Public Statement

Statement of Commissioners Jackson and Lee on Non-Transparent Exchange Traded Funds

Commissioner Robert J. Jackson Jr.

Commissioner Allison Herren Lee

Nov. 15, 2019

Yesterday the Commission took action on four applications for a relatively new type of exchange-traded fund.[1] Unlike other ETFs, these funds won't provide full daily transparency of exactly what's in their portfolios. We are grateful to the tremendous Staff in the Division of Investment Management, especially Director Dalia Blass and her colleagues Daniele Marchesani, Andrea Ottomanelli Magovern, Deepak T. Pai, Kay-Mario Vobis, and Bradley Gude for the thoughtful approach they have taken to the hard questions raised by these applications. Because the Staff's work produced important guardrails that will help protect investors from the risks of non-transparent funds, we voted to support these actions.

We write separately, however, to note our core concern regarding nontransparent ETFs: that, in times of stress, ordinary investors won't be able to get a fair price for their shares in the funds. For that reason, applications that do not address the potentially serious liquidity problems arising from the fundamental structure of nontransparent ETFs should give the Commission great pause.

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Exchange-traded funds now hold nearly $5 trillion in American families' savings for education and retirement.[2] ETFs have been an important innovation for those families, delivering a low-cost, efficient way to invest in the American economy for the long run. And unlike mutual funds, which have also transformed the lives of millions of ordinary Americans, ETFs promise immediate liquidity when investors need it. When they sell shares in a mutual fund, investors generally get a price calculated at the end of the trading day, but an ETF investor can sell immediately at the market price.[3]

The way that an ETF provides that important service is by facilitating trading of its shares at market-determined prices on stock exchanges throughout the day. But the shares of an ETF can sometimes trade at a price higher or lower than the value of the actual assets held in the fund. That's why the

Commission has historically required ETF providers to ensure that the market price for ETF shares does not deviate too far from the value of the ETF's underlying holdings.[4] That way, when retail investors sell their ETF shares, they get a price as close as possible to the actual value of the assets they own.

An ETF keeps the price of its shares close to the value of its assets by entering into agreements with trading firms called authorized participants (APs).[5] APs have the power to create and redeem shares of the ETF—and strong incentives to do so in a way that keeps the value of those shares close to the value of the fund's assets. For example, when an ETF's shares trade at a price above the value of those assets, APs will create new shares, and the added supply will bring the price of the shares down. And when the ETF trades below asset value, APs will buy shares, and the new demand will bring the price up.

The way APs do this important work is by constantly examining the value of the assets held in the ETF. When ETFs are transparent about their assets, APs can calculate their own measures of the fund's value in real time, allowing them to make sure that the ETF's price doesn't stray too far from the value of the fund's assets. So the question presented by nontransparent ETFs is: how can an ETF ensure that the price investors get reflects the fund's value when the ETF is not transparent about its assets?

Thanks to the Staff's exceptional work, these applicants have come a long way toward answering that question. APs for these funds will have access to a "proxy" portfolio that, the applicants say, gives them enough information to keep the fund's price in line with asset values.[6] Each fund's portfolio will only include securities that trade on an exchange, and the fund will establish thresholds for tracking error and bid-ask spreads, with the board taking needed action if the thresholds are crossed.[7] These protections, combined with the Commission's previous approval of one other non-transparent ETF—creating the need for competition that can help protect investors—convinced us that we could support these actions.[8]

But we would not be so sanguine without those protections. Nontransparent ETFs come with real risk that, in moments of limited liquidity, ordinary investors will face wider spreads and hence get prices that do not accurately reflect the value of their shares.[9] By targeting largely liquid assets and adopting guardrails to address these issues, these applicants have helped mitigate that concern. But we would be skeptical of nontransparent funds focused on different asset classes that lack those characteristics.

We also want to keep close watch over the appropriate disclosure regime for nontransparent ETFs. In particular, we wonder whether additional disclosure of the risks, as well as enhanced board oversight of the efficiency of these ETFs, is necessary. Because these products have not yet launched, we are only in the early stages of determining the information investors need to evaluate the unique risks of nontransparent ETFs, including mechanisms to ensure accuracy and price efficiency.[10] We urge our colleagues to consider whether prospectus disclosure of these measures is necessary going forward.[11]

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We are grateful to the Staff for the thoughtful approach they have taken to resolve the hard questions raised by today's applications. And we look forward to hearing from the market about the limits of the nontransparent ETF model—and how we can make sure disclosures give investors the information they need about these funds.

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[1] The Commission's action yesterday did not approve these applications; instead, the Commission is notifying the public of the funds' requests for exemptive relief. However, the next step is for the Commission to issue an order granting the requested relief unless the Commission orders a hearing; interested persons can request a hearing before the Commission on any of these applications before December 9, 2019. In May, the Commission approved one other application related to a non-transparent ETF. Investment Company Act Rel. No. 33477 (May 20, 2019) (the "Precidian Application"). The

Precidian Application took a substantially different approach to the issues presented by non-transparent ETFs than the funds we address today.

[2] By March 2019—the 39th anniversary of the first exchange-traded fund—total global assets held in exchange traded funds reached $5.32 trillion, with some predicting 15% annual growth of that figure for years to come. *Compare* Nasdaq, *Assets Invested in Global ETF/ETP Industry Reach Record* (Mar. 12, 2019) *with* EY, Global ETF Survey 2017 4 & fig. 4 (2018).

[3] Of course, investors in open-ended mutual funds are generally free to place an order to buy or sell shares at any time, but their order is filled at the net asset value next computed by the fund—often at the close of trading on the day the order is placed. *See* 15 U.S.C. § 80a-22(d); *see also* 17 C.F.R. § 270.22c-1.

[4] The fidelity of fund prices to underlying asset values has generally been a condition of our providing exemptive relief relating to Section 22(d) of the Investment Company Act and Rule 22c-1 thereunder. *See* Precidian ETF Trust, et al., Investment Company Act Rel. No. 31300, at 8 (Oct. 21, 2014) ("In granting relief from section 22(d) of the Act, the Commission relies on this close tie between what retail investors pay and what Authorized Participants pay to make the finding that the ETF's shareholders are being treated equitably when buying and selling shares. The Commission therefore has granted exemptive relief to date only to those actively managed ETFs that have provided daily transparency of their portfolio holdings.").

[5] For a critical framework that has motivated much of our thinking regarding the regulation of exchange-traded funds and the APs who work with them, see Henry T.C. Hu & John Morley, *A Regulatory Framework for Exchange-Traded Funds*, 91 S. Cal. L. Rev. 839 (2018).

[6] Each of the applications addressed yesterday proposes a slightly different approach to the construction of the proxy portfolio. We note, however, that trading on the basis of the proxy portfolio is not truly "arbitrage." Philip H. Dybvig, and Stephen A. Ross. *Arbitrage*, The New Palgrave Dictionary of Economics: Volume 1–8 (2008): 188-197 ("An arbitrage opportunity is an investment strategy that *guarantees* (emphasis added) a positive payoff in some contingency with no possibility of a negative payoff and with no net investment."). Guessing—even good guessing—about what's in a fund's portfolio does not provide the sort of guarantees available when arbitraging traditional ETFs. Richard Brealey, Stewart Myers & Franklin Allen, Principles of Corporate Finance 44 (11th ed. 2017).

[7] In addition to the limits on the funds' portfolios holdings and the requirements related to the thresholds for tracking errors and bid-ask spreads, the funds will have to provide certain public disclosures explaining how the funds differ from traditional ETFs, specifically noting that the costs could be higher. The funds must also disclose on their websites certain information such as the prior business day's NAV and market closing price or Bid/Ask Price of the Shares, a calculation of the premium or discount of the market closing price or Bid/Ask Price against such NAV, and other information regarding premiums and discounts required under rule 6c-11. *See, e.g.*, Investment Company Act Rel. No. 33682 (Nov. 14, 2019).

[8] The Precidian Application, *see supra* note 1, was approved over Commissioner Jackson's dissent. But, given that one such application has been approved, we believe that the benefits of facilitating competition among the various models, rather than single fund control over the nontransparent ETF market, weighs in favor of our support for today's action. *See* Henry T.C. Hu & John Morley, *The SEC and Regulation of Exchange-Traded Funds: A Commendable Start and a Welcome Invitation*, 92 S. Cal. L. Rev. ___ (forthcoming 2019) (noting that the SEC's historical process has resulted in competitive disadvantages for newer entrants in the ETF market); Commissioner Robert J. Jackson, Jr., *Competition: The Forgotten Fourth Pillar of the SEC's Mission* (remarks at the Open Markets Institute, Oct. 2018) (noting that the Commission's statutory mandates include an oft-ignored requirement to consider the competitive effects of our choices).

[9] Kevin Pan & Yao Zeng, *ETF Arbitrage and Liquidity Mismatch* (working paper 2017) (providing theory and evidence indicating there can be consistent mispricings due to concerns about AP balance sheets).

Although that paper focuses on bond ETFs, where the underlying basket of securities is less liquid than the securities at issue here, the new risk associated with nontransparent ETFs is the introduction of information asymmetry—which is known to reduce liquidity. For the seminal work establishing that point, see Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. Fin. Econ. 71 (1985). We will pay close attention to the degree to which the lessons of less-liquid ETFs will apply to nontransparent ETFs, as APs take risk in trying to price ETF baskets.

[10] For example, investors might find it useful to have standardized historical average measures of premia/discounts, spreads, and the number of times that the tracking error exceeds a specified threshold. This way, investors can keep track of the different non-transparent ETF models and decide for themselves which model works best—and what they are willing to pay for it.

[11] Some metrics will be provided to the Staff on a periodic basis. We urge the Staff to review these metrics carefully, and work with applicants and investors to determine what additional public disclosure investors will need to understand each non-transparent ETF model.