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

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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 episode is the first in a two-part series titled Board Oversight of Exchange Traded Funds. In this installment, we provide an overview of ETF Structure and regulation, along with director oversight duties. For the latest news alerts and podcasts, please visit stradley.com and follow us on LinkedIn and X.

Lisa Chaikin Hamman (00:37):

Hi everyone. Welcome to another episode. Today's topic is Board Oversight of Exchange-traded Funds. My name is Lisa Hammon, and I'm an attorney with the Independent Directors' Council, 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. We recently published an update to our white paper on board oversight of exchange-traded funds. The paper is designed to assist directors of ETFs in performing their oversight duties. The paper includes practical guidance for ETF directors and takes into account the latest developments in the ETF landscape. It's an update to our 2012 paper on the same topic. This podcast will address these same issues relating to director oversight of ETFs and will be dividing it into two conversations. The first conversation will focus on how ETFs operate under EXEMPTIVE relief, the ETF rule, and the differences between ETFs, traditional mutual funds and board oversight of 'em. The second episode will include a discussion of board oversight responsibilities relating to unique ETF situations, and we'll touch on compliance issues as well as recent developments, including the introduction of semi-transparent or non-transparent, actively managed ETFs, the conversion of mutual funds to ETFs and what we call ETF share classes. The law firm of Stradley Ronon helped IDC with the recent update to IDC's White Paper, and I'm joined today with two Stradley Ronon partners specializing in ETF work, Mike Mundt and Fabio Battaglia.

Michael Mundt (02:28):

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 (03:00):

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 as well as their boards of directors. Happy to be here today. Great.
Lisa Chaikin Hamman (03:14):
Well, thanks to both of you for joining us. Let's start just to level set about what directors should understand about their oversight responsibilities and how they differ between traditional mutual funds and ETFs.

Michael Mundt (03:27):

Yeah, I think one of the key things to understand right off the bat is some of the basic structural differences between ETFs and mutual funds, which directors may be more familiar with oversight of mutual funds, but they're both registered as open-end funds under the 40 Act. However, a key difference is that while a mutual fund issues and redeems individual shares at net asset value for the ETF, it's going to issue and redeem shares only in large aggregations that are called creation units. And the folks that transact directly with the ETF are large broker-dealers or banks, typically, that have signed up with the ETF to be able to engage in those transactions. So those are called authorized participants in the ETF ecosystem. The authorized participants in order to purchase the creation units or redeem the creation units are going to transact through baskets of securities, sometimes cash, but most often baskets of securities that the ETF advisor has requested.

Michael Mundt (04:42):

Once the authorized participant creates one of these creation units and purchases a creation unit, they can turn around and sell the individual shares into the secondary market through exchange transactions. And that's where most retail investors are going to purchase ETF shares through secondary market trading, where they buy the shares at market prices rather than at NAV, and they're buying them from brokers, not from the ETF itself. So that's a very key difference. So, just to kind of walk through, again, the daily life cycle of an ETF, an advisor to the ETF is going to specify in the morning, before trading begins, a basket of securities that it would have the authorized participant deliver if the authorized participant wants to purchase shares. Once the authorized participant does that, then the authorized participant can sell those shares into the secondary market at market prices.

Michael Mundt (05:49):

So that's a very different way of ETF shares reaching the investors from the way that it normally works with mutual funds. The consequence of this structure, I think something that's important for directors of ETFs to understand the basic structure is that there's, there's an arbitrage possibility so that if the ETF shares are trading in the market at a discount to NAV, so less than the NAV, the authorized participants can buy up those shares and present them to the ETF and get a redemption at net asset value. So there's an ability for an arbitrage profit for the authorized participant, but the consequence of buying those shares in the secondary market is that it's going to raise the market price towards the net asset value. The reverse is true: if the shares were trading at a premium or greater net asset value, then the authorized participants could buy the shares from the ETF and then sell the shares at that higher market price.

Michael Mundt (07:04):

In the process of creating more supply in the market, the market price should come down towards the NAV. All of that sounds very technical, but I think the upshot is that the market price historically for ETFs is going to hover near the net asset value of the ETF because of this arbitrage possibility. So the, the shareholders won't really transact at NAV directly with the fund as they would with the mutual fund, but they will hopefully purchase shares in the secondary market at market prices that are close to the NAV because of all of this under the hood stuff that's going on with the authorized participants transacting with the ETFs.

Fabio Battaglia (07:50):

Yeah, I would just add from the point of view of the shareholders that the structure that Mike described really allows for a few types of benefits. One is intraday trading, so the shares of the ETF are traded on exchanges throughout the day. It also allows for cost efficiencies with respect to portfolio transactions because the portfolio securities are purchased and sold in kind, with the ETF reducing transaction costs that would otherwise be borne by the fund and the fund shareholders. And finally, it creates tax efficiencies because, because of the redemption process that Mike described, securities that are appreciated can be redeemed from the ETF in kind, which makes the ETF a more tax-efficient vehicle in most cases than a traditional mutual fund. So, that structure that Mike described, while it is a bit technical from the point of view of the shareholders, allows for these types of benefits, which is important for I think directors to keep in mind. Right?

Lisa Chaikin Hamman (08:47):

I think that it is really important to understand the structural differences and the benefits of the structure. We'll also talk about the board oversight of ETFs and how it lends itself to specific questions that directors can consider and what they should be aware of in the boardroom. But before we do that, let's take a step back and talk about the different types of funds. People use the term ETF loosely sometimes in ways that might not reflect the actual legal structure. So, can you describe for us, maybe Mike, we'll start with you, what are the different ways that people might use the term, and what does it mean to be an ETF? Sure.

Michael Mundt (09:31):

So the funds that we'll be focused on today are registered as open-end funds under the Investment Company Act of 1940. So that's registered in the same way that a mutual fund would be. And those funds, just like mutual funds, are required to have a board of directors, and they're going to follow the requirements of the Investment Company Act. You know, another group of products that are sometimes referred to in the press as ETFs. I'd kinda like to preserve a distinction there. These are non-40 ACT products that, instead of holding securities, might hold futures, or they might actually hold the physical asset of gold. Recently, some spot Bitcoin and Ethereum ETFs were introduced, and because they're not, they don't actually hold securities, they're not subject to the Investment Company Act of 1940. So they most commonly would not have a board of directors and would not have to follow some of the requirements that we'll talk about. But within that universe of the registered products, that's the bulk of the ETFs, and there are a few different types there. Yeah,

Fabio Battaglia (10:51):

There are a few, I think, from that. Would that make sense to mention? In terms of types, most ETFs out there today are are index based, and that's you know, the et f industry traditionally focused on index based products tracking indexes and from, from the point of view of director oversight, you know, the, a key, a key factor there is tracking error with respect to the index and making sure that the ETF is delivering the, the performance that investors are expecting when they buy a product that's, that's designed to, to track an index. Those are the bulk of the industry's assets that are still in those types of products. For a long time, the fastest-growing area of the ETF industry has been the actively managed space. And within that, you've got the, what I would think of as traditional active management, which is like what you would see in a traditional mutual fund, where you've got a portfolio management team essentially picking securities pursuant to a certain strategy.

Fabio Battaglia (11:45):

But there's also a kind of new developing area, which I like to think of as index-related products. These are products that are essentially focused on a particular index, but they are applying, for example, downside protection. So, there are equity buffer products with downside protection caps. On the upside, they're designed to deliver equity index returns within certain parameters. They're focused on an index, but they're not really an index-based product. There are some target maturity fixed income products out there that are becoming more common. So, so there's this sort of hybrid category, if you will, Mike, that, that I really think of as sort of in between the index and actively managed space. They're technically, technically actively managed products, but they really are focused on delivering an index-like performance with, you know, with CER within certain parameters.

Michael Mundt (12:34):

I also think the leveraged ETFs are geared ETFs that you hear people mention sometimes, and they also kind of fall into that gray area between index-based and actively managed. Those are products that pledge to return some multiple of the return of an index, so, you know, maybe two times the S&P 500 or the inverse of an index. So maybe you know, 200% the opposite of the return of an index. Some of those that have you have been introduced in recent years actually may just focus on a single stock. You, you know, they challenge what we think of a little bit of, as a, an investment company because they don't have a, a broad portfolio of securities, but they actually just have a single stock and they're gonna return some multiple of the return of that stock or the inverse return of that stock. And some of these, you know, are a little challenging to understand. They have daily investment objectives so that multiple or inverse multiples of the return are only good on a daily basis. It's not necessarily a return that's going to exist over time. And I think one of the really important things for directors is to really understand the investment objectives of the ETFs that they're overseeing. I know that has disclosure consequences, too.

Fabio Battaglia (14:12):

Yeah, I think the, the key there is making sure that for, for these types of products that are pursuing these more esoteric strategies, I think it's really important that the directors understand not just the product, but understand how the product is being, how the, how the details of the product are being disclosed to investors. And that's really kind of where the rubber meets the road with respect to those products.
Lisa Chaikin Hamman (14:30):
Great. That's really helpful. So, just to recap the big picture, the funds that we're talking about, whether they're index-based, actively managed, or what we call leveraged, are funds that are ETFs registered under the 1940 Act. These ETPs, exchange-traded products, might be registered, but they're not registered under the 40 Act, and that's the distinction. And the ETPs are importantly not overseen by independent boards, generally speaking, at least not under the 40 act. Exactly. So that's really helpful. What else should directors know about the regulatory framework for ETFs that are registered under the FORTI Act?

Fabio Battaglia (15:12):

A couple things. The operation of ETFs really requires some sort of exemptive relief from the FORTI Act. There are various provisions of the FORTI Act that ETFs simply couldn't operate without violating those provisions. And so there, so relief is necessary. And prior to 2019, that relief came always in the form of an exemptive order from the SEC that would permit ETFs to operate in 2019. The SEC adopted the ETF rule, which is six C 11, which provides relief for the majority of ETFs that are operating today. The rule has you know, from the point of view of boards, there aren't specific board requirements within the rule. I think from the board's perspective, it's important to understand whether the ETF that you're overseeing is relying on the rule or is relying on an exemptive order.

Because it's the, it's an ETF of the type that the rule wouldn't permit, and you're still relying on an exemptive order.

Fabio Battaglia (16:11):

The EXEMPTIVE orders may have certain conditions, and it would be important for the boards to understand that. But the rule basically codified the majority of the orders that were in place prior to 2019. And a couple key aspects of the rule that I would point out, one is the rule requires full port portfolio transparency. So that means that the portfolio is disclosed publicly on a daily basis. So that's an important distinction. And also that, you know, the, I would also point out that boards don't have specific duties under the rule, but most ETFs will adopt policies and procedures in order to comply with Section 11. And so boards will have a role to play there in terms of approving those policies and procedures and ensuring compliance with the

Michael Mundt (16:54):

Rule. Yeah. And with the basket transactions that I described earlier, where authorized participants would be depositing baskets of securities with the ETF in order to purchase ETF shares or when they redeem, receiving a basket of securities, that's provided for under this ETF rule as well. And there's a requirement that there be specific written procedures for those in-kind basket transactions, and even more specific procedures if the baskets are something called custom baskets. But I agree with you, Fabio, that, you know, from a board perspective, I think it's useful for the directors to understand what regime this fund is operating under. The issue of portfolio transparency that you mentioned is a key requirement of the rule. There are some ETFs where, and this is, you know, particularly true in the actively managed front, where they weren't the advisors weren't comfortable with that level of transparency.

Michael Mundt (18:01):

And so that's an example that you were mentioning where a fund group might still seek an ETF exemptive order. So, their ETF couldn't rely on this ETF rule; instead, the sponsor would have to seek specific permission from the SEC to run an ETF that would not present its portfolio on a daily basis. And in the industry, those are referred to as semi-transparent or non-transparent active ETFs. So that's an example of an ETF that would still operate under an exemptive order. And Lisa, you mentioned that we'll talk a little bit later about ETF classes. That's another example of a structure that's not allowed under the rule. And so, an exemptive relief in the form of an exemptive order would be necessary from the SEC, and those exemptive orders would be necessary. You know, we'll see where the dust settles on the ETF class relief, but those exemptive orders can have specific requirements for boards. And so I think it's, you know, always important to understand what is the regulatory regime that applies here, and is it going to have some specific board aspects to it. So I guess, you know, that kind of flows into, well, what are the things that the board is supposed to be focused on with respect to these ETF rule-compliant ETFs? And I think a lot of 'em are gonna be familiar with mutual funds.

Fabio Battaglia (19:33):

Directors. Yeah, I think that's right, Mike. For directors who have experience overseeing traditional mutual funds, a lot of the activities and a lot of the responsibilities that they're going to have overseeing an ETF will be quite similar. So, things like the annual contract renewal process under section 15C will be the same for ETFs as they are for traditional mutual funds. Some of the key areas of oversight that traditional boards have with respect to traditional mutual funds are. So, think about compliance rule 38, a chief compliance officer's investment performance valuation of the portfolio securities disclosure to investors, and oversight of service providers; all of those things are going to apply in much the same way as they do for traditional mutual funds. A lot of the same programs that have been adopted, a lot of the same reporting that boards receive, are gonna be there.

Fabio Battaglia (20:29):

You know, one thing, and maybe it's, and this is a good place to, to just note it, but ETFs, generally speaking, you know, do not pay 12 B one fees. That's an area that a lot of boards have been focused on for many years. What's typically happened in over the over the years is that ETFs have been established with 12 B one plans in place but have not actually paid 12 B one fees to date. So, you know, the question is out there, sort of what will happen with 12 B one payments for ETFs. So, so boards that are traditionally kind of, of traditional mutual funds that are focused on overseeing those plans, you know, that's an aspect of, of ETFs that, that isn't there right now, but could be in the future.
Lisa Chaikin Hamman (21:09):
So we've talked about how a lot of the duties are similar to the duties of directors overseeing traditional mutual funds because the basic obligations are the same. They still have the specific oversight responsibilities and all of the general oversight responsibilities. What duties are kind of unique that trace back to the operations of an ETF?

Michael Mundt (21:32):

Yeah, one that jumps out at me real quickly is again, this special role of the authorized participant, the bank or broker-dealer that's specifically authorized to engage in these transactions directly with the ETF. And typically, you might find, you know, there may be 20 apps that have been signed up to work with a particular ETF. It may be the reality may be they're, they're just four or five aps that actively purchase and redeem shares from, from the ETF, but typically the, the ETF advisor is going to try to line up a number of authorized participants that are at least capable of doing creations and redemptions from the ETF and they execute AP agreements. Usually, the board is going to be presented with at least a form of the AP agreement that would exist between the distributor of the ETF and the authorized participants.

Michael Mundt (22:37):

The agreement kind of lays out the basics of how these baskets are going to be conveyed from one party to the other, as well as a few other mechanical things that deal with the relationship between the ETF and the authorized participants. So the director's probably not going to have to get into the weeds of these agreements, but it's good to be generally aware of the agreements and there will probably be some presentations along the way on a regular basis about how many aps have been signed up for a given ETF, how active are the aps that can be important to, to understand because that gives an indication of assets flowing into the ETF and the shares making their way out to the market for retail investors to purchase. A lot of times, ETF advisors are certainly going to want to have as many active apps as they can because that will improve the trading of the ETF shares in the secondary market.

Lisa Chaikin Hamman (23:39):

Are there other unique contractual relationships that directors should be aware of and should oversee?

Fabio Battaglia (23:46):

You know, one thing that I think I would point out is that a lot of the, as we mentioned, a lot of ETFs are index-based. And so oftentimes there will be licensing agreements with the various index providers that run the indexes that the ETFs are tracking. So, similar to what Mike just described, it's not an area where I think the directors really need to be in the, in the weeds, but I think it's important that they understand at a high level what the relationships with the index providers are and what, what those licensing agreements you know, what's in those licensing agreements, which

Michael Mundt (24:12):

A lot of times the agreement's gonna be between the advisor and the index provider to begin with, but still the, the ability to track the index is gonna be so critical for an index-based ETF that I think the directors are definitely gonna be, wanna be aware of what the basic licensing arrangement is. You know, another one that comes to mind for me is with semi-transparent or non-transparent active ETFs. There's been an interesting thing that happened. I mentioned earlier that those can only come to market if the SEC has granted specific exemptive relief to allow those products. And there are half a dozen groups that have created different models that can support these semi-transparent or non-transparent active ETFs. And so to the extent that fund groups want to utilize one of those models, they will typically license that ability with the solution providers. We

Lisa Chaikin Hamman (25:16):

Talked about how exchange-traded funds are listed on exchanges. So what kind of rules and requirements are there from the exchanges, if any?

Fabio Battaglia (25:25):

You know, the exchanges have certain rules that apply to any listed company. And with respect to ETFs, and particularly from the perspective of board members, I think there's a couple that are worth noting. One is that ETFs, unlike closed-end funds that are listed on exchanges, don't actually have, aren't subject to annual re-meeting requirements as imposed by the exchanges. That's an important distinction because closed-end funds, you know, are required to have an annual shareholder meeting, and ETFs are carved out of that requirement within the listing rules. The other thing I would mention is that there are rules that apply to the audit committee and the charter of the audit committee, as well as certain things that must be in there, per the exchange rules. And there's also kind of financial liter literacy requirements that apply to directors. So, the directors of the ETF under the exchange rules have to meet certain financial literacy standards in order to serve on the board of the ETF.

Lisa Chaikin Hamman (26:14):

Any other unique duties that we could talk about that relate to the operations of ETFs?

Michael Mundt (26:21):

I think an important one is just for the directors to understand the, the way that the ETF shares are trading in the secondary market. You know, are they trading at a routine discount to the net asset value, or are they routinely trading at a premium to the net asset value? A lot of times, directors will receive reports at their meetings about the trading experience for the ETF shares and, you know, maybe what the spreads have been on the secondary market trading. I think this is important. It's certainly been an important issue for the SEC. They believe that the arbitrage mechanism that I described at the beginning is going to keep the market price close to the net asset value. So that's kind of everybody's expectation about how the ETF's going to operate. If these reports that the directors are receiving suggest that they're not trading that efficiently, then I think the directors are going to wanna understand why that is the case and whether there is anything that the advisor might be able to do that would help the trading be more efficient. Whether that's working hard to recruit additional authorized participants, or maybe making adjustments to the baskets that are being deposited or used in redemptions. Are there ways to make trading more efficient?

Lisa Chaikin Hamman (27:49):

Thanks, this is really helpful. It's been a great discussion about the general structure of ETFs, their operations and board oversight. So thanks to both of you. Our next episode will address board duties for unique ETF situations, including some of the unique compliance obligations of ETFs, as well as semi-transparent or non-transparent active ETFs, mutual fund conversions to ETFs and the ETF share class structure that we talked about earlier.

(28:21):

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 in 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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