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# Waiting for the Green Light: Nontransparent Active ETFs are Ready to Launch Subject to SEC Review

*By Peter M. Allen*

The Securities and Exchange Commission (SEC) has been conducting several meetings this year to allow Exchange Traded Fund (ETF) sponsors to make their case for nontransparent active ETFs.[1] This has increased confidence among industry insiders that the SEC will soon authorize such structures.[2]

The growing momentum for nontransparent active ETFs is evidenced by several ETF sponsor exemptive applications over the past eight years, along with recent filings on behalf of such structures made this year and the previous year, Eaton Vance and Precidian's exemptive applications and Precidian's Form N-1A filing and NYSE and NASDAQ's proposed rule change filings.

The SEC's longstanding view has been that it is necessary for ETFs to disclose their portfolio holdings on a daily basis for effective arbitrage and an efficient secondary market trading of ETF shares. Consequently, since nontransparent active ETFs have proposed to disclose their portfolio holdings on a quarterly basis rather than daily the SEC has been reluctant to allow this ETF structure. Because of the SEC's steadfast focus on transparency and arbitrage, gaining authorization from the SEC may hinge on whether the proposed funds can create share prices that are linked to net asset value (NAV).[3] In response to the SEC's longstanding view, fund sponsors have made differing approaches to obtain exemptive relief. This article will focus on two approaches set forth recently, Eaton Vance's NAV based trading and Precidian's blind trust structure.

Several mutual fund providers have already filed applications for exemptive orders with the SEC for nontransparent ETFs.[4] It is also widely viewed that if the SEC permits nontransparent active ETFs to operate, mutual fund providers will launch their own ETFs and eventually these ETFs may partially, if not completely, replace the $10 trillion mutual fund industry.[5]

The SEC has been evaluating proposals for nontransparent active ETFs for the past eight years. However, up until this year no ETF sponsor had filed a registration statement for a nontransparent active ETF. In January of this year Precidian filed the first registration statement, Form N-1A, for such a fund.

There is substantial room for growth in the active ETF space. Currently, active ETFs represent only .01% of U.S. listed equity ETF assets. Comparatively, approximately 76% of equity mutual fund assets are actively managed.[6] Within the ETF space, there are 1,548 ETFs with $1.7 trillion assets, with the vast majority being passive, index ETFs; there are only 74 actively managed ETFs listed in the U.S. market, with $14.9 billion assets.[7] As of now, the most successful active ETF funds are in the fixed-income space, which include Pimco's Bond and the Pimco Enhanced Short Maturity Strategy that have $2.6 billion. Also, the WisdomTree Emerging Markets Local Debt Fund holds $1.76 billion.[8]

ETFs generally offer superior liquidity, lower tax liability and are less costly than mutual funds.[9] ETFs provide greater tax efficiency because transactions between the fund and investors are done in-kind, rather than in cash. An in-kind exchange means that the fund issues its shares in exchange for the underlying securities that make up the fund's portfolio holdings. The average active ETF's annual expense ratio is 0.8% compared with 1.17% for active mutual funds.[10] Generally, the costs of ETFs compared with mutual funds are substantially lower. This is because for an ETF transaction, an investor only pays the cost of buying and selling the ETF shares. In contrast, an investor in a mutual fund pays a pro rata share of the cost of buying and selling costs of all fund buyers and sellers so long as the investor owns the fund's shares.[11] For instance, Pimco charges 0.85% for shares of its active mutual fund compared to 0.55% for shares of its active ETF, which has an identical portfolio of securities.[12]

For the past eight years, ETF sponsors have requested SEC exemptive relief for nontransparent ETFs to maintain confidentiality of their portfolio securities. The following ETF sponsors have filed exemptive applications for such relief with the SEC: Precidian, BlackRock, Vanguard, State Street, T Rowe Price, Eaton Vance, and Guggenheim Partners.[13] Of these ETF sponsors only Precidian has taken the additional step of filing a registration statement, Form N-1A, with the SEC.

## Statutory and Regulatory Background of ETFs

ETFs and mutual funds are registered under, and regulated by, the Investment Company Act of 1940 (the 40 Act). Because of this, ETFs and mutual funds are similarly regulated. For instance, both ETFs and mutual funds are required to initially file Form N-8A with the SEC and must annually file amendments to their registration statements, Form N-1A.[14] However, unlike mutual funds, because ETFs have unique characteristics not contemplated by the 40 Act ETFs must obtain exemptions from certain sections of the 40 Act.

ETFs, like mutual funds, issue and redeem their shares at NAV. Unlike mutual funds, ETFs cannot sell their shares as individual shares directly to retail investors. The ETF shares must be issued in large blocks (e.g. 50,000 shares), referred to as "Creation Units." Only Authorized Participants (APs), which usually are large institutions such as broker-dealers, may buy Creation Units from the ETF. APs then break up the Creation Units into individual shares and sell the shares individually in the secondary market on exchanges.[15] With respect to redemptions or sales of fund shares, for mutual funds a retail or institutional investor redeems shares to the open-ended mutual fund at NAV, whereas in the case of an ETF, retail or institutional investors sell ETF shares at market prices on exchanges in the secondary market.

Section 6(c) of the 40 Act grants the SEC broad authority to exempt an ETF from certain sections of the 40 Act as long as such exemption is "consistent with the protection of investors" and other requirements.[16] In order for the ETF to carry out its fundamental defining characteristics such as to allow for purchases and redemptions of Creation Units and trading of ETFs on an exchange at market prices, an ETF must obtain exemptive relief from sections 2(a)(32), 5(a)(1) and 22(d) of the 40 Act and Rule 22c-1 thereunder. In addition, in an exemptive application, it is standard practice for an ETF to request exemptions from sections 17(a)(1) and (a)(2), 12(d)(1) and 22(e) to allow for affiliated persons to purchase and redeem Creation Units with the ETF, for other investment companies to purchase ETF shares beyond certain limits, and for ETFs to disburse redemption proceeds more than seven days after a redemption request under certain circumstances.[17]

The SEC has established certain conditions that are standard in ETF applications for exemptive relief. A standard condition in exemptive applications is that the ETF disclose the identities and quantities of the securities, called the basket securities or deposit securities, it is willing to accept in exchange for a Creation Unit in order for the AP to tender the basket or deposit securities in exchange for a Creation Unit.[18] An ETF will only redeem its shares in Creation Units, not individually. Thus, in order for an AP to redeem its shares, an AP must accumulate sufficient ETF shares to make a Creation Unit, and then tender the Creation Unit to the ETF. When an AP redeems a Creation Unit, the ETF tenders the basket or deposit securities in exchange for the AP's Creation Unit. Some other standard conditions require an ETF to: 1) have its shares listed on a national securities exchange, 2) provide on its website the previous business day's NAV on a per share basis, 3) not market itself to the public as a mutual fund or open-end investment company, and 4) comply with certain limitations placed on fund of funds.[19]

Nontransparent active ETFs seek to protect their proprietary investment positions, otherwise referred to as the ETF's portfolio securities, from traders who front run and/or free ride off such investment positions.[20] One of the reasons front running and free riding are a problem is that if the fund's portfolio holdings are transparent to the public, then likely the price of some or all of the securities in that portfolio will go up immediately or gradually, which is a substantial disadvantage to the ETF since they may later want to buy more of a particular security they are holding.

## Arbitrage and Portfolio Transparency

ETFs issue and redeem shares in Creation Units. They are listed on a national securities exchange, where their share price is made publicly available, otherwise referred to as the intraday indicative value of the ETF, which is provided every 15 seconds during trading hours. The ETF's market price changes throughout the day as result of demand for the ETF and other factors such as underlying prices of the ETF's assets. In contrast, the ETF's NAV is calculated at the end of each business day.[21]

The SEC's 2008 Proposed Rule for ETFs enumerated the SEC's view on what is needed for effective arbitrage. The SEC's Proposed Rule provides that an ETF would need to adhere to three conditions to facilitate effective arbitrage: 1) transparency of its portfolio, 2) disclosure of its intraday indicative value, and 3) its listing on a national securities exchange.[22]

Since an ETF trades at market price on an exchange, its price will change throughout the trading day due to supply and demand. Because of this, an ETF's share price can trade at, above, or below the value of its underlying securities, the NAV. When the market price of an ETF's shares are above the NAV per share, in other words the ETF shares are overvalued, an AP can engage in arbitrage by buying the underlying securities, which are relatively undervalued, and simultaneously selling the overvalued ETF shares on the secondary market for a profit. This causes the market price of the ETF's shares to trade closer to NAV. When the market price of an ETF's shares are below the NAV per share, in other words the ETF shares are undervalued, an AP can engage in arbitrage by accumulating individual ETF shares to constitute a Creation Unit, and then redeem it in-kind for the underlying securities. The AP's buying of the undervalued ETF shares will cause the market price of the ETF's shares to trade closer to NAV which in turn makes profit for the AP.[23]

## NAV Based Trading Approach

Eaton Vance filed an amended exemptive application with the SEC on January 23, 2014. In its application, Eaton Vance states that exchange-traded managed funds (ETMFs) are a new investment vehicle that are a hybrid of traditional mutual funds and ETFs. Like ETFs, ETMFs will be traded on exchanges and directly issue and redeem shares in Creation Units to APs. Like mutual funds, ETMFs will be traded at prices based on end-of-day NAV and will disclose portfolio securities on a quarterly basis.[24] Accordingly, Eaton Vance distinguishes ETMFs from nontransparent ETFs, which are traded at the market price, and asserts that since ETMFs have the pricing characteristic of a traditional mutual fund with its trading based on NAV, it should be subject to the same requirements mutual funds have as to frequency of disclosure of its portfolio holdings.[25]

ETMFs critically differ from all ETFs, including all proposed nontransparent active ETFs, in that the "NAV-Based Trading arbitrage mechanism that functions to keep secondary market trading prices of ETMFs in line with underlying asset values" does not rely on the types of assets the ETMF invests in or the nature of its investment strategy.[26] Like ETFs, ETMFs will disclose to the public at 15 second intervals the intraday indicate values of its shares during the trading day.[27] Eaton Vance's application omits the condition for daily disclosure of the portfolio holdings, and in a separate part of the application provides that the portfolio holdings will be disclosed on a quarterly basis.[28]

Like ETFs, ETMFs will issue and redeem Creation Units to APs primarily in-kind, meaning in exchange for basket or deposit securities. However, unlike ETFs including the blind trust ETF structure, as explained later, the ETMF's in-kind basket or deposit securities will not be a "pro rata slice" of the ETMF's portfolio holdings in order to keep the ETMF's portfolio holdings confidential. When the ETMF is purchasing a particular security for its portfolio or is selling it from its portfolio, that security will be excluded from the basket securities until the purchase or sale is complete. Also, the adviser to the ETMF may exclude other portfolio securities from the basket securities if the adviser deems it to be "in the best interest of an ETMF and its shareholders."[29]

The ETMF structure, like an ETF, has certain advantages compared to a traditional mutual fund. For instance, an ETMF protects fund shareholders from the dilutive effects of other fund shareholders' transactions. Traditional mutual funds usually have a cost model where the shareholders that remain in the fund incur the costs of fund shareholder purchases and selling, whereas with an ETMF the shareholder only incurs the transaction cost of purchasing or selling its shares.[30] Also, an ETMF protects fund shareholders from tax realizations stemming from the transactions of other shareholders. For a mutual fund, the fund's selling of appreciated shares to raise cash for redemptions can cause capital gains tax realizations for the fund's nonredeeming shareholders. ETMFs use in-kind distributions for redemptions to avoid this adverse tax effect.[31]

Eaton Vance contends that the ETMF structure has certain advantages compared to fully transparent active ETFs. First, it asserts that unlike ETMFs' NAV based trading model, an ETF's arbitrage mechanism connects its market prices to its NAV, which necessitates that market makers know the ETF's portfolio holdings. Fully transparent active ETFs, by disclosing their portfolio holdings on a daily basis, "can invite profit-seeking traders to front-run portfolio trades that may be executed over multi-day periods and copycat investors to replicate the fund's portfolio positioning." Thus, active managers have primarily rejected the transparent ETF model because it is not in the fund's shareholder or managers' best interests. By allowing ETMFs to disclose quarterly, it would allow investors to access a wide range of actively managed strategies of a structure with efficiencies in cost and tax and shareholder protections.[32] Second, unlike ETFs, ETMFs will provide transparency of trade execution cost and quality control to its investors since ETMFs will trade at prices based on its NAV; investors will be able to purchase and sell shares at a known premium or discount to NAV that they can control by using limit orders.[33] Third, ETMFs facilitate tighter bid-ask spreads and closer premiums/discounts of trades in the secondary markets because they provide market makers with a simpler and more reliable opportunity to arbitrage profit than ETFs.

This is because with the trading of ETMFs, a market maker assumes no intraday market risk for its share inventory positions since all transaction prices are based on end of day NAV. Consequently, unlike with ETF market making, ETMF market makers do not need to engage in transactions in the fund's underlying portfolio holdings or representative portfolio at times and amounts that correspond to their intraday transactions in shares to manage the fund's exposure to market risk.[34]

Eaton Vance contends that since the "arbitrage mechanism that underlies ETMF trading is simpler, more reliable and exposes market makers to less risk than conventional ETF arbitrage," market makers should need less inducement to profit to make and maintain close market price to NAV per share spreads than in comparable ETFs, "thereby enabling ETMFs to routinely trade at smaller premiums/discounts and narrower bid-ask spreads."[35] Eaton Vance acknowledges that the SEC "has long viewed contemporaneous portfolio holdings disclosure as necessary for efficient secondary market trading of ETFs" and that for ETFs market makers need to know the identities of the portfolio securities to allow them to "hedge the intraday market risk they assume as they take inventory positions in connection with their market-making activities" in order to facilitate a close market price to NAV spread.[36] In contrast, according to Eaton Vance, in ETMF trading, a market maker does not assume intraday market risk in its inventory of share positions since the prices for all transactions are based on the end of day NAV, and thus, since there is no intraday market risk, market makers do not need to engage in intraday hedging, and daily disclosure of the portfolio holdings is not needed to maintain a close market price to NAV spread. Further, Eaton Vance asserts that since ETMFs will provide market makers "with an opportunity to earn reliable, low-risk arbitrage profits without intraday hedging," they can be expected to consistently trade at close market price to NAV spreads despite the absence of daily disclosure of the portfolio securities.[37]

One could argue that the NAV based trading approach is more sensible than the intraday approach since it eliminates the potential complexity of intraday pricing inefficiency of the intraday market price-NAV per share spread and uses the time tested pricing method of mutual funds. Opponents of NAV based trading question whether the trading efficiency of ETFs could be undermined by not having intraday purchases and sales with a definitive price until the end of the trading day.[38]

In its filing, Eaton Vance asserts that NAV based trading will facilitate effective arbitrage because market makers and arbitrageurs will profit between the NAV and the price at which shares trade, "i.e., NAV plus or minus a premium/discount" and will "ensure that differences between NAV and trading prices remain small."[39] Accordingly, Eaton Vance states trading prices "should generally occur at prices roughly equivalent to their NAV." When shares are trading at a discount to NAV greater than the cost of redemption, the AP only needs to accumulate sufficient individual shares "to constitute a Creation Unit in order to redeem such Shares at NAV at a profit." When shares are trading at a premium to NAV greater than the creation cost, an AP only needs to purchase a Creation Unit, and then sell the shares at the trading price for a profit.[40]

## Blind Trust Structure

On July 18, 2013 Precidian filed an amended exemptive application with the SEC. Precidian's application proposed a blind trust structure much like BlackRock's Spruce ETF Trust, which filed its application on September 1, 2011.[41] Like Eaton Vance, Precidian and BlackRock's applications omit the condition for daily disclosure of the portfolio holdings, and in a separate part of the application it provides that the portfolio holdings will be disclosed on a quarterly basis.[42] Precidian's application in many instances mirrors the language of BlackRock's application.[43] Precidian's nontransparent ETF would operate much like BlackRock's by using a blind trust on behalf of APs to shield the identities of the ETF's portfolio securities, and disclose the portfolio's pricing every 15 seconds of the trading day.[44]

Under Precidian's blind trust structure, the blind trust is able to act as APs of an index-based ETF would; for instance, by removing higher cost securities thereby reducing imbedded capital gains at the fund level, and thus decreasing tax liability.[45] When an AP redeems ETF shares, the blind trust would liquidate the shares and the AP would receive cash; the blind trust does not disclose to the AP the identity of any of the securities.[46] The blind trust structure allows the portfolio securities to remain confidential because the blind trust creates and redeems ETF shares without disclosing the portfolio securities to an AP or other parties. If an AP wishes to redeem shares, the ETF puts the portfolio securities in a special custody account, the blind trust, with instructions to sell the shares at day's end. After the blind trust liquidates the shares the AP receives the cash for the selling the shares.[47]

Under Precidian's ETF structure, an AP will enter into a participant agreement with the ETF to establish a blind trust, which conceals the portfolio securities and allows for in-kind transactions. Creation of in-kind transactions are completed with the blind trust by the AP tendering the basket securities to the blind trust, and the ETF tendering the Creation Unit to the blind trust and then the blind trust tendering the Creation Unit to the AP and the basket securities to the ETF. Redemption of in-kind transactions are completed with the blind trust by the AP tendering a Creation Unit to the blind trust, and the ETF tendering the basket securities to the blind trust, and then the blind trust liquidates the basket securities and tenders cash to the AP and tenders the Creation Unit to the ETF.[48]

The SEC would like to know how changing the disclosure of an ETF's portfolio from daily to a quarterly basis would affect the ETF's ability to function. Of particular significance, the SEC would like to know if the blind trust structure would hinder APs' ability to effectively engage in arbitrage; in other words, whether APs would, as with transparent ETFs be able to maintain a tight spread between the market price and the NAV.[49]

Concerning arbitrage, Precidian's application states the pricing efficiency of its ETF does not rely on market participants' ability to arbitrage between its ETF shares and underlying portfolio holdings; rather pricing efficiency relies on market participants' ability to assess the ETF's underlying value with sufficient accuracy throughout the trading day to effectively hedge trading exposures to ETF shares. Precidian expects that market makers, "firms that specialize in electronic trading, hedge funds or other professionals," will be able to effectively hedge intraday risk.[50]

Like other ETFs, Precidian's ETF would disclose the intraday indicative value, which is a value that represents the current value of the ETF's portfolio, to the public every 15 seconds during the trading day. The intraday indicative value is intended to represent the current value of the ETF's portfolio in order to assist the arbitrage mechanism, and thereby maintain a narrow market price to NAV per share.[51]

In January of this year, Precidian filed with the SEC the first registration statement, Form N-1A, with the SEC for a nontransparent active ETF.[52] Form N-1A is a fund's primary disclosure document to the public that is filed with the SEC.[53] Precidian's Form N-1A indicates that the ETF, if permitted by the SEC, would shield its trades by having a custodian act through a blind trust on behalf of APs, which would primarily redeem shares in-kind to the fund.[54] It provides for three U.S. equity based funds: 1) a large cap stock fund, 2) a U.S. middle cap stock fund, and 3) a multi-cap fund.[55] Each of the funds would make use of a custodian and a blind trust.[56]

## NYSE and NASDAQ's SEC Filings

In late January of this year, a day after Precidian's Form N-1A filing, the New York Stock Exchange (NYSE) filed to permit nontransparent ETFs, such as Precidian's proposed active ETF, to list and trade on the Arca trading platform of the NYSE Euronext.[57] Per NYSE Arca's listing application, JPMorgan will serve as the custodian, administrator and transfer agent of Precidian's blind trust structure.[58] The filing requests that the SEC permit the proposed ETFs to report their portfolio securities quarterly, like mutual funds, rather than daily.[59]

In the NYSE's filing, it provides for proposed rule 8.900, which would eliminate the requirement for active ETFs to disclose their portfolio securities on a daily basis. The proposed rule provides that active ETFs would need to disclose their portfolio securities on a quarterly basis like a mutual fund. This represents the first time an exchange had filed to allow for listing of nontransparent ETFs. Rival NASDAQ made a similar filing shortly after NYSE's. In its filing, NYSE uses the term "Managed Portfolio Shares" as the defined term to represent nontransparent active ETFs.[60]

NYSE's proposed rule provides for a "fire wall" requirement among the investment adviser and affiliated broker-dealers which prohibits disclosure of the portfolio securities to them.[61] The proposed listed ETFs would not be permitted to invest in derivatives including swaps, which is in line with the SEC's ban on active ETFs investing in derivatives.[62]

A few weeks after NYSE's filing, in mid February of this year, NASDAQ OMX filed with the SEC for a proposed rule change to allow the listing and trading of ETMF shares.[63] NASDAQ's filing requests to allow the listing and trading of Eaton Vance Management's ETMFs. As provided in NASDAQ's filing, ETMFs would trade on Nasdaq at market prices linked to NAV by using "NAV-based trading.[64]" Per the filing, ETMF shares are anticipated to trade at consistently narrow bid-ask spreads without fully disclosing the portfolio securities since the ETMF will provide opportunities to APs to earn arbitrage profits without intraday hedging of their inventory positions.[65]

## Small Hedge Funds May Convert to the ETF Structure

Some investment industry insiders believe that nontransparent active ETFs may increase exponentially with managers of small hedge funds opting to use the ETF structure rather than a hedge fund structure.[66] Small hedge funds often struggle to raise money from wealthy investors including large pension funds and institutions. At least one small hedge fund has already switched to the ETF structure.[67] Cambria Investments, formerly a small hedge fund, switched from a hedge fund structure to the ETF structure in October 2010. This ETF now has $40 million in assets under management and the company has stated that it has found it worthwhile to think about converting two of its other private funds to the ETF structure.[68]

Most hedge funds require that an investor in the fund have at a minimum a net worth, excluding their primary residence, of $1 million or have annual income over $200,000 or joint annual income with a spouse over $300,000.[69] ETFs do not have a net worth or income requirement for investors and can be sold to the general investing public.[70] Hedge funds usually charge a performance fee of 20% of profits.[71] Unlike an investment manager to a hedge fund, an investment manager to an ETF may not charge a performance fee to investors of the fund.[72] The management fee, commonly at least 1.5%, is usually the primary means of a registered fund such as an active mutual fund or ETF to charge investors.[73] Because of this, a small hedge fund looking to switch to the ETF structure would need to gain several times more assets under management if it switched to the ETF structure for it to be worthwhile.

## Waiting for the Green Light

Both NAV based trading and the blind trust approaches arguably have relative advantages. NAV based trading allows for simpler arbitrage by eliminating the need for intraday hedging and it has stood the test of time since essentially this trading method is used for mutual funds. Further, NAV based trading removes the inherent uncertainty in pricing that ETFs have by trading at market prices in the secondary market yet issuing and redeeming at NAV with the ETF. On the other hand the blind trust structure allows the fund's in-kind transactions to be done with true pro rata slices of the portfolio holdings unlike Eaton Vance's proposal. Whether this is of much significance appears to be too early to know.

Both approaches provide an effective means of facilitating arbitrage to function well without portfolio transparency. NAV based trading, by adopting the pricing characteristic of a traditional mutual fund and by making a compelling case for effective arbitrage without disclosure of its portfolio by eliminating intraday pricing, appears to make a very strong case for gaining authorization from the SEC. The blind trust structure appears to allow for effective arbitrage without portfolio transparency since the portfolio is shielded by the trust and APs will be able to partake in intraday hedging with the blind trust. Thus, both NAV based trading and the blind trust approaches appear worthy of the green light from the SEC.

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## NOTES

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2 *Id*.

3 Matthew F. Cohen, "ETF Confidential: A Survey of Non-Transparent Actively Managed ETFs," *The Investment Lawyer*, June 2012. Vol. 19, No. 6 (June 2012).

4 *In the Matter of Eaton Vance Management, et al.*, File No. 812-14139, at 3, (January 23, 2014) (Hereafter referred to as "Eaton Vance"). *In the Matter of the Application of Precidian ETFs Trust, et al.,* File No. 812-14116, (July 18, 2013) (Hereafter referred to as "Precidian ETFs Trust"). *In the Matter of Spruce ETF Trust, et al.*, File No. 812-13953 (September 1, 2011) (Hereafter referred to as "Spruce ETF Trust"). *In the Matter of Vanguard Fixed Income Securities Funds, et al.*, File No. 812-13378 (April 25, 2007).

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11 ETF Manual, *supra* n.9, at 13.

12 Max, *supra* n.10.

13 Massoudi, *supra* n.1.

14 Form N-8A pursuant to section 8(a) of the Investment Company Act of 1940, available at *https://www.sec.gov/about/forms/formn-8a.pdf.*; Form N-1A of the Securities Act of 1933, available at *http://www.sec.*

*gov/about/forms/formn-1a.pdf* (Hereafter referred to as "SEC Form N-1A").

15 SEC, Investor Bulletin: Exchange-Traded Funds (ETFs), August 2012, available at *http://www.sec.gov/investor/alerts/etfs.pdf*.

16 *See* Section 6(c) of the Investment Company Act of 1940.

17 *See In the Matter of ALPS ETF Trust, et al.*, File No. 812-14225, Investment Company Act Release Nos. 31011 (April 8, 2014) (notice), and No. 31039 (May 6, 2014) (order); *In the Matter of ARK ETF Trust, et al.*, File No. 812-14172, Investment Company Act Release Nos. 31009 (April 7, 2014) (notice), and No. 31034 (April 29, 2014) (order); *In the Matter of Direxion Shares ETF Trust, et al.*, File No. 812-14269, Investment Company Act Release Nos. 31002 (April 3, 2014) (notice), and No. 31032 (April 29, 2014) (order); *In the Matter of Empowered Funds, LLC and Empowered Funds ETF Trust*, File No. 812-14245, Investment Company Act Release Nos. 30988 (March 21, 2014) (notice), and No. 31018 (April 16, 2014) (order); *In the Matter of Cohen & Steers Capital Management, Inc., et al.*, File No. 812-14229, Investment Company Act Release Nos. 30924 (February 24, 2014) (notice), and No. 30987 (March 21, 2014) (order).

18 *Id.*

19 *Id.*

20 *See* Eaton Vance, *supra* n.4, at 27; Precidian ETFs Trust, *supra* n.4, at 20.

21 SEC, Investor Bulletin: Exchange-Traded Funds (ETFs), *supra* n.15.

22 SEC, Federal Register, Vol. 73, No. 53, March 18, 2008, Proposed Rules, at 14624, available at *http://www.sec.gov/rules/proposed/2008/33-8901fr.pdf*. The SEC states "Today, we propose a rule with certain conditions that may permit the ETF structure to operate within the scope of the Act without sacrificing appropriate investor protection, and is designed to be consistent with the purposes fairly intended by the policy and provisions of the Act. Our orders have provided exemptions from the definition of "redeemable security" and section 22(d) and rule 22c–1 for ETFs with an arbitrage mechanism that helps maintain the equilibrium between market price and NAV. Our proposed rule would codify these exemptions subject to three conditions that appear to have facilitated the arbitrage mechanism: Transparency of the ETF's portfolio, disclosure of the ETF's Intraday Value, and listing on a national securities exchange."

23 "Why Is The Creation/Redemption Process Important?" *etf.com*, available at *http://www.etf.com/etf-education-center/21014-what-is-the-creationredemption-mechanism.html*.

24 Eaton Vance, *supra* n.4, at 3.

25 Under the 40 Act, a mutual fund is required to disclose in its Form N-CSR and N-Q its portfolio holdings in full at least once quarterly, with a delay of no more than 60 days.

26 Eaton Vance, *supra* n.4, at 5.

27 *Id.* at 4.

28 *Id.*

29 *Id.* at 15.

30 *Id.* at 25.

31 *Id.* at 26.

32 *Id.* at 27.

33 *Id.* at 28.

34 *Id.*

35 *Id.* at 29.

36 *Id.* at 30.

37 *Id.*

38 Ludwig, *supra* n.5.

39 Eaton Vance, *supra* n.4, at 31.

40 *Id.*

41 *See* Precidian ETFs Trust, *supra* n.4. Spruce ETF Trust, *supra* n.4.

42 Precidian ETFs Trust, *supra* n.4, at 1, 3; Spruce ETF Trust, *supra* n.4, at 5. Precidian ETFs Trust, *supra* n.4 Precidian ETFs trust explicitly states that it will disclose on a quarterly basis while Spruce ETF Trust implies that it will disclose on a quarterly basis.

43 *See* Precidian ETFs Trust, *supra* n.4, at 3, 34; Spruce ETF Trust, *supra* n.4, at 5, 68-69. For instance, Precidian on page 3 and Spruce on page 5 state "Rather, they will disclose their holdings in accordance with normal disclosure requirements otherwise applicable

to open-end investment companies registered under the Act" and on page 34 of Precidian ETFs Trust and pages 68-69 of Spruce ETF Trust both state "While the Funds are nontransparent ETFs, Applicants do not believe that the Funds raise any significant new regulatory issues or that the lack of disclosure regarding a Fund's portfolio holdings will in any way make the Fund more susceptible to manipulation for the benefit of one group over another. Rather, Applicants believe that nontransparency avoids the risks of "front running" and "free riding" to which actively-managed funds that disclose their holdings are subject."

44 *See* Precidian ETFs Trust, *supra* n.4; Spruce ETF Trust, *supra* n.4.

45 Ludwig, *supra* n.5.

46 Precidian ETFs Trust, *supra* n.4, at 3, 9-11. On page 11, Precidian states "The trustee of the blind trust will in turn liquidate, hedge or otherwise manage the securities based on instructions from the Authorized Participant. If the trustee is instructed to sell all securities received at the close on the redemption date, the trustee will pay the liquidation proceeds net of expenses plus or minus any cash balancing amount to the Authorized Participant through DTC."

47 *Id.*

48 *Id.* at 5-8, 9-11.

49 Massoudi*, supra* n.1

50 *Id.* at 19.

51 *Id.* at 15.

52 Precidian ETFs Trust, *supra* n.4, Form N-1A, January 22, 2014 (Hereafter referred to as "Precidian's Form N-1A")

53 SEC Form N-1A.

54 Precidian's Form N-1A at 21.

55 *Id.* at 1.

56 *Id.* at 21.

57 SEC Release No. 34-71588, File No. SR-NYSE Arca-2014-10 (February 20, 2014), available at *http://www.sec.gov/rules/sro/nysearca/2014/34-71588.pdf* (Hereafter referred to as "NYSE Filing"). "NYSE Euronext wants 'nontransparent' ETFs to list," *MarketWatch*, January 23, 2014, available at *http://www.marketwatch.com/story/nyse-euronext-wants-nontransparent-etfs-to-list-2014-01-23*.

58 NYSE Filing *supra* n.57, at 12.

59 *Id.* at 1.

60 *Id.* at 1, 2 (FN 4).

61 *Id.* at 8.

62 *Id.*

63 SEC Release No. 34-71657, File No. SR-NASDAQ-2014-020 (March 6, 2014), available at *http://www.sec.gov/rules/sro/nasdaq/2014/34-71657.pdf*. Nasdaq filed with SEC to proposed rule change to list and trade under proposed Nasdaq Rule 5745 the shares of a ETMF.

64 *Id.* at 2.

65 *Id.* at 16-17. In its filing Nasdaq states that "Different from ETFs trading in conventional intraday markets, ETMFs offer market makers an arbitrage profit opportunity that does not depend on either corresponding intraday adjustments in fund share and underlying portfolio positions or the use of a hedge portfolio to manage intraday market risk. A "perfect arbitrage" in an ETMF requires only that market makers holding short (or long) positions in ETMF Shares accumulated intraday transact with the ETMF to purchase (redeem) a corresponding number of Creation Units of ETMF Shares, buy (sell) the equivalent quantities of Composition File instruments at market-closing or better prices, and offload any remaining sub-Creation Unit ETMF Share inventory through secondary market transactions by the market close. Because the arbitrage mechanism that underlies ETMF trading is simpler, more reliable and exposes market makers to less risk than ETF arbitrage, market makers should require less profit inducement to establish and maintain markets in ETMF Shares than in similarly constituted ETFs, thereby enabling ETMFs to routinely trade at smaller premiums/discounts and narrower bid-ask spreads. Further, because the arbitrage mechanism that underlies efficient trading of ETMFs does not involve portfolio positions that are not included in the Composition File, the need for full portfolio transparency to achieve tight markets in ETMF Shares is eliminated."

66 "Hedge Funds Look to Put Strategies into ETFs to Lure More Investors," *Reuters*, March 10, 2014, available at *http://www.reuters.com/article/2014/03/10/us-etfs-hedgefunds-idUSBREA291BE20140310*.

67 *Id.*

68 *Id.*

69 Rule 501 of Regulation D of Securities Act of 1933. Hedge funds issue shares that are not registered under Securities Act of 1933. To qualify for the safe harbor of Regulation D rule 505 or 506 exemptions, the fund may sell to an unlimited number of "accredited investors," which include "a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person" "a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year."

70 Section 5 of Securities Act of 1933. ETF securities offerings are registered under section 5 of Securities Act of 1933, and consequently the securities may be sold to the public.

71 Introduction and Overview of 40 Act Liquid Alternative Funds, Citi, at 12, July 2013, available at *https://www.managedfunds.org/wp-content/uploads/2013/09/Citi-40-Act-Funds-White-Paper-July-2013-2.pdf*.

72 *See* Section 205(a)(1) of the Investment Advisers Act of 1940.

73 Marla Brill, "How to afford an investment adviser without breaking the bank," *Reuters*, December 13, 2011, available at *http://www.reuters.com/article/2011/12/13/us-usa-investing-adviser-idUSTRE7BC1AN20111213*.