The ETF Rule

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Executive Summary – Jim Toes
The “ETF Rule” was adopted by the SEC in Sept. ’19. Designed to improve ETF regulation, it applies to securities covered under the Investment Company Act of 1940 and aims to streamline the conditions around exemptive relief, making it easier for companies to bring their ETFs to market. The final rule is 269 pages and tonight’s call is only 25 mins.

Questions
What does the ETF Rule seek to improve?
There has been tremendous growth in the ETF industry and investors have a robust list of ETFs to choose from, so what is the problem that the ETF Rule seeks to solve? [response] It reduces costs and shortens the time period that issuers faced in getting exemptive relief required for bringing new ETFs to market. Thus, the Rule reduces a barrier to entry. It also provides relief for SEC staff who will no longer be required to review exemptive relief requests.

Impact to Fixed Income
Fixed-income ETFs are less than 5% of the FI AUM. Will the Rule go along to fuel this growth, and if so, how? [response] The Rule reduces a meaningful cost tied to the creation/redemption process of FI ETFs. Previously, issuers could only accept a whole pro rata slice of the fund or a full cash equivalent. Now, issuers are permitted to use custom basket which allows them to accept a portion of a bond index. This flexibility allows issuers to negotiate terms with an authorized participant. This should help the FI ETF space to grow faster.

Creation/Redemption Units
The ETF Rules allows, but does not require ETF issuers to lower the unit sizes on creation/redemptions. How does factor in to the ETF ecosystem? [response] The creation/redemption function is an efficient means to manage risk and capital for market makers. However, the costs to issuers on the creation/redemption process is on a “per transaction” basis. Therefore, decision on lowering the unit sizes for creation/redemption need to factor in these costs.

Notes from Fixed-income ETF Panel at STA’s 86th Annual Mkt Structure Conference LINK

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