide provides ETP issuers with a nonexhaustive list of events that may trigger such disclosure requirements, including:

- A temporary suspension of the creation or redemption process;
- The liquidation of an ETP;
- A substantive change in an underlying index's methodology;
- A change to a new underlying index;
- A change to an ETP's investment objective;
- Stock splits;
- The receipt of a staff-issued deficiency notification; and
- A material restatement of the NAV.

12 Good Faith Determinations of Fair Value, Investment Company Act Rel. No. 34128 (Dec. 3, 2020) (Adopting Release).

13 If the issuer submits a compliance plan within 45 days from the date the deficiency notification was provided to the issuer, the Cboe staff will review the plan and make a determination as to whether it will grant a compliance extension of up to 180 days from the date the deficiency notification was submitted to the issuer (the Cure Period).

The updated Compliance Guide has clarified this disclosure requirement by noting that issuers that wish to restate a previously displayed NAV should inform the Cboe staff prior to publishing such restatement. Additionally, the updated Compliance Guide notes that, depending on the materiality of such restatement, the staff may request that the issuer publish a press release notifying the public of the restated NAV. The Compliance Guide also warns issuers that the shares of such ETP may be subject to a temporary trading halt.

Voluntary Delisting – March 1, 2021 Update

The updated Compliance Guide also provides issuers with additional guidance related to the liquidation and voluntary delisting of an ETP. The Compliance Guide reminds issuers that written notice should be provided to the Cboe staff at least 10 days before filing a Notification of Removal From Listing and/or Registration (Form 25) with the SEC and, at the same time, a press release should be published notifying the public of its intent to delist shares of the ETP.

The Compliance Guide further notes that it is customary for the exchange to file the Form 25 with the SEC on behalf of the ETP; however, the exchange may only do so after it has received confirmation that the ETP has been fully redeemed to shareholders of record. Issuers who wish to file the Form 25 on their own behalf must, simultaneously with the filing, provide a copy to the Cboe staff.

Cash Distribution Schedules – March 1, 2021 Update

ETP issuers are required to submit their 2021 cash distribution schedules via email to **corporateactions@cboe.com**. Cash distribution rates must be submitted via email to the same address no later than 6:00 PM ET on the trading day prior to the distribution's ex-date.

Change in Trust (Reorganizations) – June 1, 2021 Update

The updated June 1 Compliance Guide requires a trust seeking to switch the registration of an ETP to a separate trust to notify the Cboe staff at least 10 business days prior to the effective date, at which time the Cboe staff will determine the documents that are necessary to complete the transaction.

SEC APPROVES CUSTOM BASKETS FOR CERTAIN PORTFOLIO-SHIELDING ETFS

In February 2021, the SEC issued exemptive orders to **Natixis Investment Managers** (Natixis), **Invesco** and **Blue Tractor Group** (Blue Tractor) approving their requests to create or redeem ETF shares through "custom baskets" that deviate from their proxy portfolios. In August 2021, the SEC issued similar relief for **Fidelity**.[14]

As discussed in a previous issue of the ETF Roundup, the SEC previously issued orders for each of Natixis, Invesco, Blue Tractor and Fidelity, approving their respective "semi-transparent" active ETF structures. These orders permitted necessary exemptions from the 1940 Act to permit the operation of actively managed ETFs that do not fully disclose their portfolios on a daily basis, as ordinarily required under Rule 6c-11, but instead required them to disclose a "proxy portfolio" designed to closely track the daily performance of an ETF's portfolio, along with certain other information that, together with the proxy portfolio, seeks to ensure that an ETF's arbitrage mechanism is effective. In addition, for these ETFs, the assets included in the proxy portfolio constitute the creation basket, rather than a pro rata portion of the ETF's portfolio required for traditional ETFs.

The amended relief provided by the SEC now enables the semitransparent ETF applicants to create so-called custom baskets that contain securities not included in, or securities in different weights than are in, an ETF's proxy portfolio when creating or redeeming shares, subject to the corresponding requirements in Rule 6c-11. Non- and semi-transparent ETFs are not covered by Rule 6c-11, which permits ETFs covered by the rule (e.g., index-tracking and transparent active ETF structures) to use custom baskets.

Natixis's custom basket order allows for the use of custom baskets in ETFs that follow NYSE's Proxy Portfolio Methodology approach, while the orders provided to Invesco, Blue Tractor and Fidelity provide custom basket relief for their proprietary models (each, together with the NYSE's Proxy Portfolio Methodology, a proxy model). In each case, the names and quantities of the instruments that may constitute a creation basket will generally be the same as the ETF's proxy model, but an ETF may accept creation baskets that differ from the proxy model. Each ETF will also publish on its website the composition of any creation basket exchanged with an authorized participant on the previous day if it differed from the same business day's proxy model, other than with respect to cash.

SEC STAFF REQUIRES CANNABIS ETFS TO FILE LEGAL STATUS OPINIONS

Beginning in late 2018, the SEC staff adopted the position that any fund seeking to register with the SEC that will invest principally in cannabis companies, including an ETF, must file as an exhibit to its registration statement a legal opinion

14 The SEC also recently approved rule changes related to the listing standards for portfolio-shielding ETFs on the NYSE Arca, Inc., Nasdaq Stock Market LLC, and Cboe BZX Exchange. Inc. providing for the use of custom baskets to the extent permitted by this exemptive relief.

from outside counsel confirming that the fund complies with all applicable US federal and state laws and foreign laws in connection with its investment in cannabis companies. If the fund will use derivatives to obtain exposure to US cannabis companies, the staff has requested that the opinion include a statement that explicitly acknowledges that the fund will use derivatives to obtain exposure to US cannabis companies, and that shareholders will not be exposed to liability as a result of that strategy. In some cases, the staff has requested that the opinion be filed on an annual basis. There are currently at least seven cannabis ETFs trading on US exchanges, each of which has filed an opinion on the legal status of the cannabis companies held by that fund. In 2021, with the advent of ETFs seeking to invest principally in other highly regulated industries, the SEC staff has requested the same legal opinion in connection with the ETFs' investments in companies in those other industries.

Morgan Lewis

PRIMARY CONTACTS

Morgan Lewis offers a deep bench of ETF lawyers who provide clients with insights into the legal, operational, and regulatory challenges facing the ETF industry. Our team draws on its understanding of US federal securities laws, derivatives, tax, and other disciplines to collaborate with clients and develop practical solutions and sophisticated products. We are proud to have been recently named **Best ETF Law Firm** by *ETF Express* at the annual *ETF Express* USA Awards 2021, recognizing the capabilities of our team in advising ETFs.

For additional information, please contact any of the following lawyers.

Investment Management

Mana Behbin
Elizabeth L. Belanger
Abigail Bertumen
Lance C. Dial
Magda El Guindi-Rosenbaum
Laura E. Flores
David W. Freese
Sean Graber
Kathleen M. Macpeak
W. John McGuire
Christopher D. Menconi
Mari Wilson
Beau Yanoshik

Broker-Dealers and Listing Markets

John J. O'Brien
Ignacio A. Sandoval

Commodities, Futures & Derivatives

Thomas V. D'Ambrosio
Michael M. Philipp

Securities & Corporate Governance

David A. Sirignano
Brian V. Soares
Emily Drazan Chapman

Intellectual Property

Kenneth J. Davis
Ron N. Dreben
Gene K. Park
Joseph E. Washington

Tax

Richard C. LaFalce
Jason P. Traue

Securities Enforcement & Litigation

David C. Boch
G. Jeffrey Boujoukos
Timothy P. Burke
Joseph E. Floren
T. Peter R. Pound

Mergers & Acquisitions

Tony Chan
R. Alec Dawson
Robert D. Goldbaum
Sheryl L. Orr
Nathan R. Pusey

Connect with us

www.morganlewis.com

121421_212042