

ETF ROUNDUP

Issue 2 – April 2017

Welcome to the second issue of *ETF Roundup*, our guide to the latest legal and regulatory developments affecting the exchange-traded fund (ETF) industry. We hope you find this newsletter useful. If you have any questions about the issues discussed here, or if there are any topics you would like us to address in future issues, please email us at etfroundup@morganlewis.com or contact any of the Morgan Lewis lawyers listed beginning on page 10.



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SEC APPROVES CONTINUED LISTING STANDARDS

The US Securities and Exchange Commission (SEC) recently approved proposals by each of [The NASDAQ Stock Market LLC](#) (Nasdaq), [Bats BZX Exchange, Inc.](#) (Bats), and [NYSE Arca, Inc.](#) (NYSE) (each, an Exchange) to amend its rules to impose continued listing requirements for ETFs listed under an Exchange's generic listing standards (generically-listed products) or in reliance on a 19b-4 order (non-generically-listed products). Previously, an index-based ETF was only required to comply with certain listing requirements on an initial basis. The amended listing rules, which are substantively similar for each Exchange, follow last year's adoption of generic listing standards for actively managed ETFs, which are required both at the initial listing and on a continuing basis.

The rule changes will require a generically-listed product to maintain the applicable Exchange's generic listing standards on a continuous basis. A non-generically-listed product will be required to comply on a continuous basis with all statements or representations made in its Rule 19b-4 filing regarding

- the description of the index, holdings or reference asset (as applicable);
- limitations on index composition, holdings or reference assets (as applicable);
- dissemination and availability of index, reference asset or intraday indicative values (as applicable); and
- the applicability of Exchange rules and surveillance procedures.

The new continued listing requirements will impose additional compliance requirements on ETFs. In particular, to the extent not already in place, ETFs will need to develop procedures for monitoring compliance with the listing requirements on a continuous basis. For a passively managed ETF, this may require monitoring compliance by the ETF's underlying index. As noted by commenters on the proposed rule changes, this may result in difficulty for passively managed ETFs that track third-party indexes where the ETF has no control over the index constituents.

In addition, each Exchange amended its rules to specify the delisting procedures due to non-compliance with the continued listing standards. In general, an Exchange will initiate delisting proceedings for an ETF that fails to meet a continued listing requirement. However, the amended rules also state that an Exchange may accept and review an ETF's plan to regain compliance when it fails to meet a continued listing requirement if the plan is submitted within 45 calendar days of the Exchange's notification of deficiency. To supplement an Exchange's surveillance of ETF



compliance, the amended rules add a requirement that an ETF promptly notify its Exchange of any non-compliance with the continued listing requirements.

Finally, Nasdaq and NYSE amended their listing rules to require delisting of an ETF if, following the initial 12-month period following commencement of trading on the applicable Exchange, there are fewer than 50 record or beneficial holders of the ETF. Previously, the rules required a delisting only if the minimum record or beneficial holder requirement was not met for "30 or more consecutive trading days." This stricter amended rule may adversely impact newer or smaller ETFs in particular. Bats did not amend its listing rules in this manner.

Nasdaq is scheduled to implement its rule changes by August 1, 2017. Bats and NYSE are scheduled to implement their rule changes by October 1, 2017.

SEC REJECTS BITCOIN ETP

On March 10, the SEC [rejected](#) a proposal by Bats to list the Winklevoss Bitcoin Trust (Bitcoin ETP) as the first ETP that would track the price of bitcoin, based largely on concerns regarding the structure of the bitcoin market that would prevent the Exchange from detecting and deterring fraudulent and manipulative conduct as required by the Securities Exchange Act of 1934 (Exchange Act).¹

About the Bitcoin ETP

The Bitcoin ETP's investment objective is to track the price of bitcoin, as measured by the clearing price of a two-sided auction that occurs daily on the Gemini Exchange. Bitcoin is a virtual currency issued by and transmitted through a decentralized peer-to-peer bitcoin computer network known as the "Blockchain" that records all bitcoin transactions. The Exchange proposed to list and trade the Bitcoin ETP's shares as commodity ETP shares under its applicable rules. Therefore, the Exchange was required to seek SEC approval of the proposed rule change and had the burden to demonstrate that the proposed rule was consistent with the Exchange Act.

The SEC's Rejection of the Proposal

The Exchange Act requires the national securities exchanges to have rules designed to prevent fraudulent and manipulative acts to protect investors and the public interest. The SEC stated that, in order to meet this standard, the Exchange must have surveillance-sharing agreements with significant markets for trading bitcoin and the same markets must be regulated. Because the exchange failed to satisfy these

¹ The decision is similar to another issued on March 28, in which the SEC [rejected](#) a proposal for the SolidX Bitcoin Trust to be listed on the NYSE Arca, raising the same concerns as it did in rejecting the proposal for the Winklevoss Bitcoin Trust.





requirements, the SEC rejected the Exchange’s proposal.

Specifically, while the Exchange claimed that it had entered into a comprehensive surveillance-sharing agreement with the Gemini Exchange, the SEC found that bitcoin trading on the Gemini Exchange represents only a small percentage of overall bitcoin trading and that the volume in the Gemini Exchange’s auction is small relative to daily trading in bitcoin and to the number of bitcoin in a creation or redemption basket for the Bitcoin ETP. Additionally, the SEC noted that most bitcoin trading occurs in non-U.S. markets where there is little to no regulation governing trading, which typically acts as a necessary deterrent to market manipulation. Therefore, the SEC determined that the Exchange has not entered, and would not be able to enter, into a surveillance-sharing agreement with a significant, regulated, bitcoin-related market of the type that had been in place with respect to all previously approved commodity ETPs. As a result, the SEC found that the proposed rule raised “concerns about the potential for fraudulent or manipulative acts and practices” and rejected it on those grounds.

What’s next for Bitcoin ETPs?

The ruling is a setback for other firms that had proposed bitcoin ETPs and hoped that the ruling would help bring bitcoin into the mainstream retail market. However, the SEC indicated that it could reconsider a bitcoin ETP in the future, noting that bitcoin is “still in the relatively early stages of its development and that, over time, regulated bitcoin-related markets of significant size may develop.” Bats [petitioned](#) the SEC on March 24 to review the decision to reject Bats’ proposal, which was issued by the SEC’s Division of Trading and Markets pursuant to delegated authority. The SEC [granted](#) the petition on April 24, providing that any party to the action or other person may file a written statement in support of or in opposition to the decision on or before May 15.

THE INDUSTRY IN BRIEF

Senate Panel Confirms SEC Nominee

On April 4, the US Senate Committee on Banking, Housing, and Urban Affairs approved Jay Clayton’s nomination to serve as Chairman of the SEC. If approved by the Senate, Mr. Clayton would take the reins from Michael Piwowar, who was designated Acting Chairman of the SEC on January 23. Mr. Clayton is currently a partner at an international law firm, where his practice involves public and private mergers and acquisitions transactions, capital markets offerings, regulatory and enforcement proceedings, and other matters.

Implementation of Liquidity Rule Disclosure Requirements²

The recently [adopted](#) liquidity rule imposes new disclosure requirements for new funds and post-effective amendments filed on or after June 1, 2017. Item 11(c) of Form N-1A will now require funds to disclose in their prospectus:

- The number of days following receipt of shareholder redemption requests in which the fund typically expects to pay out redemption proceeds to redeeming shareholders. If the number of days differs by method of payment (e.g., check, wire, automated clearing house), then disclose the typical number of days or estimated range of days that the fund expects it will take to pay out redemptions proceeds for each method used.
- The methods that the fund typically expects to use to meet redemption requests, and whether those methods are used regularly, or only in stressed market conditions (e.g., sales of portfolio assets, holdings of cash or cash equivalents, lines of credit, interfund lending, and/or ability to redeem in kind).

However, pursuant to Item 11(g) of Form N-1A, ETFs that issue or redeem fund shares in creation units of not less than 25,000 shares each may omit these requirements.

OCIE Continues to Focus on ETFs

In January, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced its [2017 priorities](#), which include examining ETFs' creation and redemption processes and ETFs' compliance with applicable regulatory requirements, including exemptive relief granted under the Exchange Act and the 1940 Act. OCIE also will focus on sales practices and disclosures involving ETFs and the suitability of broker-dealers' recommendations to purchase ETFs with niche strategies.

Fiduciary Rule Delayed³

The Department of Labor (DOL) has [delayed](#) applicability of its changes to the fiduciary investment advice regulation, commonly referred to as the fiduciary rule. The 60-day delay extends the original April 10, 2017 applicability date to June 9, and the DOL has further delayed the applicability of certain prohibited transaction exemption conditions until January 1, 2018.

Enforcement Actions Involving ETFs

In December 2016, the SEC [announced](#) that an investment adviser agreed to retain an independent compliance consultant and pay nearly \$20 million to settle charges

² For a more complete discussion of the liquidity rule, see [Issue 1 of the ETF Roundup](#).

³ For a discussion of the implications of this rule and its delay, see our [LawFlash](#).

that it misled investors about the performance of an actively managed ETF and failed to accurately value certain fund securities. According to the SEC's order, to help increase the fund's initial performance, the adviser used a strategy that involved purchasing odd lot positions of non-agency mortgage-backed securities that traded at discounts to institutional round lot positions, and then valuing those odd lot positions at the higher round lot prices provided by a third-party pricing vendor. The SEC's order found that the adviser's policies and procedures were not reasonably designed to properly address issues concerning odd lot pricing, and that, by relying on the vendor's prices for round lots without any reasonable basis to believe that they accurately reflected what the fund would receive if it sold the odd lots, the adviser overstated the fund's net asset value almost every day in the four months following its launch in February 2012.



The SEC's order also found that the adviser made misleading statements regarding the reasons for the fund's initial performance in monthly and annual reports to investors by failing to disclose the impact of the "odd lot" strategy, and that the performance resulting from the strategy was not sustainable as the fund grew in size. Finally, the SEC's order found that the adviser negligently failed to disclose the existence and impact of the "odd lot" strategy to the fund's board of trustees, despite trustee inquiries about why the fund outperformed the adviser's similarly-managed mutual fund.

In February, the SEC [announced](#) that a dually-registered investment adviser and broker-dealer agreed to pay an \$8 million penalty and admit wrongdoing to settle charges related to inverse ETF investments it recommended to advisory clients. The SEC's order found that the respondent did not adequately implement its policies and procedures to ensure that clients understood the risks involved with purchasing inverse ETFs; failed to obtain from several hundred clients a signed disclosure notice, which stated that inverse ETFs were typically unsuitable for investors planning to hold them longer than one trading session unless used as part of a trading or hedging strategy; solicited clients to purchase inverse ETFs in retirement accounts with long-term investment horizons; and failed to require a supervisor to conduct risk reviews to evaluate the suitability of inverse ETFs for each advisory client, monitor the inverse ETF positions on an ongoing basis and ensure that certain financial advisers completed inverse ETF training.

SEC Shortens Settlement Cycle to T+2

On March 22, the SEC [adopted](#) an amendment to Rule 15c6-1 under the Exchange Act to shorten settlement times for most broker-dealer transactions from three business days after the trade date (T+3) to two business days (T+2). The amended rule is designed to enhance efficiency, reduce risk, and ensure a coordinated and expeditious transition by market participants to a shortened standard settlement cycle. The compliance date for the Rule 15c6-1 amendments is September 5, 2017.

Currently, creation and redemption orders between an ETF and its authorized

participants in the primary market settle on a T+3 basis. Purchases and sales of ETF shares on the applicable listing exchanges by investors in the secondary market also settle on T+3. As of the compliance date, both primary and secondary market transactions will be required to settle on T+2.

Interestingly, in the adopting release, the SEC appears to suggest that further shortenings of the settlement cycle to T+1 and T+0 are possible in the future, noting that such shortenings could potentially result in further risk reduction in the national clearance and settlement system. The SEC stated, however, that shortening the standard settlement cycle to T+2 is the appropriate step to take at this time because implementing a T+1 or T+0 settlement cycle could require market participants to incur comparatively larger investments and would necessitate more lead time and greater coordination.

TRENDING SEC STAFF COMMENTS

Recently, we have found the following topics to be areas of focus for the SEC staff in their reviews of registration statements for ETFs and examinations of investment advisers to ETFs.

Representations of Index-Based ETFs

In reviewing registration statements for index-based ETFs, the SEC staff increasingly is requesting that such ETFs represent that the methodology of the index they are designed to track is rules-based, permits limited or no discretion, and is in compliance with the ETF's exemptive order. The staff is also requesting that, if discretion may be used in limited circumstances, such circumstances be specified. Finally, the staff is requesting that the ETF provide the staff with a "white paper" or similar documentation that describes the index methodology and that the license or sublicense agreement to which the ETF is a party be included as an exhibit to the ETF's registration statement.

Waivers of Creation and Redemption Transaction Fees

In examining investment advisers to ETFs, the SEC staff is focusing on waivers of creation and redemption transaction fees, particularly whether such waivers are permitted in exemptive orders, whether procedures governing such waivers have been adopted, and whether the ETF has disclosed its ability to waive such fees and resulting conflicts of interest.



NEW PRODUCT REGISTRATIONS

The following is a list of ETFs registered under the 1940 Act that filed a [Form 8-A](#) between November 1, 2016 and March 31, 2017. Form 8-A is filed to register a class of securities under Section 12(b) or 12(g) of the Securities and Exchange Act of 1934 and is often filed in close proximity to an ETF's commencement of operations.

- [Hartford Multifactor Low Volatility International Equity ETF \(LVIN\)](#)
- [Hartford Multifactor Low Volatility US Equity ETF \(LVUS\)](#)
- [iShares iBonds Dec 2023 Term Muni Bond ETF \(IBML\)](#)
- [JPMorgan Global Bond Opportunities ETF \(JPGB\)](#)
- [PowerShares S&P SmallCap Quality Portfolio \(XSHQ\)](#)
- [PowerShares S&P 500 Value With Momentum Portfolio \(SPVM\)](#)
- [NuShares Enhanced Yield 1-5 Year U.S. Aggregate Bond ETF \(NUSA\)](#)
- [Arrow Reserve Capital Management ETF \(ARCM\)](#)
- [ETFS Bloomberg All Commodity Strategy K-1 Free ETF \(BCI\)](#)
- [ETFS Bloomberg All Commodity Longer Dated Strategy K-1 Free ETF \(BCD\)](#)
- [ETFS Bloomberg Agriculture Commodity Strategy K-1 Free ETF \(AGRI\)](#)
- [ETFS Bloomberg Energy Commodity Strategy K-1 Free ETF \(BEI\)](#)
- [ETFS Bloomberg Energy Commodity Longer Dated Strategy K-1 Free ETF \(BEF\)](#)
- [Direxion Auspice Broad Commodity Strategy ETF \(COM\)](#)
- [CWA Income ETF \(CWAJ\)](#)
- [Active Alts Contrarian ETF \(SQZZ\)](#)
- [Hartford Corporate Bond ETF \(HCOR\)](#)
- [Hartford Quality Bond ETF \(HQBD\)](#)
- [O'Shares FTSE Russell International Quality Dividend ETF \(OEEM\)](#)
- [iShares Core MSCI International Developed Markets ETF \(IDEV\)](#)
- [Saba Closed-End Funds ETF \(CEFS\)](#)
- [Tortoise North American Pipeline Fund \(TPYP\)](#)
- [Global X U.S. Infrastructure Development ETF \(PAVE\)](#)
- [VanEck Vectors Green Bond ETF \(GRNB\)](#)
- [Inspire Global Hope Large Cap ETF \(BLES\)](#)
- [Inspire Small Mid/Cap Impact ETF \(ISMD\)](#)
- [Inspire Corporate Bond Impact ETF \(IBD\)](#)
- [SerenityShares Impact ETF \(ICAN\)](#)
- [PowerShares Conservative Multi-Asset Allocation Portfolio \(PSMC\)](#)
- [PowerShares Moderately Conservative Multi-Asset Allocation Portfolio \(PSMM\)](#)
- [PowerShares Balanced Multi-Asset Allocation Portfolio \(PSMB\)](#)
- [PowerShares Growth Multi-Asset Allocation Portfolio \(PSMG\)](#)
- [First Trust TCW Opportunistic Fixed Income ETF \(FIXD\)](#)
- [Global X Founder-Run Companies ETF \(BOSS\)](#)
- [WisdomTree Global ex-Mexico Equity Fund \(XMX\)](#)
- [Tortoise Water Fund \(TBLU\)](#)
- [MomentumShares International Quantitative Momentum ETF \(IMOM\)](#)
- [MomentumShares U.S. Quantitative Momentum ETF \(QMOM\)](#)
- [ValueShares U.S. Quantitative Value ETF \(QVAL\)](#)





- [ValueShares International Quantitative Value ETF \(IVAL\)](#)
- [IQ S&P High Yield Low Volatility Bond ETF \(HYLV\)](#)
- [QuantX Risk Managed Growth ETF \(QXGG\)](#)
- [QuantX Risk Managed Multi-Asset Income ETF \(QXMI\)](#)
- [QuantX Risk Managed Multi-Asset Total Return ETF \(QXTR\)](#)
- [QuantX Risk Managed Real Return ETF \(QXRR\)](#)
- [QuantX Dynamic Beta US Equity ETF \(XUSA\)](#)
- [Dhandho Junoon ETF \(JUNE\)](#)
- [Virtus Cumberland Municipal Bond ETF \(CUMB\)](#)
- [Franklin Liberty International Opportunities ETF \(FLIO\)](#)
- [Davis Select Financial ETF \(DFNL\)](#)
- [Davis Select U.S. Equity ETF \(DUSA\)](#)
- [Davis Select Worldwide ETF \(DWLD\)](#)
- [PowerShares Treasury Collateral Portfolio \(CLTL\)](#)
- [ALPS/Dorsey Wright Sector Momentum ETF \(SWIN\)](#)
- [Direxion Daily Consumer Staples Bear 1X Shares \(SPLZ\)](#)
- [Direxion Daily Utilities Bear 1X Shares \(UTLZ\)](#)
- [O'Shares FTSE Russell Small Cap Quality Dividend ETF \(OUSM\)](#)
- [Pacer US Cash Cows 100 ETF \(COWZ\)](#)
- [NuShares ESG Large-Cap Growth ETF \(NULG\)](#)
- [NuShares ESG Large-Cap Value ETF \(NULV\)](#)
- [NuShares ESG Mid-Cap Growth ETF \(NUMG\)](#)
- [NuShares ESG Mid-Cap Value ETF \(NUMV\)](#)
- [NuShares ESG Small-Cap ETF \(NUSC\)](#)
- [NuShares Short-Term REIT ETF \(NURE\)](#)
- [John Hancock Multifactor Developed International ETF \(JHMD\)](#)
- [Janus SG Global Quality Income ETF \(SGQI\)](#)
- [Virtus Newfleet Dynamic Credit ETF \(BLHY\)](#)
- [WBI Power Factor™ High Dividend ETF \(WBIY\)](#)
- [PowerShares S&P International Developed High Dividend Low Volatility Portfolio \(IDHD\)](#)
- [iShares MSCI USA ESG Optimized ETF \(ESGU\)](#)
- [The WEAR ETF \(WEAR\)](#)
- [InfraCap REIT Preferred ETF \(PFFR\)](#)
- [Janus Short Duration Income ETF \(VNLA\)](#)
- [Global X MSCI SuperDividend® EAFE ETF \(EFAS\)](#)
- [JPMorgan Diversified Return U.S. Small Cap Equity ETF \(JPSE\)](#)
- [FlexShares® Core Select Bond Fund \(BNDC\)](#)
- [USCF Restaurant Leaders Fund \(MENU\)](#)
- [Legg Mason Global Infrastructure ETF \(INFR\)](#)
- [Legg Mason Emerging Markets Low Volatility High Dividend ETF \(LVHE\)](#)

PRIMARY CONTACTS

Morgan Lewis offers a deep bench of ETF lawyers who provide clients with insights into the legal, operational, and regulatory challenges facing the ETF industry. Our team draws on its understanding of US federal securities laws, derivatives, tax, and other disciplines to collaborate with clients and develop practical solutions and sophisticated products.

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