IDC Independent Directors Council

Board Oversight of Exchange-Traded Funds

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About IDC

IDC represents independent directors and trustees who serve on the boards of mutual funds, closed-end funds, exchange-traded funds, and other registered investment companies. IDC's activities and advocacy promote excellence in fund governance for the benefit of shareholders. IDC's core mission is to:

- Deliver education and programming to enhance the effectiveness of independent directors in service to fund shareholders;
- Foster community and engagement among independent directors, including through peer-to-peer exchange and learning;
- Advocate for public policies from the independent director perspective in support of fund shareholders; and
- Promote public understanding.

Nothing contained in this report is intended to serve as legal advice. Each investment company board should seek the advice of counsel for issues relating to its individual circumstances.

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Board Oversight of Exchange-Traded Funds

Introduction

Demand for exchange-traded funds (ETFs) has grown markedly as investors—both institutional and retail—increasingly turn to them as investment options in their portfolios. With the increase in demand, sponsors have offered more ETFs with a greater variety of investment objectives.

ETFs are commonly structured as open-end investment companies, and generally are governed by the same regulations as other open-end funds (i.e., mutual funds) under the Investment Company Act of 1940 (1940 Act). Because ETFs have some different characteristics than mutual funds, however, ETFs also must rely on exemptive relief from the Securities and Exchange Commission (SEC) from certain provisions of the 1940 Act. Most ETFs rely on Rule 6c-11 under the Investment Company Act (the ETF Rule), which permits the operation of ETFs that publish their portfolios each day. Other actively managed ETFs, however, do not publish their portfolios daily (known as non-transparent or semi-transparent active ETFs) and therefore must operate pursuant to exemptive orders granted by the SEC. In addition, investment companies that offer classes of ETF shares must operate pursuant to exemptive orders granted by the SEC.

This paper focuses on ETFs structured as open-end funds, which require oversight by a fund board, and not on other exchanged-traded products, such as commodity ETFs and exchange-traded notes (ETNs), which are not subject to the 1940 Act and are not governed by boards.[1]

An ETF director's responsibilities are substantially similar to those of mutual fund directors, although with some differences and distinct areas of focus. Like all fund directors, ETF directors have a fiduciary duty to the fund and serve to protect the interests of fund shareholders.

[1] ETFs that invest in commodity derivatives (typically futures and/or options) are regulated primarily by the Commodity Futures Trading Commission as commodity pools, while those that invest solely in physical commodities are regulated by the SEC under provisions of the Securities Act of 1933 (1933 Act). ETNs are unsecured debt securities, typically issued by banks, which, like bonds, can be traded or held to maturity by an investor. These securities are registered under the 1933 Act but not under the 1940 Act. See Frequently Asked Questions About How ETFs Compare with Other Investments, available at www.ici.org/faqs/faqs_etfs_other_invest. ETFs also may be structured as unit investment trusts (UITs), which are registered under the 1940 Act. Commodity ETFs, ETNs, and ETFs structured as UITs are not required to have a board.

In January 2024, the SEC permitted the registration and listing of exchange-traded products that hold bitcoin. Because bitcoin is not a security, these exchange-traded products are not registered as investment companies under the 1940 Act and do not have boards.

The Independent Directors Council (IDC) has prepared this document to assist directors of ETFs in performing their oversight responsibilities. The paper also may be useful for directors who do not currently oversee ETFs but wish to be more familiar with a board's oversight role, including those whose fund groups may currently invest in ETFs or intend to launch ETFs in the future. The paper includes practical guidance in the form of potential questions to ask in areas that may be of particular interest in the ETF context.

Additional background information relating to ETFs is available at the Investment Company Institute's Exchange-Traded Funds Resource Center,[2] which includes frequently asked questions on such subjects as the ETF structure, the US ETF market, and how ETFs compare to other investments, including mutual funds. The SEC's Office of Investor Education and Advocacy also issued a bulletin to educate investors about ETFs.[3]

Overview of ETFs

Simply put, ETFs are open-end funds whose shares trade on securities exchanges. Like a mutual fund, an ETF represents a portfolio of investment assets (e.g., stocks, bonds, cash, swaps, futures, and forwards), and each share represents an undivided interest in that pool of assets. ETFs also comply with the same overarching regulatory framework as mutual funds. For example, an ETF must comply with limitations on leverage and liquidity; its assets must be maintained separate from the assets of the adviser (typically with a custodian); and it must calculate its net asset value (NAV) daily. ETFs also qualify as registered investment companies under the tax laws and, as such, must meet a tax diversification test every quarter.[4] In addition, ETFs have a chief compliance officer, designated by the board, who administers the ETF's compliance program.

While ETFs share many characteristics with mutual funds, the exchange-traded nature of an ETF's shares creates key operational and structural differences. One major difference is that investors buy and sell ETF shares on a stock exchange through broker-dealers, much as they would trade individual stocks. In contrast, mutual fund shares are not listed on stock exchanges. Investors buy and sell mutual fund shares through a variety of distribution channels, including directly from a fund company or through a financial adviser or broker-dealer.

In addition, the exchange-traded nature of ETFs may create differences in the prices investors pay for, or receive on selling, their shares. Mutual fund investors can place orders to buy or sell shares throughout the day, but all orders, regardless of when received during the day, will receive the same price—the fund's NAV at the next time it is computed (usually 4:00 p.m. ET). In contrast, orders for ETF shares can be placed and executed intraday at the current market price based on trading on a stock exchange.

[2] Available at www.ici.org/etf.

[3] Available at http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-exchange-traded-funds-etfs.

[4] ETFs, like mutual funds, are subject to special tax rules set forth in subchapter M of the Internal Revenue Code.

Certain specified institutional investors, called "Authorized Participants" or "APs," however, are able to transact with the ETF at the end of the day at the ETF's NAV. In ETF parlance, these transactions are called "creations" (for purchases) and "redemptions." Each business day, the ETF publishes the contents of a "creation basket," which is a specific list of names and quantities of securities or other assets the ETF will accept for a creation or will pay out for redemption. An AP provides the creation basket or cash (or both) to the ETF, which then issues to the AP a "creation unit," a large block of ETF shares (such as 50,000 shares). The AP can either keep the ETF shares that make up the creation unit or sell all or part of them on a stock exchange at market prices. For more information about the process for creating and redeeming ETF shares, see Frequently Asked Questions About ETF Basics and Structure.[5]

Investors use ETFs in a variety of ways. Individual investors may use ETFs to build a diversified portfolio for the long term, or use one or more ETFs to gain exposure to a certain asset class—either for the long term or temporarily. Institutional investors and other traders may use ETFs in the same way. They may also use ETFs for shorter-term purposes, such as to obtain short-term exposure to an asset class or hedge other investments in a portfolio.

[5] Available at www.ici.org/faqs/faqs_etfs.

Comparison of Key Features of ETFs and Mutual Funds

	ETFs	Mutual funds
REGULATORY FRAMEWORK	Regulated as open-end funds under the 1940 Act; either operate under the ETF Rule or through exemptive orders (for non-transparent or semi-transparent active ETFs and for ETF classes); subject to exchange's listing requirements.	Regulated as open-end funds under the 1940 Act.
BOARD OVERSIGHT	Required to have a fund board.	Required to have a fund board.
TRANSPARENCY REQUIREMENTS	Daily disclosure of portfolio holdings and/or composition of creation basket (except for some non-transparent or semi-transparent active ETFs), in addition to quarterly disclosure of portfolio holdings.	Quarterly disclosure of portfolio holdings.
SHARE PRICES	Individual shares are bought and sold on a stock exchange at market-quoted prices throughout the trading day. Only APs transact with the ETF at the NAV through creation unit transactions.	Shares purchased or redeemed throughout the day receive the same daily price—the fund's NAV at the next time it is computed (usually 4:00 p.m. ET).
TAX EFFICIENCY	To the extent that an ETF distributes its portfolio holdings "in kind" to APs that redeem shares, the ETFs do not incur capital gains on the disposition of portfolio holdings (and may also distribute low cost basis holdings to the redeeming AP). Instead, investors pay taxes on the appreciation of their ETF shares when they sell them. This may make some ETFs more tax efficient than comparable mutual funds.	Share redemptions by a mutual fund investor may require the fund manager to sell portfolio holdings at a gain, which will result in taxable distributions to shareholders if there are no offsetting losses. This may make some mutual funds less tax efficient than comparable ETFs.

As discussed below, ETFs, like traditional mutual funds, generally can be classified as index-based or actively managed. Currently, the vast majority of ETFs are index-based.

- **Index-based.** An index-based ETF tracks the performance of a target index either by replicating the holdings of the index (i.e., holding all securities in the target index in the same proportion as the index) or using an optimization or sampling technique (i.e., holding only a representative sample of the component securities). Representative sampling is a practical solution for an ETF when its target index contains hundreds or thousands of securities or some securities that are hard to obtain and/or trade.
- **Actively managed.** An actively managed ETF does not seek to track the return of a particular index. Instead, its investment adviser, like the adviser of an actively managed mutual fund, creates a unique mix of investments to meet a particular investment objective and policy. Most actively managed ETFs rely on the ETF Rule and therefore are required to publish their portfolios daily on their websites. Some actively managed ETFs, referred to as non-transparent or semi-transparent active ETFs, operate under SEC exemptive orders and do not publish their portfolios daily, but instead publish intraday values of their portfolios every second or publish proxy portfolios that have characteristics and pricing similar to the actual portfolios.

Certain ETFs called leveraged or geared ETFs seek to provide magnified exposure to an index (typically by a multiple of two or three times the return of the index) as measured on a daily basis. Inverse ETFs seek to produce the opposite of the daily return of an index, and also may be leveraged to magnify performance.

The market price of an ETF share on an exchange is influenced by the forces of supply and demand. While imbalances in supply and demand can cause the price of an ETF share to deviate from the market value of the assets held in the ETF portfolio, substantial deviations tend to be short-lived for many ETFs.

Two primary features of an ETF's structure promote trading of an ETF's shares at a price that approximates the market value of the ETF's underlying assets: (1) knowledge of the approximate intraday value of the ETF portfolio; and (2) the ability for APs to create or redeem ETF shares at the NAV at the end of each trading day.

ETFs may use different approaches to communicate information about the intraday value of the ETF portfolio. Some ETFs contract with third parties (typically market data vendors) to calculate an estimate of an ETF's intraday value (an "intraday indicative value" or "IIV"), based on the ETF's portfolio information. Such IIVs are disseminated at regular intervals during the trading day (such as every 15 seconds). Some market participants use their own computer programs to estimate the underlying value of the ETF on a more real-time basis based on an ETF's published portfolio. A non-transparent or semi-transparent active ETF may publish an approximate portfolio value every second or may publish a proxy portfolio with characteristics and pricing that are similar to the actual portfolio. With each of these approaches, knowledge of the approximate value of an ETF's holdings enables investors to observe discrepancies between the market price of an ETF's share and its estimated underlying value during the trading day.

The creation and redemption process allows APs to engage in an arbitrage strategy that adjusts the supply of an ETF's shares in the market, and thus helps the ETF trade at market prices approximating its estimated underlying value. For example, when an ETF is trading at a premium (a market price higher than the value of the ETF's portfolio securities), APs may sell short the ETF shares during the day while simultaneously buying underlying portfolio securities. At the end of the day, the AP will deliver the creation basket of securities to the ETF in exchange for ETF shares that they use to cover their short sales. The AP will make a profit (the difference between its purchase price of the underlying securities and the sale price of the ETF shares), and the additional supply of ETF shares should help bring the ETF share price back in line with the estimated value of its underlying assets. When an ETF is trading at a discount, the reverse happens (i.e., the AP may buy the ETF shares and sell short the underlying securities). See "What determines an ETF's price?" in Frequently Asked Questions About ETF Basics and Structure[6] for more detail.

Although ETF shares are designed to trade on the secondary market at a price that approximates the market value of their underlying assets, they typically trade at some premium or discount, for a number of reasons. For one, an AP will generally create shares only when the premium is sufficient for it to realize a profit after covering the associated trading costs. The ETF's bid-ask spread and liquidity, as well as the liquidity of the underlying securities, factor into the trading costs, which APs consider when determining whether to engage in arbitrage transactions. Trading costs may be higher with respect to some ETFs than others. For example, international equity ETFs typically have higher spreads than domestic equity ETFs. The higher spreads are due to higher transaction costs in the underlying securities, as well as increased market risks absorbed by the market maker resulting from underlying markets being closed during ETF trading hours.

Oversight by Fund Directors

ETF directors have the same general oversight responsibilities for a fund's management and operations, under the same regulatory framework, as the directors of other registered funds. The 1940 Act imposes a number of responsibilities on fund directors in addition to the duties of loyalty and care to which they are typically bound under state law. Courts have held that independent directors, in particular, serve an important role on behalf of the fund's shareholders: they serve as independent watchdogs and oversee potential conflicts of interest between the fund and its adviser and other affiliates.

ETF directors, like all fund directors, engage in a variety of oversight activities. They meet regularly, request and review written and oral information relating to fund matters, and engage in ongoing discussions with the adviser, counsel, and others. They oversee compliance, portfolio performance, valuation, and disclosure, among other functions. They also annually review and approve continuation of the advisory contract. (For more information about fund directors' roles and responsibilities generally, see Frequently Asked Questions About Mutual Fund Directors.[7])

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[6] *See* id.

[7] Available at www.idc.org/idc/faqs/mutual-fund-directors#.

ETFs may be subject to requirements in addition to those imposed by the federal securities laws, such as those imposed by the exchange on which the ETF is listed. For example, the New York Stock Exchange requires each audit committee member to be "financially literate." ETFs, however, are often exempt from certain listing requirements (including those applicable to closed-end funds), such as the requirement to hold an annual shareholder meeting. Accordingly, ETFs are subject to listing requirements that do not apply to mutual funds (which are not listed on an exchange) and that are different than the listing requirements for closed-end funds.

ETFs may also be subject to SEC exemptive relief conditions that impose certain additional responsibilities. For example, most ETFs operate in reliance on the ETF Rule, the SEC rule that grants exemptions from various provisions of the 1940 Act in order to permit ETF operations. Non-transparent or semi-transparent active ETFs rely on SEC exemptive orders to operate instead of the ETF Rule because those ETFs do not publish their portfolios on a daily basis. Rule 12d1-4 under the 1940 Act (the Fund of Funds Rule) is an exemptive rule that permits other funds to purchase ETF shares in excess of the limits imposed by the 1940 Act.[8] Each of these exemptive rules and orders contains unique requirements that should be addressed with board-approved compliance procedures. More information on ETF exemptive relief can be found below.

Potential Areas of Inquiry

The oversight practices of ETF directors (such as types of reports reviewed, topics discussed with the adviser, and questions asked) vary depending upon a number of different factors, including the investment objective of the ETF(s) overseen by the board (e.g., index or actively managed, international or domestic, equity or fixed income). Below is a list of topics and questions that a board might consider in connection with its oversight of ETFs.

The matters below are not intended to reflect best practices or to be a model for boards to follow, as there is no "one size fits all" approach to board oversight. Rather, the questions are meant to assist boards in considering the types of information they might seek and discuss with the adviser and other service providers as part of their oversight responsibilities. Many boards may already address these topics, while others may determine that the topics are not applicable, given the facts and circumstances of their particular funds.

[8] Section 12(d)(1) of the 1940 Act limits the amount one fund can invest in another fund. A fund may use ETFs to implement an investment strategy (e.g., to allocate assets easily among different asset classes; to gain interim exposure to a particular market while gradually investing directly in that market) and may want to own ETFs in excess of these limits.

Regulatory Framework for ETFs

Historically, ETFs have needed exemptive relief from a number of provisions of the 1940 Act in order to operate. In general, the relief relates to the ability to create and redeem shares at the NAV only with Authorized Participants and in units of a designated size (the creation unit), while at the same time allowing ETF shares to trade on a secondary market at negotiated prices, rather than at the NAV.

Today, most index and active ETFs operate under the ETF Rule. The ETF Rule contains some important operational requirements, such as the requirement that the ETF must disclose its portfolio holdings on its website each day before trading begins on the primary listing exchange for the ETF. The ETF is also required to disclose information about the premiums and discounts at which the ETF shares trade, as well as information about the bid-ask spread on the trading of the ETF shares. While the ETF Rule does not specify any particular director obligations, the rule provides that an ETF must adopt and implement written policies and procedures that govern in-kind basket transactions between the ETF and Authorized Participants. To the extent that an ETF uses custom baskets that vary from the standard baskets, the policies and procedures must contain detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders. As part of its oversight role, the board reviews and approves such policies and procedures as part of the compliance program for the ETF, which may vary among ETF fund groups. For example, some policies may envision a board reporting process with respect to custom baskets.

With respect to non-transparent or semi-transparent active ETFs that do not publish their portfolios daily, the SEC has granted limited exemptive relief through exemptive orders. Notably, the ETFs are only permitted to invest in certain specified assets. The exemptive relief also requires special risk disclosure in the prospectus and other marketing materials about the potential that less portfolio transparency may cause the ETF shares to trade at prices that are different than the NAV and at wider bid-ask spreads. The exemptive applications for this relief also provide that the investment adviser to the ETF would promptly call a meeting of the board in certain situations, such as if the ETF shares trade at a significant premium/discount or bid-ask spread over an extended period of time. In that case, the board would have to consider whether shareholders were being harmed, and what action to take, if any.

Some ETFs are also offered to investors as shares of an investment company that offers both ETF classes and mutual fund classes. This type of ETF structure is not covered by the ETF Rule, so fund groups that wish to offer ETF classes of shares would need an exemptive order from the SEC.[9] As with any investment company that offers multiple classes, the board would need to approve a written plan setting forth the class structure, and would need to find that the plan is in the best interests of each class individually and the company as a whole.

[9] As of early 2024, only one fund complex has obtained the necessary exemptive relief from the SEC to offer ETF share classes. However, multiple other fund complexes have filed exemptive applications to permit ETF classes and these applications are pending with the SEC. Any future exemptive orders granted in response to those applications may be subject to terms and conditions that include board obligations or findings.

In addition to exemptive relief to permit basic ETF operations, many ETFs also rely on the Fund of Funds Rule so that mutual funds and other investment companies, including funds from different groups of investment companies, may make significant investments in ETF shares. Under the requirements of the rule, the investment adviser to the underlying ETF would need to make a finding that any undue influence concerns associated with the investment are reasonably addressed. The adviser must report this finding and the basis for the finding to the board no later than the next regularly scheduled meeting. If the acquiring fund and the acquired ETF do not have the same investment adviser, then the funds also must enter into a fund of funds investment agreement that includes any material terms necessary for the advisers to make their findings under the rule. The board may be asked to review this agreement or a form of this agreement.

ETF directors should understand whether the ETF is operating under the ETF Rule or an exemptive order. If the ETF is operating pursuant to an exemptive order, then the directors should understand the general terms of the exemptive relief under which the ETF operates, the conditions for that relief, and the adviser's processes for ensuring compliance with the conditions. The directors, of course, should know if the exemptive relief and related compliance procedures impose certain responsibilities on them.

Directors might consider:

- Do the ETFs rely on the ETF Rule or an SEC exemptive order for ETF operations?
- If an exemptive order is necessary, what is the process for obtaining the order from the SEC and how long might it take?
- Has the SEC previously granted similar relief to other ETFs?
- What are the conditions to the exemptive relief? What processes are employed to ensure compliance with those conditions?
- Does the exemptive relief (or the related compliance procedures) impose specific responsibilities on the fund board?
- In connection with any fund of funds exemptive relief, has the investment adviser to an underlying ETF explained why an investment under the Fund of Funds Rule would not raise concerns about undue influence by the acquiring fund over the ETF?
- Does any fund of funds investment agreement between an acquiring fund and an underlying ETF address the material terms supporting the investment adviser's finding?

ETF Design and Investment Objective

To provide a framework for overseeing the management and operations of an ETF, directors should have a general understanding of the structure and investment objective of the ETF, just as they would for a traditional mutual fund. The board also might seek to understand how the ETF's investment objective affects its design and the adviser's expectations for the ETF's performance, given that design. Many ETFs that follow very broad indexes use an optimization or sampling technique to track the performance of the index because it is impractical to hold all the index components. An ETF also might weight its holdings differently from its underlying index in order to comply with applicable legal requirements. For example, some sector or country funds are not permitted to hold the full weighting of a single security because of securities or tax law diversification requirements.

The design of an index-based ETF may involve trade-offs between minimizing tracking error, on one hand, and reducing costs and increasing efficiency of the creation and redemption process, on the other. An ETF that replicates (rather than samples) an index may minimize tracking error because it is an exact replica of the index. However, depending on the number of underlying securities and their liquidity, among other factors, it also might have higher trading costs for APs, which could lead to higher premiums and discounts. By contrast, an ETF that samples its index may have a higher tracking error, but may be less costly to create and redeem and therefore may trade more efficiently. The liquidity of the securities in the index also is a factor: the bid-ask spread is likely to be much lower for an ETF with highly liquid portfolio securities, such as an S&P 500-based index ETF, than one that tracks an index with less-liquid securities.

The board also might inquire whether APs will be permitted to purchase or redeem creation units in kind, with cash, or both (subject to the parameters of the relevant ETF exemptive relief and related procedures). ETFs that track indexes of less-liquid or hard-to-obtain securities, or securities that cannot be readily transferred to APs, such as those in an emerging market index, might allow APs to purchase creation units in cash, rather than with a creation basket of securities. Cash transactions create transaction costs for the funds, however, and eliminate some of the tax efficiencies created by the in-kind creation/redemption process. Where APs purchase or redeem creation units partly or wholly in cash, ETFs typically charge APs an additional fee to protect shareholders from the transaction costs associated with investing the cash or selling portfolio holdings to generate cash.

Whether creation units may be purchased or redeemed in cash also may be a factor in determining whether and what kind of policies the ETF should have to detect and deter frequent trading and market timing of ETF shares.[10] Often, it may not be necessary to adopt a policy because frequent trading of ETF shares on secondary markets does not disrupt portfolio management or raise the other types of concerns relating to market timing that frequent trading of mutual funds do. With respect to the creation and redemption process, frequent creation and redemption activity by APs similarly would not disrupt portfolio management if the transactions are done in kind. If an ETF permits creations or redemptions partly or totally in cash, some boards may determine to adopt policies on frequent trading, while other boards may determine that it is not necessary to adopt a policy for various reasons, including, for example, the payment by APs of fees, which are designed to protect the ETF and its shareholders from the dilutive costs associated with the creation and redemption activity.

Directors might consider:

- What is the investment objective of the ETF and what is the adviser's strategy for seeking to achieve this investment objective?
- How does the ETF fit within the adviser's fund offerings? If the ETF's investment objective is similar to existing funds within the complex, what is the expected impact of the ETF on the existing fund and its shareholder base?
- If the ETF is index-based:
  - How was the index selected? What are the characteristics of the index? What due diligence was performed on the index provider?
  - Does the adviser seek to replicate the index or sample it? If it uses an optimization or sampling technique to track the performance of the index, why does the adviser believe its methodology is appropriate?
  - Does the construction of the index pose any SEC or Internal Revenue Service (IRS) limitation issues (e.g., diversification)?
  - Are there any size limitations to the ETF?
  - Does the ETF seek to return a multiple of its target index (e.g., for a leveraged ETF) or an inverse of the index? What is the adviser's strategy for seeking to achieve this objective?

[10] All funds, including ETFs, must disclose whether the board has adopted policies and procedures with respect to frequent purchases and redemptions of fund shares by fund shareholders. See Item 11(e) of Form N-1A under the 1940 Act.

» If the ETF is actively managed:

  » How frequently does the portfolio manager anticipate trading portfolio securities?

  » What processes does the adviser employ to minimize the potential for market participants to access the ETF's investment strategies (free ride) or to trade ahead of the ETF (front-running)?

» Are APs permitted to create and redeem in kind, in cash, or both? What are the key considerations and implications with respect to those options?

ETF Contractual Relationships

ETF directors oversee the same types of service providers as mutual fund directors—e.g., the adviser, auditor, distributor, custodian, and transfer agent. However, the focus of their oversight may be tailored to the ETF context. (For more information about directors' oversight of service providers, see *Board Oversight of Certain Service Providers and Board Oversight of Subadvisers.*[11]) For instance, the distributor plays an important role in promoting the ETF to APs and market makers, whose trading helps to maintain efficient pricing of ETF shares. The APs operate pursuant to a contract, typically with the ETF and its distributor. The APs are not selling agents of the ETF, however, and have no legal obligation to purchase or redeem creation units. All fund boards, including an ETF board, oversee the distributor and annually approve the continuation of the fund's contract with it. ETF directors might consider the distributor's services in connection with the APs and market makers when evaluating the distributor's services.

The board also may oversee additional contractual relationships, including with a primary listing exchange. Listing on an exchange provides an organized and continuous trading market for the ETF shares at negotiated prices. The ETF will contract with a primary listing exchange, which also provides a designated or lead market maker for the ETF.

Some ETF sponsors may contemplate listing ETFs on foreign exchanges to gain access to investors in foreign markets. ETF directors will want to be aware of any material implications for the ETF, its shareholders, and the board if the ETF were listed on a foreign exchange, including the risks and potential liabilities under the foreign jurisdiction.

For an ETF that is index-based, another important contractual relationship can be the license that permits the ETF to track the index. Such licensing agreements may be between the investment adviser and the index provider, but ETF directors should be aware of the key aspects of the relevant arrangements. An index provider may be unaffiliated or affiliated with the investment adviser to the ETF. The considerations relating to the relationship with the ETF index provider will be similar to those of an index provider for a traditional mutual fund.

[11] Available at www.idc.org/pdf/21229.pdf and www.idc.org/pdf/idc_10_subadvisers.pdf, respectively.

A non-transparent or semi-transparent active ETF (or its investment adviser) also may need a license to utilize one of the methods that the SEC has approved as an alternative to full portfolio transparency. As noted above, the SEC has issued exemptive orders that approve ETFs that use various approaches to providing portfolio information to the market, such as providing an approximate portfolio value every second or publishing a proxy portfolio with characteristics and pricing that are similar to the actual portfolio. Non-transparent or semi-transparent active ETFs or their investment advisers may license these methodologies from the service providers that originally obtained SEC approval.

With respect to a primary listing exchange, directors might consider the following:

- Why was the exchange selected to serve as the primary listing exchange? What are the listing costs?
- Do the listing standards of the exchange impose responsibilities on the board?
- Who is the recommended lead or designated market maker? What is the market maker's expertise? What is the market maker's willingness to make capital commitments, including seed capital, to support the ETF?
- If listing on a foreign exchange is being contemplated, what are the key implications for the ETF, its shareholders, and the board (including any potential liabilities)?

With respect to an index provider, directors might consider the following:

- Is the index maintained by the fund adviser or a third party?
  - If by the fund adviser, what processes and policies are in place to prevent communication of material nonpublic information by index personnel?
- What are the key terms of the licensing agreement (e.g., cost, exclusivity, duration, and termination)?
- When will the licensing agreement with the index provider expire? What are the adviser's contingency plans if it is unable to renew the license? Is the ETF's name linked to the name of the index?

Trading of ETF Shares

Directors should have a general understanding of the processes for creating and redeeming ETF creation units, the trading of ETF shares on the secondary market, and how the adviser seeks to ensure that these processes work for the benefit of ETF investors. Important considerations include the extent to which ETF shares have been trading at a premium or a discount, as well as the bid-ask spread, which is an important element of the cost to ETF investors.

To oversee the ETF's trading, fund boards might receive regular reports regarding premiums and discounts, bid-ask spreads, tracking error and correlation, and trading volume. Boards also might receive periodic reports on the number of APs, the number of market makers, and their trading volumes so that a board is generally familiar with their activities in making markets for the ETF.

Like other open-end funds, an ETF also must adopt and implement a written liquidity risk management program that is reasonably designed to assess and manage its liquidity risk under Rule 22e-4 under the 1940 Act (the Liquidity Risk Management Rule). The assessment and management of liquidity risk must include a consideration of the relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, ETF shares trade, including the efficiency of the arbitrage function and the level of active participation by market participants (including Authorized Participants). An ETF also must consider the effect of the composition of its baskets on the overall liquidity of the ETF's portfolio. An ETF's board must initially approve the liquidity risk management program and periodically review reports relating to the program.

Directors might consider the following:

- Have ETF shares been trading persistently at a premium or a discount on the secondary market?
  - If so, why is that? What steps are being taken to address this?
- What has been the historic bid-ask spread for the ETF's shares in the secondary market? How does this spread compare with relevant industry data?
  - If historic spreads are larger than, or significantly different from, relevant industry data, what are the reasons? Are there any steps that should be taken to address this?
- What has been the trading volume? How does it compare to relevant industry data?
- What are the exchange's policies for breaking trades, and how frequently have trades of the ETF's shares been broken?
- How does the liquidity of the ETF portfolio impact the trading of the ETF shares?

As discussed in the next section, boards also may inquire about the ETF's tracking error.

Portfolio Management and Trading of Underlying Securities

ETF directors' considerations in overseeing performance will be similar to those of mutual funds with similar investment objectives. For instance, as noted earlier, tracking error will be a key consideration for the director of an index-based ETF, just as it is for the director of an index mutual fund. If the ETF tracks an index using a sampling methodology (rather than replicating the index), performance oversight will likely include evaluation of the effectiveness of that methodology. The relationship of the ETF's portfolio performance with the process for creating ETF shares also might be a point of inquiry. For instance, as noted earlier, sampling may enable APs to more cost-effectively assemble the creation basket and participate in arbitrage transactions, which then promotes liquidity in the ETF shares. However, sampling also is likely to produce a larger tracking error than replicating the index would.

A number of factors may affect the ETF's tracking error (for both those that seek to replicate the index and those that sample it), including portfolio trading and differences in the pricing sources and methodology of the ETF and the index. For example, an international ETF and its target index may price the same securities differently because the index generally uses closing prices on local markets while the ETF must value its securities at "fair value" prices reflecting the events that occur after the close of local markets. In addition, the index may use different pricing vendors.

While directors of actively managed ETFs have the same oversight responsibilities regarding portfolio management as directors of a traditional mutual fund, they also have some areas of inquiry about trading considerations unique to ETFs. In theory, an actively managed ETF could trade its portfolio securities regularly. In practice, however, most existing actively managed ETFs trade less frequently for a number of reasons, including minimizing the risk of other market participants front-running their trades (submitting trades in advance of the ETF to take advantage of any predictable changes in security prices). In addition, a relatively stable portfolio promotes arbitrage and AP trading.

Additionally, if the ETF has an investment objective similar to other mutual funds in the fund complex, then the ETF board might inquire about trade allocation policies and other policies that address potential conflicts of interest between funds.

Some ETFs may use derivatives to implement their investment strategies. For example, a leveraged ETF might use swaps or futures as a substitute for investing directly in stocks or bonds, in order to gain leveraged exposure to a target index. As is the case with traditional mutual funds, the ETF board may wish to inquire about how the adviser proposes to use derivatives and the processes it will use for managing risks associated with them. For more information about derivatives oversight, see IDC's paper, *Board Oversight of Derivatives*.[12] Some ETFs also may engage in securities lending, and the board's oversight role would be the same as it is for a mutual fund that loans securities.

[12] Available at www.idc.org/files/2023/23-ppr-bd-oversight-derivatives.pdf.

Directors might consider the following:

- If the ETF is index-based:
  - What is the adviser's expectation for the tracking error, given the design of the ETF? Has this expectation been adjusted since the ETF was launched? If so, why?
  - If the adviser uses a sampling strategy for tracking the index, how effective has the strategy been? Have there been any changes to the methodology, or are any changes recommended?
  - If the tracking error is larger than expected, why is that so, and what steps are being taken to address it?
    - What factors have affected tracking error (e.g., portfolio trading to reflect a rebalanced index; differences between the ETF and the index in the pricing of the securities; restrictions on the ability to mirror the index, such as SEC or IRS tax diversification requirements; the methodology for sampling the index; and fees)?
- Does the ETF engage in securities lending?
  - What entity is the lending agent and what are its qualifications?
  - What have been the results and costs of the securities lending program?
  - What risks does securities lending pose and how are those risks being minimized?
- Does the ETF have the authority to use derivatives, and if so, how does the adviser use them?
  - What processes does the adviser follow to manage any counterparty risks?
- Does the ETF have an investment objective similar to those of other funds in the fund complex? If so, what policies are followed to address any potential conflicts between the funds?

Disclosure

ETFs comply with the same general disclosure requirements as mutual funds. For example, ETFs, like mutual funds, are required to maintain a current prospectus, which provides investors with information about the ETF's investment objectives, investment strategies, risks, fees and expenses, and performance. They also may provide investors with a summary prospectus containing key information about the ETF, while making more information available on the internet and in paper format upon request. In addition, like mutual funds, ETFs are required to prepare statements of additional information and issue annual and semiannual reports.

Some disclosure requirements, however, are tailored to ETFs. In particular, the ETF Rule requires a variety of disclosures on the ETF website. Each business day, an ETF relying on the ETF Rule must disclose its full portfolio on its website before the opening of regular trading on the primary listing exchange. The ETF must also disclose its NAV, the market price of its shares, and the premium or discount, each as of the end of the prior business day. The ETF's website disclosure must also include tables and line graphs with information about historical premiums or discounts, as well as current information about the median bid-ask spread for the ETF shares. If the ETF's premium or discount is greater than 2% for more than seven consecutive trading days, the ETF must include on its website a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount.

In addition, some exemptive orders, such as those relating to non-transparent and semi-transparent active ETFs, may require specific disclosures. For example, the prospectus, summary prospectus, ETF website, and any marketing material must include a prescribed legend noting various additional risks that could be relevant to shareholders, including that the differences between the market prices of the shares and the portfolio value may be greater than for fully transparent ETFs.

The board oversees the process by which ETF disclosure is prepared and updated, and it may be liable under the federal securities laws for material misstatements or omissions in the ETF's registration statement, including its prospectus. ETFs are available in a wide range of strategies. Some are complex and some, such as leveraged and inverse ETFs, may be designed to achieve their performance objectives on a daily, rather than a long-term, basis.[13] Fund boards may seek to understand the investor base for which the ETF is designed and how the ETF is marketed.

[13] The SEC has issued an investor alert regarding leveraged and inverse ETFs because it believes individual investors might be confused about their performance objectives. Updated *Investor Bulletin: Leveraged and Inverse ETFs* at www.sec.gov/investor/pubs/leveragedetfs-alert.

Directors might consider the following:

- Are there any inherent or unique factors that will likely affect tracking error (such as SEC/IRS diversification requirements, sampling methodology, and liquidity) that should be disclosed in the ETF's prospectus?
- Are the ETF's use of derivatives and its securities lending practices (if applicable) appropriately disclosed?
- If the ETF is designed to achieve its performance objective on a daily (rather than long-term) basis, is that appropriately disclosed?
- What is the process for ensuring that the marketing materials and website content are consistent with the ETF's registration statement and satisfy the requirements of the ETF Rule or applicable SEC exemptive order?

Conversion of Traditional Mutual Funds To ETFs

Due to the increased popularity of ETFs, among other reasons, some mutual fund sponsors have decided to convert certain traditional mutual funds into ETFs. Such conversions generally have been styled as shell mergers, where the existing mutual fund merges into a new shell ETF. Such mergers proceed under Rule 17a-8 under the 1940 Act relating to mergers of affiliated investment companies. Under the requirements of the rule, the board of the traditional mutual fund must determine that participation in the merger is in the best interests of the merging fund and that the interests of the merging fund's existing shareholders will not be diluted as a result of the merger. Such mergers may or may not require a shareholder vote. One of the practical issues to address in such a merger is the mutual fund's approach to shareholders who do not identify a brokerage account in which they will hold the ETF shares after the conversion, including whether such shareholders would have their shares redeemed at the time of the conversion or whether a temporary account would be established to hold the converted shares for an additional period of time.

When faced with a proposed conversion, traditional mutual fund directors might consider the following:

- How will the mutual fund shareholders benefit from the ETF structure?
- How will the distribution of the fund change?
- Will the investment adviser be able to pursue the fund's investment strategy within the ETF structure?
- Will the ETFs have the same board as the mutual funds?
- Will the mutual fund need to have a shareholder vote in connection with the conversion?
- What is the communication strategy for informing shareholders of the consequences of a conversion?
- What is the plan for mutual fund shareholders without brokerage accounts to hold ETF shares?

Conclusion

ETF directors are generally subject to the same oversight and regulatory responsibilities as directors of traditional mutual funds, although ETF directors may have some specific responsibilities or considerations that reflect the unique nature of ETFs, their operations, and their regulatory framework. As such, ETF directors seek to protect the interests of fund shareholders, and do so through ongoing oversight of the ETF's management and operations.

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