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The Rise of Self-Indexing ETFs: The Spectrum From Passive Index to Actively Managed ETFs

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In recent years, exchange traded funds (ETFs) have been the fastest growing investment fund for both institutional and retail investors and now amount to $3 trillion of investment assets globally.[1] ETFs are a product of relatively recent exemptive relief. The Securities and Exchange Commission (SEC) granted exemptive relief for the first ETF in 1993.[2] Most ETFs are based on indexes that are designed by names well-known within the financial industry such as S&P and MSCI.[3] These popular index providers are able to charge relatively high fees to ETF providers for using and following their brand-name indexes.[4]

Some ETF providers have opted instead to create their own indexes, also known as "Self-Indexing" in order to avoid paying fees to index providers.[5] Another reason a sponsor may opt to Self-Index would be to capitalize on the value of its brand name. Established brand names such as Goldman Sachs have recently launched their own Self-Indexing ETFs. Proponents of Self-Indexing argue that the cost savings can be passed on to investors in the form of lower annual ETF fees.[6] Others are concerned about the potential conflicts of interests Self-Indexing presents.[7]

Self-Indexing ETFs have grown in number substantially since July 2013 when the SEC granted exemptive relief for a new framework for these ETFs.[8] Since the SEC put the new framework for Self-Indexing ETFs in place about two years ago, at least 33 different ETF sponsors have launched their own Self-Indexing ETFs.[9] Self-Indexing ETF means that the ETF is based on an underlying index created and maintained by an affiliate of the ETF, of an adviser, or of the distributor.

The new framework provides greater flexibility than the old framework for Self-Indexing ETFs. Unlike the new framework, to address certain concerns of conflicts of interest the old framework required such ETFs to publicly disclose the methodology of its underlying index, to put in place firewalls and to use a third-party index calculation agent. The new framework only requires Self-Indexing ETFs, like all other ETFs, to disclose their portfolio holdings daily on a website to address potential conflicts of interest.[10]

As this article will later explain index ETFs incur transparency costs by disclosing their underlying index methodology. Now that Self-Indexing ETFs do not need to disclose their underlying index methodology this will allow these ETFs to operate, from a cost standpoint, more efficiently to the benefit of their investors.

Goldman Sachs and other major financial institutions such as JP Morgan have joined in on launching

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their branded Self-Indexing ETFs. Earlier this year the SEC granted exemptive relief to Goldman's Self-Indexing ETF.[11] In May of this year, Goldman filed its amended Form N-1A Registration Statement.[12]

Self-Indexing gives issuers like Goldman Sachs the opportunity to brand their own ETFs and perhaps charge a premium compared to other popular ETF providers.[13] European fund managers are not allowed to Self Index because of concerns of potential conflicts of interest. Thus, this creates the possibility for regulatory arbitrage; some European managers may open Self-Indexing ETFs in the US The LIBOR scandal purportedly was caused in part by self-indexing.[14]

This article will provide analysis of Self-Indexing ETFs, their regulatory framework, and also provide background as to the spectrum of index ETFs from passive traditional index ETFs to non-traditional index ETFs that replicate strategies of actively managed funds. The trend for non-traditional index ETFs including Self-Indexing ETFs is that their strategies are becoming more and more like actively managed ETFs. This article will examine this trend. Another non-traditional index ETF is a "strategy based index"; these index ETFs have the objective of outperforming, rather than tracking, their underlying indexes. This article will provide background on strategy based index ETFs to provide context as to the spectrum of ETFs, from fully passive, hybrid, fully active, and other variants in order to provide greater understanding as to how Self-Indexing ETFs fit in the spectrum. Also, this article will examine Goldman Sachs' exemptive application and its amended Form N-1A for its Self-Indexing ETFs.

Potential Conflicts of Interest of Self-Indexing ETFs

One of the main concerns with Self-Indexing ETFs is potential conflicts of interest. The new framework relies primarily on the Self-Indexing ETF disclosing its portfolio securities on a daily basis just like all other ETFs, to address potential conflicts of interest. Specifically, opponents of Self-Indexing are concerned about problems regarding the pricing of index components, embedded costs that are poorly disclosed, substandard index construction methodology, and incentives to manipulate the index rules to boost returns.[15]

Additional potential conflicts include affiliates trading based on prior knowledge of index changes, also called "front-running," making index changes that benefit the manager, affiliates or preferred clients rather than investors in the index ETF, and/or the manipulation of pricing of the index in such a way that is favorable for the funds' performance or tracking ability.[16] Many believe that similar abusive tactics occurred in the LIBOR scandal.[17]

Perhaps the most obvious potential conflict with Self-Indexing is component pricing; especially for an ETF or fund with less liquid securities since often there is some discretion involved in valuing the component securities, which in turn impacts the calculation of net asset value, and thus impacts the ETF's performance.[18] However, as to concerns of poorly disclosed embedded cost it could be argued that it is generally difficult for ETF investors to understand the exact costs linked with licensing a specific name brand index.[19] Thus, as far as fee transparency ETF investors would be no worse off with Self-Indexing.[20]

The SEC views the new framework of daily portfolio transparency as sufficient to protect against potential conflicts of interest concerning affiliates being involved with managing a fund or its underlying index. The potential conflicts of interest in Self-Indexing led the SEC to previously require such ETFs to disclose to the public the underlying index methodology, the use of a third-party index calculation agent, and formal "firewall" procedures.[21]

For both actively managed ETFs and Self-Indexing ETFs, affiliates decide the changes to the investments of the portfolio, and therefore arguably both present the same potential conflicts of interest.[22] In the case of Self-Indexing ETFs, affiliates first make the changes to the index and then make the equivalent changes to the ETF's portfolio.[23] But the result is the same for both actively managed ETFs and

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Self-Indexing ETFs since in both cases affiliates decide the changes to the investments of the portfolio.[24]

New Framework for Self-Indexing ETFs

Unlike the old framework, the new framework provides that the ETF or its index need not disclose its underlying index methodology.[25] This is significant because as explained later in detail, arbitragers often trade on information disclosed about the underlying index methodology leading to "transparency cost" or "front-running cost." As explained in detail later, the ETF and its index, by keeping the index methodology confidential significantly lower the transparency cost, and in turn substantially improve the net returns of the ETF to the benefit of the ETF and its shareholders.

In the SEC's new framework the ETF sponsors acknowledged that a Self-Indexing ETF could raise concerns in regards to an affiliate potentially having the ability to manipulate the underlying index for the benefit or detriment of the Self-Indexing ETF.[26] Also, the sponsors acknowledged the potential for conflicts of interest with regard to the personal trading activity of the affiliate's personnel, who may have access to or knowledge of changes the index provider makes to the methodology of the underlying index's composition or the component securities in an underlying index before such information is disclosed publicly.

In prior Self-Indexing Orders, to address these potential conflicts of interest, the SEC required 1) the underlying index methodology be transparent; 2) the adoption of policies and procedures in addition to the obligations under the Investment Company Act of 1940 (40 Act) or the rules under the 40 Act, which are designed to address such conflicts of interest; 3) limiting the ability to change the rules of the index composition and the component securities of the index; 4) the index have an unaffiliated third party acting as the calculation agent; and 5) firewalls be put in place to separate employees of the index provider, adviser, and calculation agent.

In order to address these potential conflicts of interest, in place of the old framework, the new framework provides that the ETF sponsors fully disclose the portfolio holdings of the Self-Indexing ETF to address the potential conflicts of interest.[27] The SEC's new framework adopts the ETF sponsors' view that full portfolio transparency provides an effective alternative means to address any potential conflicts of interest.[28]

The old framework set forth in the prior orders for Self-Indexing ETFs was created before the SEC authorized a framework for actively managed ETFs.[29] Actively managed ETFs use active investment strategies unlike traditional index ETFs, which passively follow an underlying index. The current framework for actively managed ETFs requires that such ETFs disclose their portfolio securities on a daily basis as a condition for exemptive relief in order to address potential conflicts of interest.[30]

The SEC adopted the view that the structure of actively managed ETFs pose potential conflicts of interest that are equal to or greater than those posed by Self-Indexing ETFs since the asset manager of an actively managed ETF has advance knowledge of pending portfolio changes.[31] Thus, in the new framework for Self-Indexing ETFs, the SEC adopted the view that the conflicts posed by Self-Indexing ETFs could be adequately addressed through full portfolio transparency.[32]

Also, the new framework states that the potential conflicts of interest raised by an adviser's use of underlying indexes relating to the managing of Self-Indexing ETFs and affiliated accounts do not substantially differ from the conflicts presented by an adviser that manages two or more registered funds.[33]

Further, the new framework provides that the conflicts presented by an investment adviser's use of underlying indexes relating to the managing of ETFs and the affiliated accounts do not substantially differ from the conflicts presented by the side by side management of ETFs that follow the performance of an index, which also serves as the benchmark for a traditional mutual fund or unregistered account that the same adviser manages.[34]

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The 40 Act and the Investment Advisers Act of 1940 (Advisers Act) provide various protections that address conflicts presented where an adviser is managing two or more registered funds and these protections also address these conflicts with regard to Self-Indexing ETFs.[35] The new framework provides that Self-Indexing ETFs do not materially differ from those for which the SEC had already granted exemptive relief.[36]

Under the new framework, Self-Indexing ETFs must disclose their portfolio securities to the public on a daily basis in lieu of policies and procedures from the prior order for Self-Indexing ETFs.[37] It also states that the underlying indexes will maintain a level of disclosure to the public with respect to component securities, weightings, additions, and deletions, which will be similar to that of other underlying indexes used by unaffiliated index ETFs.[38]

Regarding investment advisers to Self-Indexing ETFs, the new framework requires that each adviser and any sub-adviser has adopted or will adopt, pursuant to Rule 206(4)-7 under the Advisers Act, written policies and procedures designed to prevent violations of the Advisers Act and its rules.[39] For instance, the policies and procedures are designed to minimize potential conflicts among Self-Indexing ETFs and the affiliated account, including cross trading policies, and policies and procedures designed to ensure the equitable allocation of portfolio transactions and brokerage commissions.[40]

Also, the new framework provides that the initial adviser will or has adopted policies and procedures required under Section 204A of the Advisers Act reasonably designed to prevent the initial adviser or associated person from misusing material nonpublic information, commonly referred to as inside information, in violation of the Advisers Act or the Exchange Act or the rules thereunder.[41] Any other adviser and/or sub-adviser will be required to implement and maintain a similar policy for inside information.[42]

The new framework states that the Code of Ethics and policy for inside information that applies to each adviser and sub-adviser, and the personnel of such entities with knowledge of the composition of a portfolio deposit, prohibits them from disclosing such information to any other person unless authorized to do so in the course of their employment, until such information is made public.[43] The purpose of a Code of Ethics of an ETF or fund is to prevent the ETF's directors, officers, general partners, or employees from engaging in any act, practice, or course of business that would operate as a fraud, deceit, or manipulative practice on the ETF.

Also, the new framework requires that the initial adviser and any other adviser adopt a Code of Ethics pursuant to Rule 17j-1 under the 40 Act and Rule 204A-1 under the Advisers Act, which contain provisions to prevent "Access Persons" from engaging in conduct that is prohibited in Rule 17j-1.[44] Any sub-adviser will be required to adopt polices and procedures to monitor and restrict securities trading by certain employees, and adopt a Code of Ethics pursuant to Rule 17j-1 under the 40 Act and Rule 204A-1 under the Advisers Act.[45] Any adviser or sub-adviser may not receive incentive fees for outperforming the underlying index of any Self-Indexing ETF or affiliated account.[46]

Under the new framework, each index or Self-Indexing ETFs must invest at least 80 percent of its assets in component securities of its respective underlying index.[47] Each index and Self-Indexing ETF may invest up to 20 percent of its assets in certain derivatives such as index futures, options, options on index futures, and swap contracts.[48] An Index and Self-Indexing ETF may also short sell in accordance with its investment objective.[49]

Also, the new framework provides that an index or Self-Indexing ETF may utilize a "replication strategy" or "representative sampling."[50] An Index or Self-Indexing ETF using a "replication strategy" will invest in component securities in its underlying index in approximately the same proportions as the underlying index.[51] An index or Self-Indexing ETF utilizing "representative sampling" will hold some, but is not required to hold all, of the component

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securities of its underlying index.[52] An index or Self-Indexing ETF may hold as part of its 20 percent of asset basket, securities and other financial instruments that are not included in its underlying index, but which an adviser and/or sub-adviser believes will assist the index or Self-Indexing ETF follow the performance of its underlying index.[53]

The Spectrum: From Passive to Active

A traditional index ETF seeks to simply track its underlying index's performance, and thus is a passive investment structure. A non-traditional index ETF is an index ETF that has at least some characteristics of active management. A Self-Indexing ETF is an example of a non-traditional index ETF since the fund sponsor controls both the index and the fund and active strategies such as investing for value, momentum, and volatility are used.

Another example of a non-traditional index ETF is a "strategy based" index ETF. Strategy based index ETFs seek to outperform the underlying index rather than to track it, use various factors to identify stocks, and have characteristics very similar to actively managed funds.[54] For example, a strategy based index ETF with a rule-based methodology may use an algorithm that generally tracks the underlying index; in other words buys the same portfolio holdings as the index, when the market environment is positive, and sells portfolio holdings if the algorithm is sufficiently convinced of potential declining prices and is neutral when there is market uncertainty.[55]

Also, a strategy-based index ETF may incorporate technical analysis in its methodology by favoring the trends of rising stocks and disfavoring declining stocks.[56] Some strategy-based index ETFs use measures such as the volatility of a particular stock compared with the market and measures to identify "growth" or "value" stocks.[57] These strategies are very much in line with the strategies used by actively managed funds. But because an algorithm is making the investment decisions, index funds have been viewed by some as lacking the human weaknesses like bias and irrational deviation from planned strategies.[58]

Strategy based index ETFs and their underlying indexes strategically add and/or delete investment positions, known as rebalancing, as dictated by their rules-based index methodology. Also, these ETFs and their indexes periodically change their investment positions monthly, quarterly, semiannually, or annually, which is known as reconstituting, per their rules based index methodology and the ETF often intentionally deviate in tracking the underlying index. Strategy based index ETFs are growing in popularity and now make up a sizable portion of the ETF space. In 2014, investors poured in about \$50.5 billion into strategy based index ETFs, which made up about 27 percent of total ETF investing of \$188.9 billion for the year.[59]

Some ETFs substantially deviate from tracking many of the investments in their underlying indexes. This is, yet again, another example of a non-traditional index ETF using strategies of active management. The following is an illustration of two very different approaches to index tracking and ETF management used by two ETFs that are based on the same underlying index.[60] Both the Vanguard Emerging Markets ETF and the iShares MSCI Emerging Markets ETF are based on the MSCI emerging markets index.[61] In early 2010, Vanguard's ETF held 816 investments positions compared with 761 investment positions that the MSCI's index held.[62] In early 2010, the iShares MSCI Emerging Markets ETF reported 429 investment positions on the same day MSCI emerging markets index reported 761 investment positions.[63] The iShares' ETF uses a representative sample of stocks in the index. iShares' management policies state that the 429 investment positions are representative of what the position would be on other dates.[64]

Also, not surprisingly, the Vanguard and iShares index ETFs, which are based on the same underlying index, MSCI emerging markets index, have wildly differing performance. In 2007, the Vanguard ETF underperformed the index by 33 basis points

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(.33 percent) while the iShares ETF underperformed the index by 483 basis points (4.83 percent).[65] However, in 2008, the iShares outperformed the index by 332 basis points (3.32 percent) while the Vanguard ETF underperformed the benchmark index by 9 basis points.[66] The decision of the iShares' portfolio managers to not replicate the index closely is an active choice.[67]

Investors can buy shares in non-traditional ETFs that are targeted to corporate events such as spin-offs, stock buybacks, and merger arbitrage. For instance, to invest in a non-tradtional index ETF that focuses its strategy on spin-offs, share buybacks, or merger arbitrage an investor could buy shares respectively in the Claymore Beacon Spin-Off index ETF, PowerShares Buyback Achievers index ETF, IndexIQ IQ ARB Merger Arbitrage index ETF.[68]

For non-traditional ETFs replicating active strategies for value, growth, or volatility, the frequency that the underlying index or ETF reconstitutes can significantly affect the ETF's return on investment.[69] Some indexes are reconstituted as often as monthly or quarterly and others only semi-annually or annually. Also, frequently, indexes may rebalance, which means that the index adds or deletes shares in proportion to its rule-based methodology. Rebalancing, like all ETF transactions, is not a taxable transaction because the ETF buys or sells shares to institutional investors through in-kind transactions.

On average, non-traditional ETFs have expense ratios that are much lower than actively managed equity funds; but have higher expense ratios than traditional index ETFs and sector ETFs.[70] For instance, First Trust's Alphex index series has an average expense ratio of .75 percent compared to 1.41 percent charged by the average actively managed US mutual fund.[71]

Strategy based indexes can be viewed as a hybrid between actively managed funds and passive traditional index tracking funds. A strategy based index ETF still is based on an underlying index, but through its proprietary algorithms it engages in actively managed strategies such as value and growth investing by actively rebalancing and reconstituting the portfolio securities of the ETF and its underlying index and the ETF often intentionally deviates in the tracking of the underlying index.

Now that the index methodology for Self-Indexing ETFs is confidential it is much more difficult for index arbitragers, in other words front runners or copycat traders, to predict the rebalancing or reconstitution of these indexes or their ETFs. Rule-based indexes use pre-set formulas, commonly mathematically based, to choose investments.[72]

Another phrase similar in meaning to strategy based index ETFs is "smart beta."[73] Smart beta is also "sometimes known as advanced beta, alternative beta" or strategy indexes.[74] Smart beta can be "understood as an umbrella term for rules based investment strategies that do not use the conventional market capitalization weights" and using actively managed strategies.[75]

Among the most well known strategy based or "smart beta" index ETFs is Research Affiliates index ETF, which was developed in 2005 and ranks its constituents by book value, cash flow, dividends, and sales.[76] Smart beta ETFs are purportedly partly a reaction to the global financial crisis of 2007-2008 since these ETFs can adjust to volatility and risk rather than simply tracking an underlying index that holds a portfolio of securities subject to overall market volatility and risk.[77]

Over 45 percent of assets in strategy based index ETFs are based on underlying indexes that focus on investing in "growth" or "value" stocks, and 30 percent of these underlying indexes focus on dividend paying stocks, and the remaining 25 percent of these underlying indexes invest in a variety of strategies such as buying stock based on momentum or low volatility compared to the market.[78]

The PowerShares FTSE RAFI US 1000 Portfolio invests in stocks of the Russell 1000, but invests based on fundamentals such as book value, cash flow, sales, and dividends unlike the Russell 1000 index that passively invests based on market capitalization.[79] The PowerShares index has outperformed

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the Russell 1000 by 0.70 percent per year on average since December 2005 when it started through March 13, 2015.[80] The Arrow QVM Equity Factor ETF aims to capture market gains while minimizing risks by focusing on three factors that influence stock prices: quality, value, and momentum.[81]

Recent Developments of Self-Indexing ETFs

Goldman filed an amended Form N-1A Registration Statement with the SEC in May of this year for its branded ActiveBeta and Hedge Fund Tracker Self-Indexing ETFs.[82] The strategy for any ETF is stated in its Form N-1A Registration Statement, which includes the ETF's prospectus. For Goldman's six ActiveBeta ETFs each respective ETF will focus on investing in US large cap and small cap companies, emerging markets equity, international equity, and European and Japanese markets and focus on momentum, value, or growth stocks that have low correlations to the overall market.[83] The ActiveBeta Self-Indexing ETFs are based on methodologies created by Westpeak Global Advisors, which Goldman acquired in June of 2014.[84]

Goldman is a major participant in the ETF market already as a market maker, otherwise known as an Authorized Participant, which provides liquidity for industry leaders such as iShares Core S&P 500 ETF and the iShares Russell 2000 ETF.[85] Goldman intends to list the 11 ETFs on the NYSE Arca exchange.[86]

All 11 of Goldman's Self-Indexing ETFs, the 5 Hedge Fund Tracker ETFs, and the 6 Active Beta ETFs originally had the objective of outperforming their underlying index as stated in their original Form N-1A, Registration Statement, as filed with the SEC.[87] However, in its amended Form N-1A Goldman changed its objective from "to outperform" its underlying indexes to "track" the underlying index for both its hedge fund and Active Beta ETFs. Perhaps the reason for the change is that the SEC notified Goldman that they needed to revise the objective in order to gain approval for the ETFs.

Each of Goldman's five Hedge Fund Tracker Self-Indexing ETFs has specific strategies for relative value, event driven, long/short, macro, and multi-strategy to replicate their respective strategies through investing in ETFs, which may be strategy based.[88] Goldman's Hedge Fund Tracker Self-Indexing ETFs each are fund of funds; more specifically each is a fund of "underlying ETFs."

Goldman's Hedge Fund Tracker Self-Indexing ETFs are not technically strategy based ETFs because their objectives are to "track" rather than to "outperform" their underlying index. However, since the underlying index is designed to replicate hedge fund strategies such as "long/short" and "event driven" strategies, Goldman may plan to accomplish this by having their portfolio of the underlying indexes composed of strategy based ETFs designed to outperform their respective underlying indexes.[89] Thus, for each of the Hedge Fund Tracker ETFs they would be a fund of underlying strategy based ETFs. Also, each of the Hedge Fund Tracker underlying indexes reconstitute and rebalance on a monthly basis thereby making the composition changes more actively managed than a traditional index.[90] In contrast, Goldman's Active Beta indexes reconstitute and rebalance on a quarterly basis.[91]

While Goldman's Self-Indexing ETFs technically are not strategy based ETFs since they "track" the underlying index these ETFs use active strategies such as investing for value, growth and/or volatility and its Hedge Fund Tracker ETFs reconstitute and rebalance more frequently than traditionally passive index ETFs. Unlike unaffiliated index ETF, in the Self-Indexing ETF context the sponsors' strategies are built into the index. This is because the affiliate controls both the underlying index and ETF, and it thus has control of managing the underlying portfolio of the ETF. Therefore there is less of a need to try to outperform the index. In contrast, for an unaffiliated underlying index the sponsor of the ETF does not have control of the index, and thus in this circumstance it may be of benefit to be able to have the objective "outperforming" the underlying index.

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For Self-Indexing ETFs, one benefit of having the objective be "outperform" rather than "track" would be they can take defensive measures in a declining market meaning that if the stock market or another market were to suffer from sharp declines like in the 2008-2009 financial crisis the ETF could immediately sell shares in the declining investment. Goldman's Hedge Fund Tracker ETFs follow its index, which has a portfolio that is composed of underlying ETFs, which will likely be strategies based index ETFs meaning they take defensive measures in a declining market and their objective is to outperform their respective underlying indexes.[92]

Goldman's Self-Indexing ETFs: An Affiliate Affair

Under section 17(a) of the Act, an "affiliated person" includes any person directly or indirectly owning, controlling or holding the power to vote 5 percent of the outstanding voting securities of the company or any person directly or indirectly controlling, controlled by or under common control with the company; control meaning any person who beneficially owns greater than 25 percent of the voting securities of the company.[93] The term "affiliated person" is a term of art and in practice the term usually applies to entities such as a company rather than people.

Many times the ETF sponsor and the authorized participant (AP) are the same entity. Thus, if the ETF sponsor and the AP are the same company or an affiliate of the company then the AP is an "affiliated person" of the ETF. In Goldman Sachs' case, the use of affiliates is taken quite a couple of steps further; Goldman owns and controls the ETF, one or more of the APs, the investment adviser to the ETF, the underlying index, and may own or control the distributor.[94]

Section 17(a) of the 40 Act generally prohibits sales or purchases of securities among a registered investment company and any affiliated person of the company.[95] As previously stated, a Self-Indexing ETF is an ETF that is based on an underlying index created and owned by an affiliate of the adviser, the distributor, or the ETF.[96] ETFs, both index ETF and actively managed ETFs, often seek exemptive relief from affiliated transactions prohibited by Section 17(a) in order for an ETF to engage in transactions with affiliates.

Both the new and old frameworks permit certain affiliated persons to engage in purchases and redemptions "in-kind" with the Self-Indexing ETF.[97] Section 17(b) provides that the SEC will grant an exemption from Section 17(a) if evidence shows that the terms of the transaction are reasonable and fair, do not involve overreaching on the part of any person concerned, and the transaction is consistent with the policy of the fund and consistent with the general purposes of the 40 Act.[98] All ETFs including Self-Indexing ETFs engage in "in-kind" transactions with affiliated persons.[99] An "in kind" transaction means that it is a non-cash transaction where the ETF issues and redeems its shares with Authorized Participants who in exchange purchase or redeem the ETF's shares with the underlying securities of the ETF's portfolio securities or other securities which the ETF will accept. The new and old Self-Indexing ETF frameworks also permit such ETFs to engage in transactions with affiliated persons of a Fund of Funds.[100]

SEC's Influence on Strategies of ETFs

The vast majority of ETFs, over 99.9 percent, are index ETFs.[101] This fact illustrates the profound impact SEC regulation has had on the strategies of ETFs. ETF sponsors have spent over 9 years trying to obtain SEC approval for nontransparent actively managed ETFs.[102] The SEC has yet to approve a nontransparent actively managed ETF structure. A nontransparent actively managed ETF means that the ETF discloses its portfolio securities on a quarterly basis rather than on a daily basis like "transparent" ETFs. Since the SEC requires all ETFs to disclose their portfolio holdings on a daily basis, asset managers have had very little interest in launching

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actively managed equity ETFs because of concerns of front-running and copycat traders.[103] While the SEC has yet to authorize a nontransparent actively managed ETF structure, it recently greenlighted exemptive relief for Eaton Vance's exchange traded managed fund (ETMF) structure, which is a hybrid of an actively managed ETF and mutual fund; it discloses its portfolio on a quarterly basis just like a mutual fund and has the advantages of an ETF such as tax and cost efficiency.[104]

SEC regulation has and continues to influence the growth of non-traditional index ETFs. For instance, Goldman sought exemptive relief for non-transparent ETFs, but abandoned it after the SEC rejected BlackRock and Precidian's proposals for the "Blind Trust" structure in November 2014.[105] After the SEC's rejection of the "Blind Trust" structure, Goldman opted to create the 11 Self-Indexing ETFs, as previously explained, which replicate active management strategies.[106] Since there is already an existing regulatory framework through SEC exemptive orders for non-traditional index ETFs that replicate active strategies, an asset manager can use the existing SEC authorized index ETF structures to carry out actively managed strategies.[107]

Problem of Arbitrage and Transparency Costs

The financial industry often overemphasizes the concept of "transparency" particularly for ETFs; if a fund reveals its trading plans in advance by disclosing its index methodology, that trading transparency is certain to reduce the fund's returns.[108] Proponents of the old framework argue that a crucial characteristic of ETFs is transparency and that not requiring ETFs to disclose their underlying index methodology defeats a key advantage of ETFs of providing transparency, and that this is to the detriment of investors.[109] However, as the following discussion demonstrates, this view fails to acknowledge that requiring ETFs to disclose their underlying index methodology leads to high transparency cost to the detriment of investors.

Transparency cost is the cost incurred because of arbitragers trading based on information the index discloses publicly about its index methodology, thereby reducing the fund's returns.[110] Since the beginning, the focus of indexing has been on reducing unnecessary costs for investors to benefit from greater net returns.[111] Indexes, particularly ones that are well known, suffer substantial losses due to transparency cost.[112] When an index changes the stocks in its portfolio, often it announces the changes it will make in advance.[113] An index's methodology for making changes follow rules that, if transparent, allow arbitragers to easily predict the changes that will be made, allows the arbitrager to buy or sell a stock early at the expense of investors of the ETF that tracks the index.[114] Such arbitrage can cost some of the well known index funds hundreds of millions of dollars each year.[115]

For instance, the rule-based Russell 2000 index, which publishes its index methodology, suffered significantly from transparency cost.[116] A study, which covered 1989 through 2002, showed that index funds tracking the Russell 2000 lost $560 million annually.[117] Further, if all assets benchmarked to the index were considered, rather than only passively indexed assets, the loss could be as high as $3.43 billion.[118]

The market impact costs associated with composition changes in popular indexes are far greater than the operating expenses of index funds.[119] In other words, the transparency cost associated with transparency of the index methodology are far more than the operating expenses of index funds because arbitragers use the disclosed information about the index methodology to profit at the expense of the ETF's net return, and thus to the detriment of the ETF shareholders.

Many of today's index ETFs are not in line with the ideals of limiting trading and keeping costs low.[120] There are high trading costs associated with transparent index portfolio composition changes.[121] Proponents of indexes often ignore these costs and instead focus on low operating expense ratios and the low trading costs in connection with basket trades of standard index portfolios.[122]

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Over the past 30 years, the market impact cost of index composition changes, especially in the most popular indexes, has increased.[123] The principal index publishers have implemented strategies to reduce the cost of composition changes, and to make it more difficult to measure these costs.[124] In most cases, investors, analysts, and advisers are not overly concerned about tracking differences between an ETF and its underlying index if the asset manager can add value by reducing costs to improve the return of the index ETF.[125]

Some recent trends in indexing techniques adopted by strategy based ETFs have moved in the direction of actively trading portfolio securities to follow quantitative models that result in high composition turnover and different index weighting schemes, which tend to increase the transparency costs embedded in the process of index composition changes.[126]

Costs not associated with transparency, for ETFs, are substantially less than mutual funds. This is because for a mutual fund all shareholders pay the costs of purchasing and redemption of other investors. In contrast, investors in an ETF pay only their own transaction cost of buying and selling ETF shares.[127] However, for mutual funds, as well as ETFs, the cost of transparency for index composition change trades is far greater than the expenses of the index fund.[128]

A simple way to improve the investment results of an index fund is to select a fund with as broad an index and with the lowest composition turnover as possible, such as the Wilshire 5000; one of the broadest and lowest turnover indexes for US stocks.[129] By selecting a fund with a low composition turnover this avoids most of the trading cost of impact of index composition changes.[130]

Arbitragers or traders exploit the market impact of composition changes in popular indexes such as the S&P 500 and Russell 2000.[131] A trader who sells a security that is added to an index and then buys that security after the temporary demand ceases often will profit.[132] Since the price tends to temporarily increase because of the increased demand due to the index buying the shares, the trader who sells can sell at a higher price than normal, and then, after the index stops buying, the demand decreases and the price tends to decline, and the trader can buy the security at a lower price.[133] Likewise, a trader who buys a security that is deleted from an index and then sells that security after the temporary supply has ceased often will profit. The abundance of supply tends to make the price lower so the trader buys at a lower price and then after the supply normalizes the price tends to increase and the trader can profit by selling.[134]

By 1989 the portfolios of index funds started to have a substantial impact on the prices of stocks added to and deleted from the index.[135] The volume of trading occurring after a change in an index impacted index fund operators and others significantly, such that they demanded that preannouncement of changes, so they could trade the instant the change went into effect.[136]

Absent an announcement before the change became effective, index funds would lag the performance of the index because of the "index effect."[137] The "index effect" refers to the wide range of effects that index changes have on the returns of stocks and portfolios.[138] The most significant consequence of the practice of pre-announcing index changes is that arbitrageurs can front-run the trades of index funds for committee based indexes like S&P 500.[139] Also, usually, rules-based indexes incurred transparency cost because the SEC previously required the index methodolgy be disclosed to the public.[140]

ETF trading transparency costs also are referred to as front running costs.[141] Commentators often praise ETFs for their transparency. However, ETFs' transparency often times harms fund performance to the detriment of investors.[142] The transparency cost of trading for the S&P 500 and the Russell 2000 indexes are well documented.[143] According to two fairly recent studies, Blume and Edelen (2004) and Chen, Noronha, and Singal (2006), index composition changes are often costly.[144]

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More than 60 percent of the measurable of cost of the S&P 500 and Russell 2000 composition changes has been attributed to transparency cost.[145] Index funds' expense ratios are arguably misleading and not particularly useful. The index funds' trading costs, including the cost of trading transparency, are likely much greater than funds' disclosed expenses.[146]

ETF sponsors licensed the name brand indexes for use in the names of ETFs, and thus, issuers of new ETFs after 2001 opted to base their ETFs on less popular indexes or on custom indexes.[147] Thus far, there is a lack of sufficient data to quantify the cost of transparency for custom index or Self-Indexing ETFs.[148] However, based on data for other indexes, it is reasonable to hypothesize that a custom or Self-Indexing ETF that trades without disclosing its underlying index methodology, thereby eliminating its transparency cost, incurs substantially less cost than a custom or Self-Indexing ETF that trades and discloses its underlying index methodology.[149] In other words, nontransparent trades are substantially less costly than transparent trades.[150]

As previously stated, the new framework allows Self-Indexing ETFs and their indexes to keep their index methodology confidential. This means that arbitragers will have more difficulty with predicting changes in the portfolio stocks of the ETF since the index methodology will not be disclosed, and this will in turn eliminate the transparency cost and will allow such ETFs and their investors to benefit from substantially higher net returns.

What's Next?

A Silent Index is an index designed and owned for the use of a single ETF or single mutual fund and is not designed to serve as a performance benchmark, as an underlying index for multiple funds or as a stand-alone derivative instrument trading.[151]

Changes to the Silent Index will not be made public until after its fund has made index changes to the composition of the fund portfolio.[152] The performance of the Silent Index fund should be superior to an index fund tracking a benchmark index because the benchmark index fund has higher transparent transactions costs.[153]

Benchmark indexes have higher transparent transaction costs than a Silent Index because the benchmark index has multiple funds replicating its benchmark index and speculators and investors easily obtain knowledge of changes in the benchmark index because the changes are transparent.[154]

A Silent Index can be based on rules like a rules-based benchmark index; however, the specific rules of the Silent Index would not be published.[155] The rules would need to be sufficiently obscure to safeguard against speculators trying to "front-run" the fund's trades.[156] The rebalancing dates and capitalization range would not be disclosed.[157] By delaying disclosure of index changes and eliminating transparency costs, a Silent Index fund should outperform a comparable benchmark index fund by up to a few hundred basis points per year.[158]

A Silent Index fund would have the ability to fully function as an actively managed fund.[159] Because of this, if the SEC were to green light Silent Index ETFs, such ETFs would almost surely not be allowed to call themselves an index ETF and these ETFs would need to clearly label themselves as an actively managed ETF or as an index with the ability to convert to an actively managed ETF.

Conclusion

As explained in this article, studies indicate the high transparency cost due to arbitragers trading based on information the index publicly discloses about its index methodology. As stated, over 60 percent of the measurable of cost of the S&P 500 and Russell 2000 composition changes has been attributed to transparency cost. Accordingly, the new framework that allows Self-Indexing ETFs and their indexes to keep their index methodology confidential will allow such ETFs and their investors to benefit from substantially higher net returns because of lower transparency costs. Also, as stated, for Self-Indexing ETFs and actively managed ETFs, affiliates decide on the changes to the composition securities of the portfolio, and thus

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arguably both present the same potential conflicts of interest. Thus, the SEC has decided that the potential conflicts of interest for both actively managed ETFs and Self-Indexing ETFs are adequately and appropriately addressed by requiring such ETFs to disclose their portfolio securities on a daily basis.

Since the SEC put the new framework in place, Self-Indexing ETFs have been increasing in number. A Self-Indexing ETF is one example of a non-traditional index ETF; Self-Indexing ETFs replicate strategies, such as trading for value or trading on volatility or momentum. Another example of a non-traditional index ETF are strategy based index ETFs, which now are a sizable portion of the ETF market, comprising about 27 percent of total ETF investing with ETF shareholder investment of about $50 billion in such index ETFs out of a total of $188.9 billion invested in all ETFs for the year of 2014.

The SEC's regulation of ETFs has significantly shaped the ETF space. Due in great part to SEC regulation, over 99.9 percent of all ETFs are index ETFs. After the SEC rejected the "Blind Trust" proposal for nontransparent actively managed ETFs late last year, Goldman abandoned its plans for an actively managed ETF, and decided to launch its own Self-Indexing ETFs with strategies that replicate actively managed funds.

The trend of index ETFs using actively managed strategies will likely continue. Of course, in order for an ETF to be fully actively managed it must not be based on an underlying index. The Silent Index ETF, by having the ability to convert to a fully actively managed ETF, takes the final step on the spectrum to full active management.

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NOTES

1 Ky Trang Ho, "Stock Market Milestone: ETFs One-Up Hedge Funds As Investor Assets Hit $3 Trillion," May 8, 2015, available *at http://www.forbes.com/sites/trangho/2015/05/08/etf-assets-surpass-hedge-funds-marking-massive-industry-milestone/*; "Goldman Continues ETF Market Push With Proposal To Launch 11 New ETFs," December 17, 2014, available at *http://www.forbes.com/sites/greatspeculations/2014/12/17/goldman-continues-etf-market-push-with-proposal-to-launch-11-new-etfs*.

2 State Street Global Advisors ETF, January 22, 1993, FN 1, available at *https://www.sec.gov/divisions/marketreg/mr-noaction/etifclassrelief081701-msr.pdf.*

3 Alastair Kellett, "Self-Indexing: Conflict in the ETF Industry," December 20, 2012, available at *http://www.morningstar.co.uk/uk/news/97786/self-indexing-conflict-in-the-etf-industry.aspx.*

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 *In the Matter of Sigma Investment Advisors, LLC, et al.,* File No. 812-14046, Investment Company Act Rel. Nos. 30559 (June 14, 2013) (notice), and 30597 (July 10, 2013) (order) (hereafter referred to as *New Framework for Self-Indexing ETFs*); *In the Matter of Guggenheim Funds Investment Advisors, LLC, et al.,* File No. 812-13991, Investment Company Act Rel. Nos. 30560 (June 14, 2013) (notice), and 30598 (July 10, 2013) (order); *In the Matter of Transparent Value Trust, et al.,* File No. 812-14121, Investment Company Act Rel. Nos. 30558 (June 14, 2013) (notice), and 30596 (July 10, 2013) (order).

9 *See* SEC website, available *at http://www.sec.gov/rules/icreleases.shtml#etf-index*.

10 *New Framework for Self-Indexing ETFs*.

11 *In the Matter of Goldman Sachs ETF Trust, et al.,* File No. 812-14361, Investment Company Act Rel. Nos. 31428 (January 26, 2015) (notice), and 31465 (February 23, 2015) (order).

12 Goldman Sachs ETF Trust, amended Form N-1A Registration Statement, No. 811-23013, May 4,

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2015 (hereafter referred to as *Goldman's amended Form N-1A*).

[13] *http://www.valuewalk.com/2014/09/goldman-sachs-active-etf/*; Michael Ide, "Goldman Sachs Asks For Permission To Launch Active ETF," Posted date: September 23, 2014.

[14] Chris Flood, "Green light given to ETF 'self-indexing,'" *http://www.ft.com/cms/s/0/7713063a-ae89-11e2-bdfd-00144feabdc0.html*; April 29, 2013.

[15] Alastair Kellett, "Self-Indexing: Conflict in the ETF Industry," December 20, 2012, available at *http://www.morningstar.co.uk/uk/news/97786/self-indexing-conflict-in-the-etf-industry.aspx.*

[16] Paul Amery, "SEC Self-Index Rule Hurts ETF Brands," August 6, 2013, available at *http://www.etf.com/sections/features/19514-sec-self-index-rule-hurts-etf-brands.html?nopaging=1*.

[17] *Id.*

[18] Alastair Kellett, "Self-Indexing: Conflict in the ETF Industry," December 20, 2012, available at *http://www.morningstar.co.uk/uk/news/97786/self-indexing-conflict-in-the-etf-industry.aspx.*

[19] *Id.*

[20] *Id.*

[21] Prior Self-Indexing ETF Orders.

[22] Paul Amery, '"SEC Self-Indexing Ruling 'Jeopardises ETF Brand,'" August 6, 2013, available at *http://europe.etf.com/europe/features-a-news/9148-sec-self-indexing-ruling-jeopardises-etf-brand.html?fullart=1&start=2*.

[23] *Id.*

[24] *Id.*

[25] New Framework for Self-Indexing ETFs at 12. "In addition, an Index Provider will not provide any information relating to changes to an Underlying Index's methodology for the inclusion of component securities, the inclusion or exclusion of specific component securities, or methodology for the calculation or the return of component securities, in advance of a public announcement of such changes by the Index Provider."

[26] *Id.* at 13.

[27] *Id.* at 14.

[28] *Id.* at 14.

[29] *Id.* at 14.

[30] *Id.* at 14, 15. *See In the Matter of Huntington Asset Advisors, Inc., et al.,* Investment Company Act Rel. Nos. 30032 (April 10, 2012) (notice) and 30061 (May 8, 2012) (order) (*Huntington Order*) at Representation 14 and Condition 4.

[31] *New Framework for Self-Indexing ETFs* at 12.

[32] *Id.* at 14. "i.e., requiring each actively managed ETF to post on its website on each Business Day, before commencement of trading of shares on the Exchange, the identities and quantities of the portfolio securities and other assets held by the actively managed ETF that will form the basis for such ETF's calculation of NAV at the end of the Business Day."

[33] *New Framework for Self-Indexing ETFs* at 15.

[34] *Id.* at 15.

[35] *Id.* at 15. *See, e.g.,* Rule 17j-1 under the Act and Section 204A under the Advisers Act and Rules 204A-1 and 206(4)-7 under the Advisers Act, the requirements of which with respect to the Adviser and any Sub-Adviser.

[36] *New Framework for Self-Indexing ETFs* at 15.

[37] *Id.* at 15.

[38] *Id.* at 16.

[39] *Id.* at 16.

[40] *Id.* at 16. "The Adviser will include under Item 10.C. of Part 2 of its Form ADV a discussion of its relationship to any Affiliated Index Provider and any material conflicts of interest resulting therefrom, regardless of whether the Affiliated Index Provider is a type of affiliate specified in Item 10."

[41] *New Framework for Self-Indexing ETFs* at 16.

[42] *Id.* at 16.

[43] *Id.* at 16.

[44] *Id.* at 17. "Access Persons" is defined in Rule 17j-1.

[45] *Id.* at 17.

[46] *Id.* at 17.

[47] *Id.* at 19.

[48] *Id.* at 19. Each ETF may invest up to 20 percent of its assets in "certain index futures, options, options on index futures, swap contracts or other derivatives

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("Financial Instruments"), as related to its respective Underlying Index and its Component Securities, cash and cash equivalents, other investment companies, as well as in securities and other instruments not included in its Underlying Index but which the Adviser believes will help the Fund track its Underlying Index."

[49] *Id.* at 19, 20. Each Long/Short ETF "will establish (i) exposures equal to approximately 100% of the long positions specified by the Long/Short Index (as defined below) and (ii) exposures equal to approximately 100%" of the short positions specified by the Long/Short Index. Each 130/30 ETF "will include strategies that: (i) establish long positions in securities so that total long exposure represents approximately 130% of a Fund's net assets; and (ii) simultaneously establish short positions in other securities so that total short exposure represents approximately 30%" of such ETF's net assets.

[50] *Id.* at 20.

[51] *Id.* at 20.

[52] *Id.* at 20.

[53] *Id.* at 21. "Securities in Fund's 20% Asset Basket Not Included in its Underlying Index. The following examples illustrate the circumstances in which a Fund would hold Portfolio Securities that are not Component Securities of its Underlying Index. First, in order to reflect various corporate actions (such as mergers) and other changes in the Fund's Underlying Index (such as reconstitutions), a Fund may accept as Deposit Instruments (defined below), securities that are publicly announced as additions to the Underlying Index prior to their actual date of inclusion in such Underlying Index. Second, a Fund may hold Portfolio Securities that have recently been deleted from the Underlying Index due to various corporate actions and reconstitutions. Third, a Fund may invest in securities that are not Component Securities of its Underlying Index when necessary to meet RIC diversification requirements (if applicable). For example, if an issuer represents a percentage of the Underlying Index that is in excess of the RIC single issuer limits, the applicable Adviser and/or Sub-Adviser may invest in securities that are not Component Securities of its Underlying Index, but which the applicable Adviser and/or Sub-Adviser believes have performance characteristics of the securities of that large issuer. In such cases, the securities will be securities in the relevant region, country, industry, market, market segment or market sector tracked by its Underlying Index."

[54] Ari I. Weinberg, "ETFs Mimic Stock Pickers' Strategies Portfolios Track a New Wave of Indexes that Emulate Approaches Used by Active Fund Managers," November 7, 2011, available at *http://www.wsj.com/articles/SB10001424052970204002304576627343870756576*.

[55] "Innovative ETFs: A Rules-Based Strategy ETF The C-QUADRAT iQ European Equity ETF is the First Rules-Based Strategy ETF Using the EURO STOXX 50 TR Index as a Benchmark," May 2012, available at *http://www.morningstar.co.uk/uk/news/69669/innovative-etfs-a-rules-based-strategy-etf.aspx#sthash.rzGDWUPX.dpuf*.

[56] Ari I. Weinberg, "ETFs Mimic Stock Pickers' Strategies Portfolios Track a New Wave of Indexes that Emulate Approaches Used by Active Fund Managers," November 7, 2011, available at *http://www.wsj.com/articles/SB10001424052970204002304576627343870756576*.

[57] *Id.*

[58] *Id.*

[59] Jackie Noblett, "Goldman taking alternatives route to ETF launch," December 18, 2014, *Financial Times*, available at *http://www.ft.com/intl/cms/s/0/8053a416-86b4-11e4-9c2d-00144feabdc0.html#axzz3UUBeZss9*.

[60] Gary L. Gastineau, *The Exchange-Traded Funds Manual*, at 126, Second Edition, Hoboken: John Wiley & Sons, Inc. (2010) (Hereafter referred to as *ETF Manual*).

[61] *Id.* at 126.

[62] *Id.* at 126.

[63] *Id.* at 126.

[64] *Id.* at 126.

[65] *Id.* at 126.

[66] *Id.* at 126.

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67 *Id.* at 130.

68 Claymore Beacon Spin-Off index ETF, PowerShares Buyback Achievers index ETF, IndexIQ IQ ARB Merger Arbitrage index ETF.

69 Ari I. Weinberg, "ETFs Mimic Stock Pickers' Strategies Portfolios Track a New Wave of Indexes that Emulate Approaches Used by Active Fund Managers," November 7, 2011, available at *http://www.wsj.com/articles/SB10001424052970204002304576627343870756576*.

70 *Id.*

71 Christopher Condon, "ETFs Passive No More in Challenge to $7.8 Trillion Market," June 26, 2012, available at *http://www.bloomberg.com/news/articles/2012-06-26/etfs-passive-no-more-in-challenge-to-7-8-trillion-market*.

72 *Id.*

73 *Financial Times* available at *http://lexicon.ft.com/Term?term=smart-beta*.

74 *Id.*

75 *Id.*

76 *Id.*

77 *Id.*

78 CNBC, "Are 'Smart Beta' Funds Intelligent Investments?" March 16, 2015, available at *http://www.cnbc.com/id/102500144*.

79 *Id.*

80 *Id.*

81 ArrowShares to Launch the Arrow QVM Equity Factor ETF (QVM), available at *http://money.cnn.com/news/newsfeeds/articles/marketwire/1170759.htm*. Marketwired; January 22, 2015.

82 *Goldman's amended Form N-1A*, *ActiveBeta ETFs Prospectus* at cover page; Hedge Fund Tracker ETFs Prospectus at cover page.

83 *Goldman's amended Form N-1A*, *ActiveBeta ETFs Prospectus* at 1, 5, 9, 13, 17, 20.

84 Jackie Noblett, "Goldman Taking Alternatives Route to ETF Launch," *Financial Times,* December 18, 2014, available at *http://www.ft.com/intl/cms/s/0/8053a416-86b4-11e4-9c2d-00144feabdc0.html#axzz3UUBeZss9*.

85 *Id.*; For more about Authorized Participants and ETFs generally *see* Peter M. Allen, "Waiting for the Green Light: Nontransparent Active ETFs are Ready to Launch Subject to SEC Review," *The Investment Lawyer*, July 2014, Vol. 21, No. 7 (July 2014).

86 "Goldman Continues ETF Market Push With Proposal To Launch 11 New ETFs," December 17, 2014, *http://www.forbes.com/sites/greatspeculations/2014/12/17/goldman-continues-etf-market-push-with-proposal-to-launch-11-new-etfs*.

87 *Goldman Sachs ETF Trust*, Form N-1A Registration Statement, December 12, 2014, *ActiveBeta ETFs Prospectus* at 1, 5, 9, 13, 17, 20; *Hedge Fund Tracker ETFs Prospectus* at 1, 6, 12, 18, 25.

88 *Goldman's amended Form N-1A*.

89 *Goldman amended Form N-1A*. Hedge Fund Tracker ETFs Prospectus, at 3, "Principal Risks of the Underlying ETFs: The investments in the Underlying ETFs are subject to change. Such changes may cause the Fund to be subject to additional or different risks than the risks listed below. The investment program of some of the Underlying ETFs is speculative, entails substantial risks and includes alternative investment techniques that may not be employed by traditional funds. The investment techniques of some of the Underlying ETFs (if they do not perform as designed) may increase the volatility of performance and the risk of investment loss, including the loss of the entire amount that is invested, and there can be no assurance that the investment objective of those Underlying ETFs will be achieved."

90 *Id.* at 2.

91 *Goldman's amended Form N-1A*, *Active Beta ETFs Prospectus* at 2.

92 *Goldman amended Form N-1A*, *Hedge Fund Tracker ETFs Prospectus* at 3.

93 *See* Investment Company Act of 1940 Section 2(a)(3)(A), 2(a)(3)(C), Section 2(a)(9). *See* ICA section 2(a)(3). "An "affiliated person" of a fund, pursuant to Section 2(a)(3)(A) of the Act, includes "any person directly or indirectly owning, controlling, or holding with the power to vote, 5 per centum or more of the outstanding voting securities of such other person"; and pursuant to Section 2(a)(3)(C) of the Act "any person directly or indirectly controlling, controlled

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by, or under common control with, such other person." "Section 2(a)(9) of the Act defines "control" as "... the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. . ."

94 *In the Matter of Goldman Sachs ETF Trust, et al.,* File No. 812-14361 at 8, 9, Investment Company Act Rel. Nos. 31428 (January 26, 2015) (notice), and 31465 (February 23, 2015) (order); Jackie Noblett, "Goldman Taking Alternatives Route to ETF Launch," *Financial Times*, December 18, 2014, available at *http://www.ft.com/intl/cms/s/0/8053a416-86b4-11e4-9c2d-00144feabdc0.html#axzz3UUBeZss9*.

95 *Id.*

96 *New Framework for Self-Indexing ETFs* at 12. "In the case of Self-Indexing Funds, an "affiliated person," as defined in Section 2(a)(3) of the Act, or an affiliated person of an affiliated person, of the Trust or a Fund, of an Adviser, of any Sub-Adviser to or promoter of a Fund, or of the Distributor (the "Affiliated Index Provider") will create a proprietary, rules based methodology described below ("Rules Based Process") to create Underlying Indexes (each an "Affiliated Index" and collectively the "Affiliated Indexes"). For the reasons discussed herein, the portfolios of the Self-Indexing Funds will be fully "transparent," meaning that each Self-Indexing Fund will post on its website ("Website") on each day that the NYSE, the relevant Listing Exchange and each Trust are open for business and includes any day that a Fund is required to be open under Section 22(e) of the Act (a "Business Day"), before commencement of trading of Shares on the Exchange, the identities and quantities of the portfolio securities, assets and other positions held by the Fund that will form the basis for the Fund's calculation of NAV at the end of the Business Day ("Portfolio Holdings")."

97 *Id.* at 54. For more about "in kind" transactions *see* Peter M. Allen, "Waiting for the Green Light: Nontransparent Active ETFs are Ready to Launch Subject to SEC Review," *The Investment Lawyer*, July 2014, Vol. 21, No. 7 (July 2014).

98 *New Framework for Self-Indexing ETFs* at 55. ICA Section 17(b). "Past applications of Prior ETFs have suggested the possibility that Section 17(b) could be interpreted to exempt only a single transaction from Section 17(a) and that relief for a series of ongoing transactions, such as the ongoing sale and redemption of Creation Units, requires an exemption under Section 6(c) of the Act as well. Accordingly, Applicants are also requesting an exemption from Section 17(a) under Section 6(c)." *See, e.g.,* Keystone Custodian Funds, Inc., 21 S.E.C. 295 (1945).

99 *Id.* at 56, 57. "Applicants assert that no useful purpose would be served by prohibiting such affiliated persons from making "in-kind" purchases or "in-kind" redemptions of Shares of a Fund in Creation Units. Both the deposit procedures for "in-kind" purchases of Creation Units and the redemption procedures for "in-kind" redemptions of Creation Units will be effected in exactly the same manner for all purchases and redemptions, regardless of size or number. It is immaterial to a Fund whether 12 or 1,200 Creation Units exist for such Fund. All will be issued and redeemed in the same manner. There will be no discrimination between purchasers or redeemers. Deposit Instruments and Redemption Instruments will be valued in the identical manner as those Portfolio Securities currently held by the relevant Funds and the valuation of the Deposit Instruments and Redemption Instruments will be made in an identical manner regardless of the identity of the purchaser or redeemer. Applicants also note that the ability to take deposits and make redemptions "in-kind" will help each Fund to track closely its Underlying Index and therefore aid in achieving the Fund's objectives. Applicants do not

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believe that "in-kind" purchases and redemptions will result in abusive self-dealing or overreaching, but rather assert that such procedures will be implemented consistently with each Fund's objectives and with the general purposes of the Act."

100 *Id.* at 68. "Applicants seek relief from Section 17(a) to permit a Fund that is an affiliated person, or an affiliated person of an affiliated person, of a Fund of Funds to sell its Shares to and redeem its Shares from a Fund of Funds, and to engage in the accompanying in-kind transactions with the Fund of Funds. Although Applicants believe that most Fund of Funds will purchase Shares in the secondary market and will not purchase Creation Units directly from a Fund, a Fund of Funds might seek to transact in Creation Units directly with a Fund that is an affiliated person of a Fund of Funds. To the extent that purchases and sales of Shares occur in the secondary market and not through principal transactions directly between a Fund of Funds and a Fund, relief from Section 17(a) would not be necessary. However, the requested relief would apply to direct sales of Shares in Creation Units by a Fund to a Fund of Funds and redemptions of those Shares."

101 "NYSE Euronext wants "nontransparent" ETFs to list," *MarketWatch*, January 23, 2014, available at *http://www.marketwatch.com/story/nyse-euronextwants-nontransparent-etfs-to-list-2014-01-23*.

102 Arash Massoudi, "New ETF Breed Faces Hurdle of Strategy Disclosure," January 31, 2014, available at *http://www.ft.com*.

103 In the SEC's view daily portfolio transparency is necessary for effective intra-day arbitrage; for more about intra-day arbitrage and portfolio transparency *see* Peter M. Allen, "Waiting for the Green Light: Nontransparent Active ETFs are Ready to Launch Subject to SEC Review," *The Investment Lawyer*, July 2014, Vol. 21, No. 7 (July 2014).

104 *In the Matter of Eaton Vance Management, et al.,* File 812-14139, Investment Company Act Rel. Nos. 31333 (November 6, 2014) (notice), and 31361 (December 2, 2014) (order).

105 "Goldman Continues ETF Market Push With Proposal To Launch 11 New ETFs," December 17, 2014, *http://www.forbes.com/sites/greatspeculations/2014/12/17/goldman-continues-etf-market-push-with-proposal-to-launch-11-new-etfs*; for more about the "Blind Trust" structure *see* Peter M. Allen, "Waiting for the Green Light: Nontransparent Active ETFs are Ready to Launch Subject to SEC Review," *The Investment Lawyer*, July 2014, Vol. 21, No. 7 (July 2014).

106 *Id.*

107 Christopher Condon, "ETFs Passive No More in Challenge to $7.8 Trillion Market," June 26, 2012, available at *http://www.bloomberg.com/news/articles/2012-06-26/etfs-passive-no-more-in-challenge-to-7-8-trillion-market*.

108 *ETF Manual* at 102.

109 Paul Amery, "SEC Self-Index Rule Hurts ETF Brands," August 6, 2013, available at *http://www.etf.com/sections/features/19514-sec-self-index-rule-hurts-etf-brands.html?nopaging=1*.

110 *See Id.* at 102.

111 *Id.* at 102.

112 Honghui Chen *et al.,* "Index Changes and Losses to Index Fund Investors," 62 *FIN. ANALYSIS J.* 31, 34 (2006) (hereafter referred to as *Chen*). Thor Mclaughlin, "Eyes Wide Shut: Exchange Traded Funds, Index Arbitrage, and the Need for Change," *Exchange Traded Fund Arbitrage*, 2008 at 597.

113 *Chen* at 31.

114 *Id.* at 32.

115 *Id.*

116 *ETF Manual* at 110.

117 *Chen* at 35.

118 *Chen* at 35.

119 *ETF Manual* at 105.

120 *Id.* at 105.

121 *Id.* at 105.

122 *Id.* at 106.

123 *Id.* at 106.

124 *Id.* at 106.

125 *Id.* at 106.

126 *Id.* at 106.

127 *Id.* at 106.

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[128] *Id.* at 106.
[129] *Id.* at 107.
[130] *Id.* at 107.
[131] *Id.* at 107.
[132] *Id.* at 108.
[133] *Id.* at 108.
[134] *Id.* at 108.
[135] *Id.* at 109.
[136] *Id.* at 109.
[137] *Id.* at 109.
[138] *Id.* at 109, 131.
[139] *Id.* at 110.
[140] *Id.* at 110.
[141] *Id.* at 110.
[142] *Id.* at 110.
[143] *Id.* at 110.
[144] *Id.* at 114, 131.
[145] *Id.* at 117.
[146] *Id.* at 124.
[147] *Id.* at 118.
[148] *Id.* at 123, 124.
[149] *See Id.* at 123, 124.
[150] *Id.* at 123, 124.
[151] *Id.* at 124.
[152] *Id.* at 124.
[153] *Id.* at 124.
[154] *Id.* at 124, 125.
[155] *Id.* at 125.
[156] *Id.* at 125.
[157] *Id.* at 125.
[158] *Id.* at 125.
[159] *Id.* at 125.

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