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Talking Investment Management: Diving into ETFs: Are You Ready for a Sea Change?

March 10, 2025 | Podcast Transcript

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Jamie M. Gershkow (00:04):

Hello, and welcome to the latest episode of Talking Investment Management. I'm Jamie Gershkow, a partner here at Stradley Ronon, and I'm excited to give you a sneak peek into our Lunch and Learn panel session at the Investment Company Institute's Investment Management conference coming up in San Diego, where our panel will be diving into ETFs. Are you ready for a sea change? We'll discuss the regulatory tides that may be turning on ETF product development. I'm excited to be joined today by my co-panelists and Stradley Ronon Partners, Brian Murphy, Mark Greer, and Michael Mundt.

(00:36):

Jamie. Thanks. Hey, Jamie, thanks for having us. Thanks, Jamie.

Jamie M. Gershkow (00:40):

Brian, let's start with you. There's been a lot of change in Washington recently under the new administration, from a flurry of executive orders to personnel changes and lots in between. Can you give us a brief update on the latest leadership developments and what you plan to discuss at the conference, with the caveat that this is all as of today, February 28, and with how quickly everything's turning? We may very well have some new topics by next month when we're all together in San Diego.

Brian Murphy (01:07):

Yeah, absolutely. And thanks. This is, as you mentioned, a time of significant change in Washington, DC and the SEC over the last few months. And, in connection with the broader presidential transition, we've seen two of the five commissioners depart the SEC chair. Gensler, a Biden appointee, has left, and President Trump has appointed Commissioner UDA acting chair while the Senate considers former Commissioner Atkins as the new chair. This is exciting. I think the industry is going to feel a sense of calm with

Commissioner Atkins because he has a long track record of being in the security space. He spent about six years in the early two thousand years at the SEC and frequently advocated for a free market approach to regulation and a thoughtful consideration of new rules. We'll stay tuned to watch that Senate confirmation and the new chair to assume his role at the top of the SEC.

Brian Murphy (02:10):

We'd usually expect to see division directors appointed over the next few months. And once that happens, we'll start to see more concrete policy initiatives being discussed in the IM space. But we are seeing some movement on the policy front. We've definitely seen a focus on capital formation over the last three or four weeks, as well as the SEC delaying implementation of certain rules adopted by the prior administration. On top of that, as you mentioned or alluded to, Jamie, we've seen numerous executive orders. President Trump has issued over 70 executive orders in the LA since January 20, some of which will have an indirect impact on our mutual fund and ETF clients. Some of these executive orders require the SEC to submit its rules to the Executive Office of the President for review. Some also require independent agencies and other federal agencies to identify at least 10 existing regulations to repeal when proposing a new rule. And then, of course, there is an ever-present concept of a reduction in force in the government. So all of these changes could have a very big impact on the fund industry, and we're excited to talk about that with you in the coming weeks.

Jamie M. Gershkow (03:34):

Great, thanks, Brian. With the new administration comes some new views on Crypto. Stradley Ronon has been excited to be at the forefront representing clients involved in crypto products, and we spoke about some of these developments at our last lunch and learn, but there's a lot of new ground to cover these days. So Mark, can you give us a rundown of what's new since the last conference and what you plan to be diving into at our panel?

Mark Greer (03:57):

Sure, Jamie. Happy to do so. So, of all the sea changes we were gonna be discussing at this panel, I would think that crypto is probably the fastest moving waters. I mean, it was only a few years ago that the industry was wondering if we could even have any sort of retail access to crypto. And in late 2021, as we've discussed, they allowed the ability to invest funds in futures products on Bitcoin. And as Jamie mentioned, just last January, finally, after many years of lobbying, the industry was allowed to have spot Bitcoin products. And there were about, well, almost a dozen, maybe 11 products that launched. Since then, things have moved even faster. We have seen new products come up, particularly with Ethereum spot products. And now with the new sea change in the administration, there's optimism. There'll be even more quick development in those areas.

Mark Greer (04:44):

In the past administration, there was sort of a, a view in some that it was a cautious approach to crypto and the industry felt a little bit stymied. And so there are thoughts now based on what we've seen so far, just in a few short weeks of the Trump administration, that we're gonna have some more changes and allow a loosening of regulations. We've seen the SEC pause some enforcement efforts, including one case, and it's a crypto exchange, and they've also promised some more regulatory clarity. So, one of the efforts they've done is implementing a crypto task force that will be seeking to develop a clear regulatory framework for crypto assets. The SEC has also revamped an existing crypto asset and cyber unit within the commission to focus on a larger ambit of crypto enforcement and to focus more on emerging technologies generally.

Mark Greer (05:30):

And I think what we're gonna see, and we'll talk about the panels, the next big thing for the industry is just gonna be the development of a truly active management for crypto products. Having multiple tools in the toolbox for portfolio managers to use, for example, not just futures, but other derivatives, not just one type of spot coin, but multiple. We're also beginning to see products that hold Bitcoin and Ether in a single product. For example, we've seen filings for other spot crypto products such as So Salon and Litecoin. And we could see the development of passive crypto products that track indices containing multiple types of currencies. And there are some that are saying that the biggest ETPs in crypto products in this space have yet to even be invented. So it's a very exciting time.

Jamie M. Gershkow (06:08):

Thanks, Mark. Lots of exciting developments, and we're really looking forward to getting the deep dive at our upcoming lunch and learn. So, turning to our next topic, we've been hearing a lot about ETF share classes these days. There have been a lot of applications filed with the SEC, Mike, and you've been very actively involved in this area. Could you tell us a bit about ETF share classes and the current efforts to obtain SEC permission to offer this structure?

Michael Mundt (06:35):

This is definitely one of the big-ticket regulatory items that I think people are hoping for movement on with the new administration. And most ETFs are set up as standalone ETFs. But this idea is that a fund would have both a mutual fund class and an ETF class, and the mutual fund class would operate much like a traditional mutual fund. The ETF class would operate much as a traditional ETF, but both classes would go into the same portfolio of securities. And there are about 50 asset managers now that have submitted Exemptive applications to the SEC to get permission to offer this unique ETF class approach to ETFs. One thing that's kind of interesting is even though this is being viewed as an innovation, it's actually the way that Vanguard has approached ETFs for almost 25 years, and there are actually almost 30% of ETF assets that are invested in ETF share classes currently.

Michael Mundt (07:41):

So in a way, this is an effort to allow for that structure to be utilized by other asset managers since the time that Vanguard first launched its CTF classes, and now the SEC has identified some areas that they're interested in about whether both classes are treated fairly under this structure. And in 2019, when the SEC adopted Rule six C 11, which is the exemptive rule that most ETFs rely on, they declined to allow for ETF share classes and instead said that sponsors should submit exemptive applications if they want to do that structure. And the SEC kind of flagged a few things that they were worried about, mainly that the cash flows that come in and out of a mutual fund class might generate certain costs that the ETF shareholders would bear as well. So, things like brokerage costs, cash drag, and maybe tax consequences come from portfolio transactions.

Michael Mundt (08:52):

So I think the SEC staff has been very focused on the structure and what the benefits are, and maybe some of the adverse consequences to the different shareholders in the different classes. I think that's something that we'll talk about at our panel. And also just generally what we the think, what we think the road forward will, will look like. Some of the applications propose that the board would have a significant role in looking at the structure and the benefits to the respective shareholders and make a determination that the structure was really in the best interests of the fund as a whole, as well as the individual classes. And I think Brian's actually gonna chime in on some of these issues during our panel as well.

Brian Murphy (09:43):

Yeah, thanks, Mike. When we talk to boards about this structure, we've got, we're getting, we're hearing three key questions, and that is, what is the ETF share class structure? How should I evaluate whether the structure is right for my funds, and what are the key considerations in this evaluation? We'll get deeper into these questions during our panel, and we look forward to you joining us.

Jamie M. Gershkow (10:05):

Great. Thanks, Mike. Thanks, Brian. I just want to touch on two final ETF developments: private credit ETFs and non-transparent ETFs. Mark, could you maybe kick us off and give us a description of some updates in the private credit ETF space?

Mark Greer (10:19):

Sure, Jamie. So what we're finally seeing now is the kind of culmination of an evolution in the industry. There's been a great demand in the private retail space to get more 40 ACT retail investors in the 40 act retail space to get more assets access to private credits. So what we've seen recently is filings trying to harmonize those two things about having 40 act ETF wrapper vehicles invest in private credit. Now, one of the issues, of course, that the SEC has raised is both liquidity and valuation, and there have been some filings that have come up with innovative solutions to that, including one that has gone effective just this week. However, the SEC has exhibited a lot of concerns with some of those aspects of those structures. So what remains to be seen is what we'll see more filings along this line or how the SEC will deal with it. But I think the overwhelming point here is just, again, the democratization of the retail access for funds that want to get into this different type of private credit.

Jamie M. Gershkow (11:15):

Thanks, Mark. And passing it over. Back to you, Mike. Anything going on in the non-transparent ETF space?

Michael Mundt (11:23):

Well, we'll find out this is another area where people are wondering how the, the new administration will think about these products. Just to remind folks, most actively managed ETFs rely on Rule 60-11, which requires full portfolio transparency, but a number of asset managers obtained exemptive orders so that they could offer actively managed ETFs that don't publish their portfolios every day. And instead, they would publish a proxy portfolio or maybe deliver a very frequent portfolio value to the market. One big limitation with those exemptive orders was that they were limited pretty much to domestic equity securities that trade on US exchanges. A few other assets were permitted, but in general, that's most of what the SEC allowed. So I think the question that is in front of asset managers is whether they can expand this relief so that the products could include other asset classes. And there are a couple of exemptive applications already pending with the SEC to allow for that flexibility. And I think we got a sense with the last administration that they weren't really inclined to expand this product type, but I think with this new administration, there may be more of an appetite to do that.

Jamie M. Gershkow (13:06):

Well, thank you, Brian, Mark, and Mike, for sharing all of these developments. It sounds like we all have our work cut out for us at this lunch-and-learn panel. Given all of these new, exciting, and very rapidly evolving developments for ETFs, we appreciate you all tuning into our lunch-and-learn panel preview, and we look forward to exploring these key topics further at the conference. See you there.

(13:30):

For more than 95 years, Stradley Ronon's investment management practice has helped shape the investment management industry by assisting with the creation of innovative investment products and services from obtaining industry first exemptive and no action relief to assisting in the development of novel products, we have helped our clients become or remain industry leaders as the investment management industry and our clients have evolved. So, are we adding attorneys with experience in emerging areas such as next-generation exchange-traded products, commodity futures, trading, commission regulation, swaps, and other derivatives trading? Meet our team at stradley.com.

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