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Talking Investment Management:
Board Oversight of Exchange-Traded Funds - Part 2

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(00:03):

Thank you for tuning in to Stradley Ronon's Talking Investment Management podcast. This episode is hosted by Partners Fabio Battaglia and Michael Mundt with guest Lisa Chaikin Hamman from the Independent Directors' Council. This is the second episode in a two-part series titled Board Oversight of Exchange Traded Funds. You'll hear about unique ETF situations, including some of the unique compliance obligations of ETFs, semi-transparent or non-transparent active ETFs, mutual fund conversions to ETFs, and the possibility of ETF classes. For the latest news alerts and podcasts, please visit stradley.com and follow us on LinkedIn and X.

Lisa Chaikin Hamman (00:45):

Hi everyone. Welcome to another episode of the Investment Management podcast. Today's topic is Board Oversight of Exchange-traded Funds. This is part two of a two-part series. My name is Lisa Hamman, and I'm with the Independent Directors Council. I'm the Associate managing director there. I've been there 20 years, and before that, I was in private practice with Morgan Lewis, and I started my career at Fidelity Investments. IDC, the Independent Directors Council, serves the fund independent director community through a four-part mission of education, engagement, advocacy, and promoting public understanding of the role and responsibilities of fund directors. IDC recently published an update to our white paper on board oversight of ETFs. And this podcast addresses some of those issues relating to board oversight of ETFs and is divided into two conversations. Episode one focused on ETFs generally, their structure and operations and how they operate under the law, whether it be under exemptive relief or the ETF rule. The second episode will include a discussion of board oversight for unique ETF situations, and we'll touch on recent developments, including the introduction of semi-transparent or non-transparent, actively managed ETFs, the conversion of mutual funds to ETFs and the pending exemptive relief requests to introduce ETF share classes of mutual funds. The law firm of Stradley Ronon Ronan helped IDC with our recent update to the white paper, and I'm joined today by two Stradley Ronon partners who specialize in ETF work, Mike Mundt and Fabio Battaglia. Thank you both for joining us today.

Michael Mundt (02:36):

Thanks, Lisa. Hi everyone, I'm Mike Mundt. I'm a partner at Stradley Ronon in our Washington, DC office, and I've worked here at Stradley Ronon for the last 13 years, focusing a lot on the launch and operation of actively managed and index-based ETFs as well as novel products. And prior to my work here at Stradley Ronon, I worked for about 13 years in the division of investment management at the SEC, where I was in charge of the review of a lot of the ETF innovations that came to the SEC during that time.

Fabio Battaglia (03:07):

Thanks, Lisa. Fabio Battaglia. I'm a partner at Stradley Ronon in the Philadelphia office, where my practice focuses on registered investment companies, including ETFs. I represent funds and their boards of directors. I'm happy to be here today.

Lisa Chaikin Hamman (03:21):

Great. Well, thanks to both of you for joining us. In our first podcast episode, we noted that because we're focused on ETFs that are registered as open-end investment companies under the 1940 Act, those funds' directors are generally subject to the same regulatory provisions as traditional mutual funds. But we also talked about how there are some special considerations for ETFs and their boards under some of the rules that ETFs often rely on. We talked about how a lot of the ETFs that operate today operate under what's known as the ETF rule. One of the aspects of the rule was welcomed by ETF advisors when the rule was adopted in 2019, and that was greater flexibility to use custom baskets. So, Mike, I'm wondering if you can start us off by telling us what our custom baskets are and whether the use of custom baskets triggers unique board responsibilities?

Michael Mundt (04:15):

Yeah, I think in the last episode of the podcast, we talked a bit about this unique way that et TF shares are created and redeemed by authorized participants. And typically that involves an authorized participant depositing a basket of securities with the ETF or receiving a basket of securities when it redeems shares from the ETF. Sometimes those baskets also include cash components. Sometimes they consist exclusively of cash. And so these are the basket transactions that are addressed under the ETF rule. But one of the things, as you mentioned, that ETF advisors had lobbied for, for a long time before the rule was adopted, was whether you could use these custom baskets. So when, when exemptive orders were the way that ETFs operated, especially for actively managed ones, they typically had a requirement that the in-kind baskets had to be a neat pro rata slice of the portfolio.

Michael Mundt (05:21):

And if you can vary from that and instead make the custom basket a subset of the portfolio and maybe even have different baskets for different authorized participants, it could open up some greater possibilities for doing portfolio management through those custom baskets or achieving tax efficiencies through the custom baskets. This was viewed as one of the really nice features of the ETF rule that was adopted in 2019. It allows for the ETFs to use these custom baskets, and it is subject to a requirement that the fund is going to adopt specific written policies and procedures that set forth the detailed parameters for these baskets to ensure that they're in the best interests of the ETF. This was something that was important to the SEC because they thought if we're going to give you the flexibility to do custom baskets, we wanna make sure that the authorized participants are not going to use this as an opportunity to dump securities onto the ETF or to cherry pick certain, you know, really nice securities out of the portfolio.

Michael Mundt (06:39):

So the idea was that if these procedures have been adopted, if they specify the titles and the roles of the advisors employees who are gonna review each of the custom baskets, then there's going to be those kinds of compliance protections in place to allow for this happy medium of the benefits of the custom baskets, but still protections from the things that the SEC was concerned about. So, directors don't have a specific role in the custom basket process other than to approve the procedures that would apply. And then often what we see is that there are periodic reports to the boards about the extent to which the advisor has engaged in the custom baskets just not get the directors to second guess the basket composition or anything like that, but just to be aware of how common the custom baskets are being utilized and, and maybe what the purpose of those custom baskets was.

Lisa Chaikin Hamman (07:45):

Great, that's really helpful. Let's talk about liquidity for a second. All mutual funds, including traditional mutual funds and ETFs, have to adopt and implement a written liquidity risk management program reasonably designed to assess and manage liquidity risk under the rules. So, what are some unique considerations for ETFs and board oversight as it relates to liquidity?

Fabio Battaglia (08:10):

The liquidity rule does apply to ETFs, but it does so few, with a few wrinkles. So directors that are familiar with the liquidity rule from serving on boards of traditional mutual funds will recognize some of these some of these aspects. But I thought we would focus on how it applies differently to ETFs. And so the first thing to think about there is the type of ETF, if the ETF meets certain requirements with respect to how it does its redemptions, that is, it does the redemptions generally in kind, it would be under the rule classified as an in-kind ETF. And if it is an in-kind ETF, then it's going to be exempt from some of the more labor-intensive and some of the more onerous requirements of the liquidity rule. So more specifically, an in-kind ETF would not have to classify its portfolio investments into different liquidity categories, and it also would not have to do the bucketing that traditional mutual funds must do. It also wouldn't have to have a highly liquid investment minimum or an H limit. So, an in-kind ETF is sort of exempt from two of the key provisions of the liquidity rule.

Michael Mundt (09:17):

I mean, one thing that I've heard though is that especially I think for advisors that already advise mutual funds, and they may have been complying with the liquidity risk management rule for those mutual funds, they may already have the infrastructure in place to do the, the bucketing and to do the designation of the highly liquid investment minimum. And so they may just decide to go ahead and comply with those aspects of the rule rather than get into you know, debates about whether the ETF truly satisfies the in-kind ETF status or not. Another thing that I think is interesting about the rule is and ETFs is that there are in the approval process some special considerations that are, that apply. So the board is supposed to approve the liquidity risk management program, and in addition to the, the normal considerations dictated under the rule with respect to ETFs, there's supposed to be a consideration of the relationship between the ETF's portfolio liquidity and the way in which the shares trade in the market, including any bid ask spreads that apply to the trading of the shares or the arbitrage efficiency of the ETF, which kind of relates to whether the market price of the ETF is close to the net asset value.

Michael Mundt (10:47):

Kind of the thought there is that, or an expectation, I guess, would be that if the portfolio is more liquid, then it may be easier for authorized participants to pull together those securities for the baskets that we described earlier, including for the custom baskets. And if that process is more efficient because those portfolio securities are very liquid, then that might mean that the bid-ask spreads would be smaller, and maybe the arbitrage efficiency would be greater. And so the market price would be closer to the net asset value. So that's one thing that the SEC wanted the program to contemplate and boards to consider. A second factor that is specific to ETFs is the effect of the basket composition on the overall liquidity of the portfolio. And I, in, in my mind, this kind of goes back to one of the issues that we were talking about in the custom basket context of, of just making sure that when those baskets are being put together by the ETF advisor, that you know, what is the impact of that on the liquidity of the ETF portfolio, just to make sure you're not releasing so many of your liquid portfolio securities, that you're leaving the remaining portfolio in a less liquid state, or if you're receiving securities from the authorized participants, that they're going to be liquid enough to fit into the expectations for the overall portfolio.

Lisa Chaikin Hamman (12:25):

Thanks for explaining that. It's helpful to hear what specific considerations ETF directors should really keep in mind as they oversee ETFs and new regulatory developments. Another somewhat recent regulatory development that ETF directors might wanna know about is the adoption of the fund-to-funds rule. What can you tell us about that one?

Michael Mundt (12:48):

Yeah, so this was another one of the big-ticket rules that the SEC has adopted in recent years. So in 2019, they adopted the ETF rule that we've talked about. In 2020, they adopted the fund-to-funds rule. And just in broad brush terms, the fund of funds limitations in the Investment Company Act are designed to limit the ability of one registered investment company to purchase shares of another registered investment company. And the SEC has traditionally been concerned that purchasing investment company might try to exert undue influence if it bought too much of the underlying fund, or from the shareholder's perspective, there might be layering of fees between the two levels in the fund to funds arrangement or just might be too complex for sh shareholders to understand. So, the SEC, for about 20 years prior to the adoption of this new fund of funds rule, granted exemptive orders that gave relief from some of the fund of funds limitations as long as certain protective conditions were followed by the funds.

Michael Mundt (14:01):

And a lot of those conditions actually had board findings attached to them. So that regime of the exemptive orders imposed a lot of obligations for directors. A nice thing about this 2020 rule is that the SEC rescinded all of those orders and put in place a new framework that doesn't contemplate any specific findings by the board. Instead, the fund of funds advisor and the advisor to the underlying fund would have to make certain findings and report to the board. And the way this really comes into play for ETFs is that it's not uncommon for a registered fund, a mutual fund, or possibly even another ETF to want to purchase shares of an ETF. You can see a lot of reasons why this might happen, especially with index-based ETFs that give exposure to particular market sectors. It might be a very efficient way for an investing fund to get some core exposure to large-cap equity or some segment of the bond market, just through purchasing an underlying ETF.

Michael Mundt (15:14):

So, there could be a real utility for a registered fund in purchasing the underlying ETFs. The findings that the advisor would report to the board are things like, you know, there is no duplication of fees or that any concerns about undue influence have been addressed. Another aspect of that rule is that if the investing fund and the underlying ETF aren't advised by the same advisor, then the funds have to enter into an investment agreement that explains the material terms of the investment. And this is a place where boards can also get involved. Usually, there would at least be a form of agreement that's been presented to the board that serves as the model, then for the different agreements that an investing fund and an underlying ETF might enter under this rule. So it, it, it does spare directors the need to necessarily get into the specifics of each fund of funds arrangement, but it's still an important element of the oversight that the board is seeing, the kind of generic form of that investment agreement that's going to be tweaked to reflect the different arrangements.

Fabio Battaglia (16:32):

I would just say too, on the point about the findings I, the boards that I work with, I think they find it helpful to see the findings laid out by the advisor and understanding why a particular fund may invest in an underlying fund and, and why it's consistent with the, with the investment strategy, the fund, and with the overall objective. So while it's not a board approval requirement, I do think it's something that boards find helpful and informative and helps them sort of understand the role that investments in other funds play.

Lisa Chaikin Hamman (17:00):

So we've talked about special considerations for ETF directors relating to liquidity and the fund-to-fund rules. Let's talk about recent regulatory developments relating to the ETF as a product. One of the first that we'll talk about is the SEC approval and introduction of actively managed ETFs that don't publish their portfolios on a daily basis. Can you tell us more about this and any ramifications for boards? I guess starting with Mike,

Michael Mundt (17:28):

This is another significant development that's cropped up in the past couple of years. We talked before in the last podcast about how one of the requirements of the ETF rule is that the ETFs have to publish their portfolios every day, and there's some ETF advisors that just felt that level of transparency might not be in the best interest of the fund. So, for example, if market participants could look at that daily portfolio transparency and kind of determine trends or where the investment advisor was going with its investment strategies, maybe there's a potential for front running or maybe somebody could copy the strategy without having to invest in the fund. And either of those situations would be suboptimal for the advisor and for the ETF investors as well. And so, even though this full transparency is contemplated by the rule, some ETF advisors approach the SEC to get specific exemptive orders, exemptive relief, that would go to those groups specifically to allow a less transparent, semi-transparent or non-transparent active ETF.

Michael Mundt (18:49):

These are all terms that people use to refer to this type of ETF. In 2019, the SEC finally issued the first of these orders, allowing active ETFs that don't publish their portfolios on a daily basis to come to market. And since that time, there have been about 70 of these ETFs that have been launched, I think, because of liquidations and other market developments. There are now about 50 of them in the market currently, but they generally fall into two broad categories. Instead of publishing the portfolio, some of the ETFs publish an approximate portfolio value every second. So the idea is that even though the market won't know what specific securities are in the portfolio, they will have a confidence level that the value of the portfolio is known every one second, and that can assist in their ability to trade the shares in the secondary market at prices that are close to that value.

Michael Mundt (19:53):

A second model that a number of the ETFs have followed is instead of publishing the actual portfolio, they'll publish a proxy portfolio that's correlated to that portfolio. So they are publishing something that contains securities that allows you to assess the value of the actual portfolio, but it's not the actual portfolio. So again, that's kind of designed to thwart front-running or copying of the strategy. So, how does all this relate to directors? Well, the SEC had grappled with whether to issue this relief for many years, and one part of the solution that they came up with was that they would allow these products to come to market, but if the advisors and the SEC were wrong and they didn't actually trade as efficiently as they were expected, so if, if the spreads grew to say more than 2% over 30 days in a quarter or more than 2% for 15 days in a row or if that same kind of deviation existed for the market price versus the net asset value, then the advisor would call a meeting of the board and present recommendations for appropriate remedial measures.

Michael Mundt (21:12):

So the board would then have to consider whether this fund continues to exist. Is there, is there any continued viability for the fund or, or is the fact that this is trading at a discount, is it actually harming any shareholders? Then, decide on the appropriate next steps for the fund. So I think the, the key takeaway is that the, the SEC really envisioned an important role for the board and the directors in evaluating whether these new types of semi-transparent or non-transparent ETFs were working properly. And I should mention that one of the key things that the SEC also did with respect to these products is that they limited them currently to products that would generally invest in exchange-traded equity securities. So, the universe for these non-transparent ETFs has been significantly limited at this point, but as I say, there are about 50 of them currently trading in the market, and they appear to be trading well.

Lisa Chaikin Hamman (22:16):

Thanks, Mike. That's really helpful. I guess we should note that at this point, it is October 2024. So, more to come in that area as demands from the marketplace continue to evolve. Another topic that I think directors are really interested in hearing about is the conversion of traditional mutual funds into exchange-traded funds. To date, we've seen about 120 conversions since 2021, including some large mutual fund advisors. This is a topic that comes up time and time again in different forums that IDC offers, and Fabio, I'm wondering if you can tell us more about that.

Fabio Battaglia (22:58):

Sure. As you mentioned in the last few years, this has been a major point of discussion in the industry. Assets are generally moving from traditional mutual funds to ETFs, and one of the ways that's happening is from mutual funds converting to ETFs, and some of the large asset managers have done this. And, you know, a few things I think worth pointing out, you know, historically the SEC staff was, was hesitant to allow these types of conversions and for a few reasons, but most importantly because concerns around whether the shareholders would really understand that the shares that they held were no longer redeemable directly from the fund in the way that they had been before. Ultimately, the SEC staff got over that concern and started to allow the conversions to go forward. One question we get a lot is whether a shareholder vote would be required to affect one of these conversions.

Fabio Battaglia (23:49):

And that really depends on a couple things. First, whether the governing documents of the fund actually permit the conversion without a shareholder vote. Second, the conversion can be done under Rule 17 eight of the 40 Act, which basically imposes some requirements, namely that the board is the same and that the fundamental investment restrictions are the same. There are some conditions that have to be met to effect one of these conversions without a shareholder vote. And I, I think, Mike, it's fair to say that most of them to date have been done without a vote, but not all. So that's something to keep in mind because obviously the shareholder vote is something that would be important for the board to consider when they're considering a potential conversion. The conversions are usually set up as shell reorganizations; a new entity is created, and the existing fund is reorganized into the shell, much as you would do a traditional fund merger.

Fabio Battaglia (24:44):

You know, there, there are questions that boards should be asking about conversions and why they're in the best interest of shareholders. There are findings that are required for a board to make one, that the conversion is in the best interest of the shareholders and also that it doesn't result in dilution of the shareholders. So I think those are sort of the important findings that boards have to make. I would point to what I think is a really useful list in the white paper that Lisa mentioned earlier, that kind of lays out several questions that boards might want to ask in the context of considering a mutual fund to ETF conversion.

Michael Mundt (25:16):

Yeah, I think one of those, well, a couple of those key points for folks to keep in mind is that the distribution of the fund will be changing significantly. So if the mutual fund previously had classes that had sales loads or classes that had 12 B one fees, distribution incentives for certain distribution partners to sell the funds, once it converts to an ETF, as we've discussed before, those sales incentives kind of fall by the wayside. And again, the shares are going to be available on the exchange through exchange trading, but there may be a little bit of a loss of control of the distribution of the fund. At least it'll be different than it was for the mutual fund. So I think directors would probably want to understand what the plan is here? Why, why do does the advisor think that this conversion is going to be beneficial?

Michael Mundt (26:20):

And I think another kind of key thing to consider is the actual investment strategy that the mutual fund was pursuing. Can it be accomplished when you shift to an ETF structure? And what I, what I mean by that is that sometimes mutual funds, even though they're very liquid, they still have some maybe less liquid components of their portfolios or maybe they invest in an asset class that has some capacity constraints. And for a mutual fund, if you hit those capacity constraints, there's, there's the option to close the fund to additional investment. But with an ETF, because of this arbitrage mechanism that we've described there, there always has to be, or, you know, ideally should be, the ability to create more shares and to redeem the shares. And the SEC is given guidance that they believe an ETF should shut off creations only under extraordinary circumstances. So I think a, a director would want to have a good sense that the portfolio management that's been occurring in the mutual fund wrapper is going to be able to work pretty seamlessly once it transitions over to an ETF structure where there really won't be some of the same tools to close down the fund to additional assets.

Lisa Chaikin Hamman (27:49):

Those are really helpful observations about conversions and director considerations. And I wanna underscore what you said Fabio, about the questions included in the IDC paper board oversight of exchange traded funds, you know, not just about this topic, but generally there are questions peppered throughout the paper to help boards be more effective in their oversight and help them think about what to consider. So I would encourage folks to access that paper on IDC's website. I do wanna talk about an alternative to conversions that is a lot of people are talking about now, because the major fund sponsor that styled its ETFs with ETF share classes had a patent that recently expired. And so even though they've been offering funds like that for 20 years, nobody else in the industry has since that patent expired. We've seen about 30 exemptive applications pending with the SEC to allow for this multi-class structure that would allow ETFs to be in one share class of a traditional mutual fund. So it'll kind of marry the two structures. Can you tell us about what's going on there?

Michael Mundt (29:10):

Yeah, it's kind of a bit of a strange situation in that, as you said, you've had ETF classes in the US market for more than 20 years. And in fact, probably about, you know, 30% of ETF assets in the market today are invested through ETF classes. So it's kind of strange to think of this as something novel or innovative, but that is kind of how the SE C's thinking about it these days. When they adopted the ETF rule in 2019, the SEC specifically decided that it would not include the necessary relief for a fund to roll out ETF classes. So as you said, this would be a fund that has a class that's a mutual fund class and by all appearances seems to be a mutual fund, and then a separate class of the same fund that by all appearances to investors would, would resemble an ETF, but it's actually an ETF class that goes into the same portfolio.

Michael Mundt (30:15):

The SEC decided not to include that relief in the ETF rule and instead said people could submit exemptive applications to get that relief if they wanted to, but they noted that they had some concerns about the structure. And I think in particular their focus is that in this multi-class fund, you could have cash coming in through the mutual fund class and cash going out when there are redemptions from the mutual fund class and you have in kind transactions between the AP and the fund through the ETF class. But is that structure really going to be in the best interests of the ETF class shareholders? Because, you know, we've talked about some of the benefits of the ETF structure. They included cost efficiencies and tax efficiencies, but if you have to generate that cash or deal with that cash coming in through the mutual fund class, is that going to somehow impact the performance of the fund in a way that's not helpful to the ETF class shareholders?

Michael Mundt (31:26):

Now there's all kinds of rejoinders to this concern. Probably the, you know, some of the biggest ones are that when you have assets coming in through both classes, it creates a bigger pool of assets, and there's some cost efficiencies and trading efficiencies that could come with that larger pool. It also gives greater choice for investors instead of that conversion that we were talking about where a mutual fund would go away and instead become an ETF here, you could have a fund that offers mutual fund shares to those types of investors that prefer that channel, or they could have ETF shares available that would give them access to that investment strategy. So there, there are definite benefits that the applicants for this relief are focused on. It's not really clear, honestly, where the SE C's going to go with this relief. As you said, there are about 30 of these applications pending as of the time of this podcast. But what does seem to be a trend in the applications, and it wouldn't surprise me for an ultimate solution, is if the board is going to be called on to really consider the benefits to the respective classes. And this goes along with a basic board obligation that exists with multi-class funds today, which is that the board has to conclude the multiple class structure is in the best interests of each class and of the fund as a whole. We don't know if that's exactly where the SEC would land, but we'll watch with great interest.

Lisa Chaikin Hamman (33:04):

So it's interesting that you say that because we did just hear the director of the division of investment management, Natasha Griner and just the other day talked at the ICIS Securities Law Conference and was asked a question about this. She said they're thinking big picture and if and how to move forward. So it should be an interesting development that we will wait and watch for. In the meantime, I wanna thank you both for this great conversation about board oversight duties for ETFs. Thank you to everybody for tuning in. Please feel free to contact us. Either contact me, Lisa Hammond, at the Independent Directors' Council, or Mike and Fabio are also happy to field any questions. You can find our contact information on our websites, either idc.org or stradley.com. And just a reminder, everyone can access our paper board oversight of ETFs on the IDC's website. Thank you, everybody.

New Speaker (34:11):

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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