Brown Brothers Harriman

EXCHANGE THOUGHTS

BBH'S ETF NEWSLETTER

NYSE

Active ETFs: Helping Managers Navigate the Various ETF Structures

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In this edition of Exchange Thoughts, Brown Brothers Harriman (BBH) has teamed up with the New York Stock Exchange (NYSE) to create a general guide for asset managers as they assess the various active exchange-traded fund (ETF) structures approved by the SEC. The variety of structures now allow managers multiple avenues to deliver their active strategy in an ETF wrapper. Managers should weigh key factors such as the funds' asset class, portfolio transparency, and basket flexibility in their decision-making process.

State of the Active ETF Market

To be clear, actively managed ETFs are not a new phenomenon in the market. They've been in play for over a decade and now account for about 2.5% of ETF market share or $175 billion in assets under management (AUM). What's different now is the introduction of new structures through which active managers can deliver their investment strategies.

Like any other ETF, active ETFs have historically been required to disclose holdings each day. These structures have been popular with fixed income managers, where the transparency requirement is not widely seen as a drag on alpha generation. Conversely, disclosing daily holdings can be a barrier to entry for some equity managers, who see this level of transparency as a risk for front running and revealing their intellectual property to the market.

Daily holdings disclosure requirements saw a major regulatory update in 2020, when the first semi-transparent ETFs were approved by the SEC and came to market. Rather than publicly disclosing the portfolio each day, these structures allow managers to either limited to receipt by the Authorized Participant Representative (APR) or publish a daily proxy portfolio in lieu of the actual fund holdings. These structures, offered by Precidian ActiveShares™, the New York Stock Exchange, Fidelity, T. Rowe Price, Blue Tractor, and Invesco, are the result of over a decade of research and collaboration across the ETF industry and regulators. Importantly, these six novel structures are all ETFs and offer investors all the benefit of the wrapper — lower expenses, tax efficiency, intra-day liquidity — while allowing product managers to disclose their fund holdings on a monthly or quarterly lag, like a mutual fund.

The arrival of semi-transparent ETFs has been a boon for the active management space and helped fuel overall industry growth in 2020. Last year saw 31 new ETF issuers launch active ETFs in the U.S., and the number of active ETFs now accounts for approximately 20% of the 2,390+ U.S.-listed ETFs.

31 new ETF issuers in 2020

Active ETFs equal 20% of the US ETF listings

Currently, the SEC has approved the following ETF structures for use, all of which have live product in the market or in registration with the Securities Exchange Commission (SEC):

Transparent ETFs

These ETFs rely on publicly disclosed daily holdings of the portfolio to facilitate market trading and Creation/Redemption (C/R) activity. Traditional ETFs are offered by an array of managers, including those that qualify for SEC rule 6c-11, commonly known as the ETF Rule.

Precidian ActiveShares

ActiveShares rely on the daily disclosure of the portfolio to an Authorized Participant Representative (APR) to confidentially facilitate market trading and C/R activity on behalf of Authorized Participants (APs). This structure requires calculation of a verified intraday indicative value (VIIV) every second. The funds publicly disclose portfolios on a quarterly or monthly holdings basis on delay.

Proxy ETFs

These ETFs require the public disclosure of a daily proxy portfolio (e.g. tracker basket) that mimics the intra-day return of the actual portfolio to facilitate market trading and C/R activity. The actual portfolio is disclosed on a monthly or quarterly basis on delay. This structure is offered by Blue Tractor, Fidelity, New York Stock Exchange, T. Rowe Price, and Invesco.

Key Considerations

Now that managers can select from multiple active ETF structures, firms can assess their investment strategies to determine which choice is the best fit. As you can see from the chart below, these new structures are all ETFs and enjoy many similarities and benefits of traditional ETFs. However, all have unique nuances based on their regulatory approvals, operating model and methodology so managers need to assess each based on the type of investment strategy they aim to deliver.

Key Features of Transparent ETFs, ActiveShares ETFs and Proxy ETFs

STRUCTURAL FEATURES	TRANSPARENT ETFs	ACTIVESHARES ETFs	PROXY ETFs
Key Similarities			
Trades on exchange at market price	✔	✔	✔
In-kind trading permitted	✔	✔	✔
Potential for tax efficiency	✔	✔	✔
Trades at Market Price	✔	✔	✔
Arbitrage opportunity for Authorized Participants (APs) and market makers	✔	✔	✔
Key Differences			
License Required	No	Yes	Varies
Public Daily Holdings Disclosure	Yes	No	Yes, via Proxy
C/R facilitated via Authorized Participant Representative (APR)	No	Yes	No
Intraday Valuation*	No requirement	Verified Indicative Intraday Value (VIIV) every second	Requirement varies
C/R Trading Basket**	Pro rata slice; Custom basket permitted	Pro rata slice	Proxy

* While requirements may vary, many transparent ETFs and proxy ETFs publish an indicative intraday valuation (IIV).
** ActiveShares and many proxy structures have filed for regualtory approval to use custom baskets.

Based on our collective engagement with asset managers and the firms behind these structures, we have highlighted four critical considerations.

1

Permissible Asset Classes

All semi-transparent structures are currently limited to providing exposure to long-only, U.S.-exchange-listed equity securities and derivatives. Providers are seeking additional relief for non-U.S. equity, fixed income, and derivatives expansion, including short positions. before expanding exemptive relief into other corners of the market.

OF NOTE

- Foreign markets that trade synchronous to the US may be eligible and managers should consult with the licensee on specific permissions in the respective exemptive relief. Managers may be able to use ADRs and ETFs as tools to try to mimic returns of foreign positions/markets and other non-permissible asset classes.
- Some proxy-based portfolios have strict exceptions and limits as to which securities the proxy will hold. Managers should contact each provider for the full list of permissible assets and perspective on additional asset class relief.
- The timeline for SEC approval of non-U.S. holdings and other asset classes is unknown, but we expect the regulators will want to see a track record from managers under current permissions.

2

Degree of Transparency

A general rule of thumb in the ETF market is that full daily disclosure of actual portfolio holdings keeps secondary market spreads tight, as market makers are able to execute effective hedges and reduce the risk they would otherwise pass along to shareholders via wider spreads. The SEC paid particular focus to this potential impact to shareholders when reviewing and approving these new structures, which is partly why they are currently limited to U.S.-listed equities today. However, early signs show these new ETF structures trading commensurate with their fully transparent active cousins. In reviewing these new ETF structures, managers need to determine how much intellectual property they are comfortable disclosing while factoring in the concentration of their portfolio.

OF NOTE

- Transparent ETFs under SEC rule 6c-11 (the ETF Rule) need to disclose the full portfolio each day on the funds' websites.
- ActiveShares maintains full holdings confidentiality in that it does not provide any daily disclosure to market participants and adheres to traditional mutual fund holdings disclosure requirements.
- Each proxy structure leverages a unique methodology to manage the degree of actual holdings disclosed daily via the proxy portfolio. The proxy can change daily and managers can choose to include full disclosure of the actual portfolio, disclosure of portfolio constituents with the positions reweighted or partial disclosure. Full portfolio holdings are disclosed on a monthly or quarterly basis with a lag, depending on structure.
- Managers should consider the degree of disclosure in the proxy portfolio against how accurately it tracks the actual portfolio to ensure market makers can hedge their exposure appropriately.

Basket Flexibility

Investment managers, specifically portfolio management teams, may want to exert daily control over what comes in and out of the portfolio via the ETF's basket — the securities that an AP will deliver to, or receive from the fund for any Create or Redeem order. Deciding how much flexibility these teams want in this process is important, as the basket could be used to help a portfolio manager transition its securities and weighting composition via in-kind security delivery, reducing the need to buy and sell securities in the market or raise cash for redemption

OF NOTE

- Fully transparent, active ETFs qualifying for SEC rule 6c-11 are permitted to leverage pro-rata baskets based on the fund holdings, as well as custom baskets that provide the greatest amount of flexibility. These customs could allow managers to create specific C/R baskets, allowing the fund to receive the securities it wants, while delivering out the securities it would otherwise sell off, all via in-kind delivery. Additionally, these ETFs can accept cash-in-lieu orders.
- ActiveShares relies on a pro-rata basket of the actual portfolio for all C/R activity. Cash in-lieu is permissible, provided it's in the best interest of shareholders.
- For Proxy ETFs, the publicly disclosed proxy basket is used for all C/R activity and in-kind delivery of securities. Some proxy structures allow for that basket to be managed at the individual security level, to better mask the portfolio while allowing for in-kind delivery of securities. Cash in-lieu is permissible for all proxy structures, provided it's in the best interest of shareholders.
- ActiveShares and most proxy structure sponsors have filed for additional exemptive relief to allow for the use of custom baskets to further increase flexibility and improve tax efficiency.

Tax Efficiency

Naturally, active ETFs with more portfolio turnover may not be as tax efficient as their passive siblings. However, because of their ability to leverage in-kind security transfers, active ETFs may still be more tax efficient than traditional mutual funds. Under the ETF Rule, fully transparent ETFs can now utilize custom baskets to further improve efficiency.

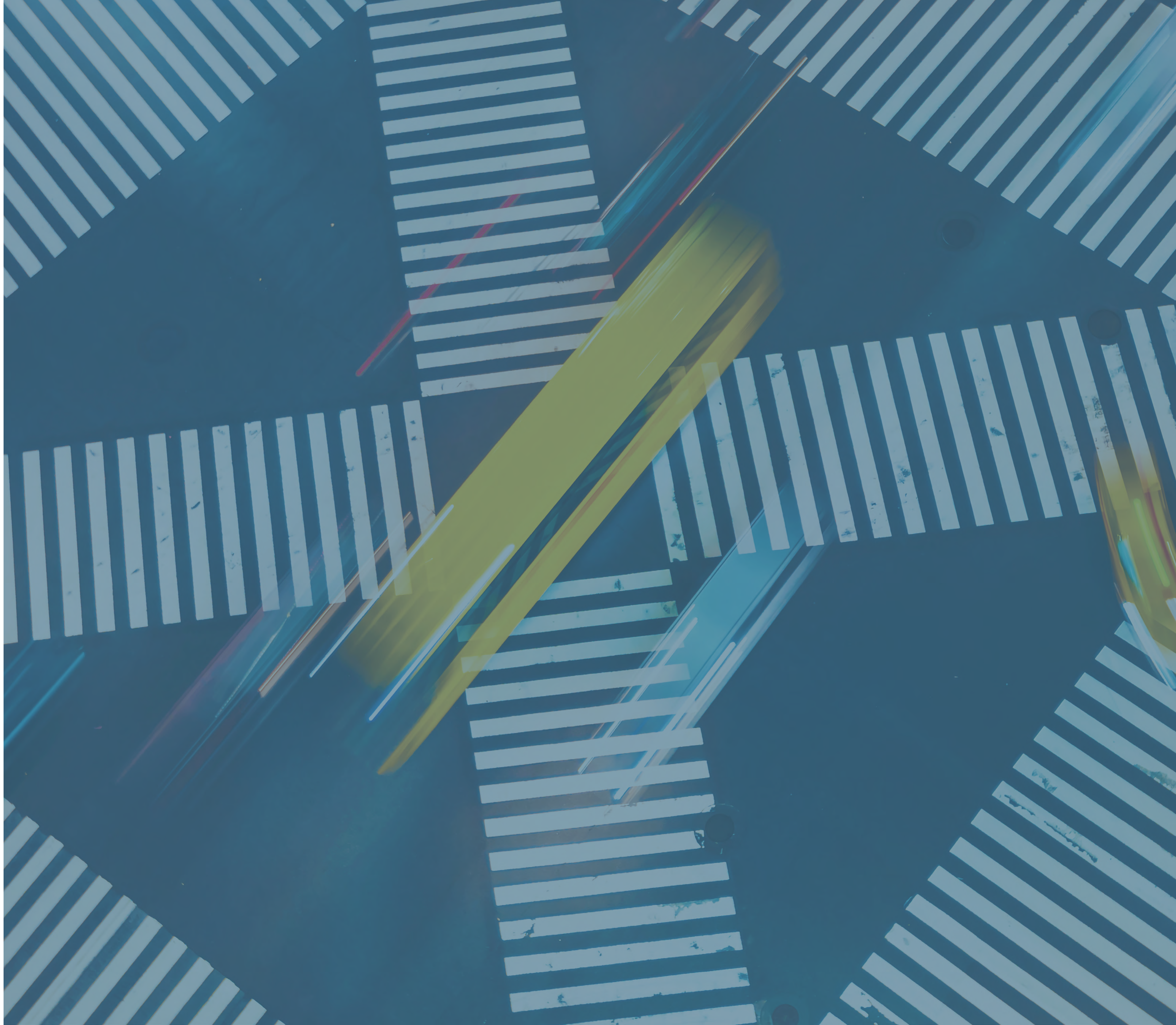
OF NOTE

- In-kind security transfers through the ETF C/R mechanism are tax exempt per IRS rules.
- Custom baskets available to transparent ETFs may foster more tax efficiency as securities with large unrealized gains can be redeemed out of the fund in-kind by an AP.
- While the ActiveShares pro-rata basket is not public, the APR does have access to the basket and will execute in-kind C/R orders on behalf of the AP, retaining the potential for tax efficient products.
- As Proxy ETF baskets are used for all C/R activity, this may cause proxies to receive or deliver securities and positions that differ from the actual portfolio. In turn, portfolio managers may need to place additional market trades to align these portfolios, increasing the trading cost and potential for capital gains.

While these topics are the most heavily discussed considerations for active managers evaluating structures, it is by no means an exhaustive list. Additional elements managers should also review include:

- Pricing strategy of the ETFs in relation to their proprietary products and new ETF peer group
- Support of active ETFs by the managers' intermediary and distribution partners
- Training and compensation planning for sales teams to support ETF marketing
- Cloning an existing strategy in a new active ETF offering, converting an existing mutual fund to an ETF or launching something new
- Manager approach and design of capital markets coverage for APs, APRs, and liquidity providers
- ETF specific requirements in the managers' daily operating model
- Alignment of fund service providers and ability to support these new products

The ETF industry is undergoing a period of standardization and many product attributes are now consistent from manager to manager. However, these new active structures all present some nuances that managers need to assess. BBH and the New York Stock Exchange are ready to help managers navigate these subtleties. We encourage both existing ETF managers and those new to the product to reach out and engage us directly on their active ETF assessment.



Over the past 15 years, Brown Brothers Harriman (BBH) has partnered with more than 50 asset managers and sponsors to bring passive and active ETFs to market in the US, Europe, and Hong Kong. We provide deep ETF SME and can help you assess the ETF landscape and support an ETF launch by providing consulting, custody, and fund accounting /administration services.

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