# COMPLIANCE CORNER

## What's in a Name? ETF or Not – Does it Matter?

By Paul M. Miller and Anthony Tu-Sekine, Seward & Kissel LLP*

**Dalia Blass**, Director of the SEC's Division of Investment Management, highlighted in a speech recently that the staff may consider reviewing the nomenclature used to refer to funds and other products in the ETF space. She explained that a variety of funds and products are referred to by the press and others as "ETFs" even when such products are not investment companies or even funds.[i] She mentioned this in the context of the staff's consideration of a new rule proposal addressing ETFs.

The confusion arises from the fact that there are a number of exchange-traded products (captured in the overall category of "ETPs") that look alike at first glance but that have functional differences, such as exchange-traded funds (ETFs), exchange-traded notes (ETNs) and exchange-traded vehicles (ETVs). The market for ETPs, including ETFs, ETNs and other ETPs such as ETVs, has exploded over the last decade. According to the Investment Company Fact Book, at year-end 2007, there were approximately 629 ETFs (including "non-1940 Act ETFs"[ii]) with approximately $608 billion in total net assets. At year-end 2016, there were approximately 1,716 of such products, with approximately $2.524 trillion in total net assets.

There are certain advantages to owning these exchange-traded securities, including the ability of advisers to manage cash balances and trade with frequency. There are, however, critical differences arising from their legal structure that can have legal and compliance implications for advisers. This article reviews the various products that have been grouped into the ETF category by the press and industry participants, provides a brief explanation of certain features of each product and why it may or may not be an ETF, discusses the implications of categorization for registered advisers from a legal and compliance perspective and outlines an approach to identifying and addressing these products for compliance purposes.

*Paul M. Miller, Partner, Seward & Kissel LLP*

*Anthony Tu-Sekine, Partner, Seward & Kissel LLP*

*"[T]here are legal and compliance implications to advisers investing on behalf of their clients in shares of ETFs, ETNs and other ETPs, and these implications differ by issuer and by the type of advisory client making an investment."*

### Exchange-Traded Product Types

**A. *ETFs.*** An exchange-traded fund is typically organized as a registered open-end investment company and its shares trade on an exchange. It is an investment company because it issues securities and uses the proceeds of that issuance to invest in securities. The value of ETF shares, though linked to the value of securities in its pool of assets, is ultimately determined by the trading of the ETF's shares on the exchange on which it is listed. In that respect, the ETF acts more like a closed-end fund than an open-end investment company, the shares of which are priced at NAV daily. Because of its unique nature as a hybrid between an open-end fund and closed-end fund, an exchange-traded fund requires exemptions from certain provisions of the Investment Company Act of 1940 (1940 Act) to operate. The Vanguard S&P 500 ETF (NYSE Arca: VOO) is an example of an exchange-traded fund, whose market price is linked to the value of securities held in its portfolio tracking the S&P 500 Index.

**B. *ETNs.*** An exchange-traded note is a debt instrument typically issued by a bank whose return is linked to a specific instrument, asset or index. The issuer of the ETN agrees to pay a return on the ETNs based on the performance of the applicable specific instrument, asset or index. ETNs often seek to employ strategies that provide enhanced returns, such as triple leverage or inverse returns. This debt instrument trades on an exchange and its value is affected not only by the

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performance of the specific instrument, asset or index but also by the credit rating of the issuer of the instrument since payment on the ETN is based on the solvency of the financial institution issuing the ETN. As with ETFs, the value of the shares of the ETN is ultimately determined by the trading of the ETN's shares on the exchange on which it is listed. The Barclays iPath® Pure Beta Cocoa ETN (NYSE Arca: CHOC) is an example of an unleveraged ETN, whose market price is linked to a cocoa index (the Barclays Cocoa Pure Beta TR Index).

C. ***Other ETPs such as ETVs.*** Exchange-traded product is a broad category of securities that are derivatively priced and trade intraday on a national securities exchange. ETVs generally are ETPs whose price is linked to an underlying asset that is not deemed to be a security, such as gold, silver or another commodity. An ETV can be structured like an ETF (that is, permitting daily redemptions and creations of ETF shares), such as the SPDR Gold Shares (NYSE Arca: GLD), or more like a closed-end fund (though permitting redemptions), such as the Sprott Physical Gold Trust (NYSE Arca: PHYS), both of which are examples of an ETP whose market price is linked to the value of gold bullion held in a trust. Again, the value of the shares of the ETVs is ultimately determined by the trading of the ETV's shares on the exchange on which it is listed.

## Certain Legal and Compliance Implications of Owning Shares of ETFs vs. Shares of ETNs and other ETPs

There are a number of legal and compliance distinctions arising from owning shares of ETFs and owning shares of ETNs and other ETPs. Most of these distinctions are based on the legal status of ETFs as registered investment companies under the 1940 Act and the fact that shares of an ETF are designed to trade at market prices that are closely aligned with the net asset value per share of the ETF.

*"There are certain advantages to owning these exchange-traded securities, including the ability of advisers to manage cash balances and trade with frequency. There are, however, critical differences arising from their legal structure that can have legal and compliance implications for advisers."*

A. ***Beneficial Ownership Reporting Obligations.*** Section 13(d) of the Securities Exchange Act of 1934 (1934 Act) requires beneficial owners of more than 5 percent of a class of equity securities registered under Section 12 of the 1934 Act or issued by a closed-end investment company registered under the 1940 Act to file reports with the SEC reflecting such ownership. Section 16(a) of the 1934 Act requires each officer, director and beneficial owner of greater than 10 percent of any class of equity securities registered under Section 12 of the 1934 Act to file reports with the SEC disclosing the number of shares of all equity securities beneficially owned and any subsequent changes to that ownership.

The SEC staff has provided no-action relief to ETFs (both to those registered as open-end investment companies and to those registered as unit investment trusts) permitting beneficial owners of ETFs to exceed the triggering ownership thresholds without reporting the beneficial owners' holdings under Section 13 or Section 16 of the 1934 Act. In providing the relief, the SEC staff cited representations made by the ETFs that their shares have traded and will continue to trade at prices that do not materially deviate from the shares' net asset value and noted that, should the price of shares materially deviate from their net asset value, the relief would no longer be available.

Such relief has not been extended to investments in equity securities of other ETPs. Because ETNs issue debt securities, beneficial owners of such securities are not subject to the reporting requirements of Section 13(d) or Section 16(a) of the 1934 Act.

B. ***Code of Ethics Requirements.*** Rule 204A-1 under the Investment Advisers Act of 1940 (Advisers Act) requires access persons of a registered adviser to periodically report their transactions and holdings in "reportable securities." Under the Rule, reportable security means any security as defined in the Advisers Act, except, among other things, shares of open-end funds.

Shares of ETFs established as unit investment trusts, ETNs and other ETPs are securities under the Advisers Act, but have not been excluded from the definition of reportable security. Consequently, transactions in these shares are required to be reported under an investment adviser's Code of Ethics and, if the Code requires preclearance of all transactions in reportable securities without exception, transactions in these shares would be required to be precleared.

C. ***Section 12(d)(1) Limitations.*** Section 12(d)(1) of the 1940 Act limits the ability of investment companies, including private funds, to invest in shares of other registered investment companies, including ETFs. In particular, Section 12(d)(1)(A) prohibits an investment company (fund) from acquiring securities issued by another fund if immediately after the acquisition the acquiring

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fund: (i) owns more than three percent of the outstanding voting stock of the acquired fund; (ii) has more than five percent of its total assets invested in the acquired fund; or (iii) has more than 10 percent of its total assets invested in the acquired fund and all other investment companies; and Section 12(d)(1)(B) prohibits a fund from knowingly selling its securities to another fund if the sale would cause the acquiring fund to own more than three percent of the acquired fund's total outstanding voting stock, or if the sale would cause more than 10 percent of the acquired fund's total outstanding voting stock to be owned by investment companies. Many ETFs have obtained exemptive relief from the SEC permitting other registered investment companies (but not private funds) to exceed those limitations, provided that any such investing fund enters into a participation agreement with the ETF requiring the investing fund and its adviser to comply with applicable conditions of the exemptive order.

Because ETNs and certain other ETPs are not registered investment companies, investors in shares of these issuers are not subject to the limitations of Section 12(d)(1) of the 1940 Act or applicable ETF exemptive orders.

D. ***Affiliated Person/Section 17 Restrictions.*** Section 17 of the 1940 Act prohibits certain principal transactions involving registered investment companies and their "affiliated persons,"[iii] absent SEC approval. Section 17(a) prohibits, among other things, an affiliated person of a fund or any affiliated person thereof (second-tier affiliate) from selling any security (other than securities issued by the buyer or seller) or other property to the fund, or buying any security (other than securities issued by the fund) or other property from the fund. Many ETFs have obtained exemptive relief from the SEC permitting them to sell their shares to and redeem their shares from certain authorized participants that are affiliated persons or second-tier affiliates of the ETFs, but such relief does not extend to transactions between the fund and persons that are not authorized participants. [iv]

## Approach to Compliance

As indicated above, there are legal and compliance implications to advisers investing on behalf of their client in shares of ETFs, ETNs and other ETPs, and these implications differ by issuer and by the type of advisory client making an investment. The following steps may be helpful in approaching potential investments in these issuers and the related legal and compliance implications.

***Step 1: Identify the ETP type***

- Review the offering document of the ETP issuer for disclosures relating to the legal status of the issuer (and its securities) under the federal securities laws.
  - Are the shares of the issuer registered under Section 12 of the 1934 Act?
  - Is the issuer registered under the 1940 Act?
  - If the issuer is an ETF, is it a unit investment trust or an open-end fund?
- Focus on the risk factors in the offering document.
  - Do any of the risk factors relate to the legal status of the issuer?
- Review the website of the issuer and the SEC's Edgar website for other filings made by the issuer and for more information about the entity.
  - What form does the entity use to register its shares? Form N-1A (for registered investment companies)?

***Step 2: Identify the Type of Advisory Client Making Investments***

- Identify which advisory clients will make investments in the particular ETP issuer.
  - Is the advisory client a managed account client, private fund or registered fund?
  - Does any client have a restriction on investing in an ETP issuer?
- If the issuer in which advisory clients will make an investment is an ETF and one or more of those clients is a mutual fund, closed-end fund or private fund, review the ETF's website for a copy of its participation agreement (if applicable) or for contact information to obtain a copy.
- If deemed necessary due to the potential size of the investment, review and execute the ETF participation agreement prior to exceeding the applicable legal limitations (*e.g.,* three percent of outstanding voting securities of the ETF).

***Step 3: Set Ownership Limitations and Reporting Thresholds in Order Management System***

- Based on the type of each ETP issuer and the types of advisory clients making an investment, input investment restrictions or reporting limitations into the order management system or other portfolio management system.
- Incorporate into the investment limitations any investment restrictions imposed under an executed participation agreement, including those that apply by fund/client and those that apply to the adviser.

***Step 4: Update compliance policies and procedures to incorporate limitations and restrictions and reevaluate existing investments, limitations and clients periodically for updates.***

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## Conclusion

While grouping issuers into a broad ETF category is convenient, the proper assessment of the legal status of the ETP issuer is critical in applying appropriate legal and compliance limitations to such investments by advisory clients. Incorrect assessments of this status and those advisory clients making investments in those issuers can lead to legal and compliance breaches. Perhaps the SEC is onto something: The name does matter.

** Paul M. Miller is a partner with Seward & Kissel LLP and is a member of its Investment Management Group. He regularly counsels registered investment companies and registered investment advisers on the application of the requirements of the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to their businesses. He can be reached at millerp@sewkis.com or 202-661-7155.*

*Anthony Tu-Sekine is a partner with Seward & Kissel LLP and is a member of its Blockchain and Cryptocurrency Group. He brings his extensive experience in domestic and cross-border capital markets transactions and fund formation to the emerging area of blockchain and cryptocurrency and has advised issuers, funds and advisers in connection with cryptocurrency issuances and investments. He can be reached at tu-sekine@sewkis.com or (202) 661-7150.* IAA

[i] An "exchange-traded fund" has been defined as an open-end management investment company (or Series or Class thereof) or unit investment trust (or series thereof), the shares of which are listed and traded on a national securities exchange at market prices, and that has formed and operates under an exemptive order under the 1940 Act granted by the Commission or in reliance on an exemptive rule under the 1940 Act adopted by the Commission.

[ii] "Non-1940 Act ETFs" are ETFs that are not registered under the 1940 Act.

[iii] A fund's "affiliated persons" include, among other persons, its investment adviser; any person owning at least five percent of the fund's outstanding voting securities; and any person directly or indirectly controlling, controlled by, or under common control with the fund.

[iv] An "authorized participant" is an institutional firm (*e.g.,* a broker-dealer, bank, trust company or clearing company) that has entered into a participant agreement with the fund's distributor.

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