MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office

CC: Marc Perlman, Investment Counsel, NAIC Securities Valuation Office
Eric Kolchinsky, Director, NAIC Structured Securities Group and Capital Markets Bureau

DATE: November 15, 2019

RE: Proposed non-substantive amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* following a new SEC rule affecting exchange-traded funds.

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1. **Introduction** – On September 26, 2019, the SEC adopted rule 6c-11 (the "Rule") under the Investment Company Act of 1940 (the "Act") which will permit exchange-traded funds ("ETFs") that satisfy certain conditions to operate without first obtaining an exemptive order from the SEC under the Act. The SEC has stated that the intent of the rule is to modernize the regulatory framework for ETFs by reducing expenses and delays in creating new ETFs, to promote greater consistency, transparency and efficiency for ETFs and to facilitate greater competition among ETFs. The Rule becomes effective December 23, 2019, followed by a one year transition period for compliance.

   ETFs contain certain features that distinguish them from the types of investment companies originally contemplated by the Act and its rules and, therefore, have needed to rely on SEC exemptive orders to operate as investment companies under the Act. Current ETF exemptive orders provide relief from: (i) Sections 2(a)(32) and 5(a)(1) which require shares to be redeemable; (ii) Section 22(d) and Rule 22c-1 which require sales of redeemable securities to be at the public offering price and the redemption price to be at current net asset value ("NAV"); (iii) Section 22(e) which requires redemption proceeds to be delivered within seven days; (iv) Sections 17(a)(1) and (2) which prohibit affiliates from selling to, or purchasing from, an ETF; and (v) Section 12(d)(1) which places limits on funds of funds. The new Rule will end the need for exemptive relief for each of these requirements except item (v). Additionally, the Rule permits ETFs to use "custom baskets" which do not reflect a pro rata representation or representative sampling of the ETF's portfolio holdings and the SEC is rescinding current ETF marketing restrictions.

   In order to rely on the new Rule, an ETF must satisfy (i) the new definition of ETF as (a) an open-end management company that issues and redeems creation units to and from authorized participants in exchange for baskets and cash balancing, if any, and (b) which issues shares that are listed on a national securities exchange and traded at market determined prices and (ii) various conditions including: (a) updated website disclosure of holdings and baskets, NAV per share, market price, premiums or discounts, median bid-ask spread, and (b) adoption of policies and procedures that govern the construction and acceptance of baskets, including custom baskets.

   The Rule will rescind the exemptive orders from existing ETFs which will be able to rely on the Rule, going forward. However, certain categories of ETF will not be covered by the Rule, including leveraged ETFs, inverse ETFs, ETFs organized as Unit Investment Trusts (UITs), share class ETFs and non-transparent active ETFs. The SEC expects most ETFs to be covered by the Rule.

2. **Recommendations** – The SVO takes the position that since the Rule primarily affects SEC exemptive relief and ETF reporting and disclosure, it will not impact the quantitative and qualitative factors the SVO considers, in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* ("P&P Manual"), when analyzing ETFs. As such, the SVO recommends the following non-substantive changes (shown below with strikethrough and underline) to the P&P Manual to remove references to SEC exemptive orders from descriptions of ETFs and clarify that Regulatory Treatment Analysis Service application filers only need to provide SEC exemptive orders to the SVO when applicable.

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2019 P&P MANUAL

Part Three – SVO Procedures and Methodology for Production of NAIC Designations

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Investments in Funds

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Directive

246. The VOS/TF directs that the SVO establish and maintain: the various NAIC Lists of fund investments or compilation processes hereinafter identified; administrative procedures to receive applications of insurance companies and of fund sponsors; procedures to disseminate the Lists to insurance companies and state insurance regulators and analytical criteria and methodology to evaluate fund eligibility. The SVO shall evaluate:

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- Exchange Traded Funds (ETFs) registered with the SEC ~~and operating under Exemptive Orders under the Act~~ that predominantly hold bonds (or preferred stock) (as more fully described below) to determine if they are eligible for inclusion on the SVO-Identified Bond ETF list (reported on Schedule D, Part 1) [or SVO-Identified Preferred Stock List (reported on Schedule D, Part 2, Section 1)].

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NAIC FUND LISTS

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The SVO-Identified Bond ETF List and the SVO-Identified Preferred Stock ETF List

255. **Description** – ~~At this time, ETFs operate under an Exemptive Order granted by the SEC that provides relief from the application of provisions of the Investment Company Act of 1940 that would otherwise apply.~~ ETFs issue creation units to initial investors in exchange for a specified portfolio of bonds. The initial investor can hold the creation units or sell the ETF shares that constitute the creation unit on the exchange on which the ETF is registered. Other investors may purchase ETF shares; including to reconstitute and redeem a creation unit. Shares of ETF are not redeemable to the fund but are traded on registered exchanges at a price set by the market. Shares of ETFs are expected to trade at or near par because of arbitrage related to the value of the portfolio or of the ETF shares. For inclusion on the SVO-Identified bond ETF list, the ETF must hold a portfolio of bonds (or preferred stock) that tracks a specified bond index (a passive investment) or it a portfolio of bonds (or of preferred stock) that it actively manages pursuant to a specified investment objective.

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Documentation

277. An insurance company or the sponsor of a bond or preferred stock fund that request that the SVO conduct the look through and credit assessment submits the following required documentation to the SVO:

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- In the case of an ETF, copies of the Application, Notice and Order associated with the fund sponsor's request for Exemptive Relief from the SEC or a link to the SEC's EDGAR where the SVO can obtain the documents, if applicable.

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