Nontransparent active ETFs can finally take flight

SEC decision lets fund managers keep their playbook under wraps

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Imagine being the head coach of a football team. You draw up a playbook with innovative schemes and strategies. You even set the order in which the first 20 plays will be called. And then you have to hand the playbook over to your opponent a day before the game! Now that doesn't seem fair, does it?

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> **—Matt Giordano**
> Deputy Practice Leader, Public Investment Management, KPMG LLP, and former Chief Accountant, Division of Investment Management, SEC

Well that essentially was the predicament that active exchange-traded fund (ETFs) managers were in since these investment vehicles began to skyrocket in popularity. It may also explain why there are so few actively managed ETFs (less than 300 out of 2,300 total ETFs),[1] and only 2 percent of U.S. ETF assets are held there.

But that may be about to change dramatically thanks to a recent U.S. Securities and Exchange Commission (SEC) ruling (technically referred to as exemptive relief).[2] Active ETF managers no longer have to tip their hands and reveal the various components that make up their ETF baskets; they can keep their playbook hidden from the public—and the competition—in a "nontransparent" ETF.

"However, there are a number of regulatory and operational considerations that need to be thoroughly vetted prior to launching a nontransparent ETF," noted Matt Giordano, Deputy Practice Leader, Public Investment Management, KPMG, and former Chief Accountant, Division of Investment Management, SEC. "For example, from a regulatory standpoint, the SEC application process can be costly and time-consuming depending on the type of exemptive relief you're looking for."

Giordano added, "From an operational standpoint, if you're already managing ETFs, it shouldn't be too difficult to add a nontransparent ETF to your fund family. But if you currently don't have an ETF infrastructure in place, the operational burdens of creating one from scratch can be extensive."

Before exploring the details of the SEC's exemptive relief and what you need to do to establish a nontransparent ETF, let's take a quick look at the market landscape for ETFs.

[1] Who benefits the most from non-transparent ETFs, InvestmentNews.com (April 12, 2019)

[2] Precidian ETFs Trust, et al, Investment Company Act Release No. 33440; 812-14405 (April 8, 2019)

ETFs skyrocketing popularity

An ETF is an investment fund that is generally made up of a diversified basket of stocks, commodities, bonds, and many other asset types. As ETFs have evolved, creative managers have built new asset classes, such as space, timber, artificial intelligence, water, and social media, and new innovations seem to be coming to market every week.

ETFs have skyrocketed in popularity with investors for a variety of reasons, with relatively low costs, ease of access, diversification, and potential tax benefits topping the list (see sidebar; also for more information about ETFs, refer to KPMG's ETF Playbook: Drawing up a game plan for ETF success). What's more, ETFs have had an annualized average growth of 15.66 percent over the past five years versus only 3.53 percent for mutual funds.[3]

Prior to the SEC exemptive order relief, fund managers generally had to disclose all ETF holdings daily, whether they wanted to or not.[4] This made it virtually impossible for active managers to keep their investment strategies a secret if they wanted to use their current ETF structure.

Active managers were particularly concerned that other traders could figure out the strategy given the daily transparency. This would potentially allow "front-running" against them, which could dilute positive returns for investors. In other words, competitors would be able to buy or sell the equities or other assets that the nontransparent ETF manager intended to acquire or sell, thus preventing the manager from getting the desired price for the shares or assets.

This front-running issue discouraged active managers from entering the ETF space. Going back to our football analogy, if your opponents know the plays in your playbook, they can get into formations that would negate your strategy.

But thanks to the exemptive order relief, certain managers of nontransparent ETFs can now actively manage their ETFs like mutual fund managers do, without having to disclose their underlying investments each day. Fund providers and active managers have been anxiously awaiting this development for some time.

According to the *Wall Street Journal*, American Century, BlackRock, Capital Group, Gabelli, JPMorgan, and Nuveen are expected to launch their own version of nontransparent ETFs.[5] What's more, a Cerulli survey report found that within a year, 55 percent of respondents would launch a nontransparent ETF equity strategy and 30 percent expected to launch a similar nontransparent fixed income ETF strategy.[6]

What do investors like about ETFs?

Below are some advantages that retail and institutional investors can get from ETFs as compared to corresponding mutual funds:

— **Fees:** ETFs typically have lower fees than comparable mutual funds.

— **Investor objectives:** ETFs are well suited to meet investor objectives related to portfolio diversification, liquidity needs, or hedging.

— **Intraday trading:** ETFs are continuously valued throughout each trading day, and the price of an ETF share is market derived.

— **Liquidity:** ETFs can be bought and sold at any time during the trading day, just like a stock. This liquidity factor is particularly important to institutional investors (e.g., pensions).

— **Taxes:** Both ETFs and mutual funds distribute realized capital gains every year to minimize or eliminate entity level taxes. But in practice, ETFs often distribute fewer capital gains than comparable mutual funds. However, ETFs using the Precidian model are more likely than other types of ETFs to distribute taxable gains to shareholders. That's because the current order limited the nontransparent ETF's ability to realize tax benefits by cherry-picking appreciated securities for redemption.

— **Access:** ETFs offer cost-effective access to an array of investment options for any investor with a brokerage account, as well as the ability to short-sell for investors looking for the inverse exposure of an ETF.

— **Transparency:** Transparency in passive ETFs allows investors to see how closely the passive ETF follows its benchmark. But nontransparency in active ETFs allows managers to buy and sell securities at the best price, which can result in improved performance for investors.

[3] KPMG analysis of Investment Company Institute (ICI) data (2019)

[4] By comparison, mutual funds typically disclose their holdings monthly and are only required to do so quarterly.

[5] What to know about 'nontransparent' ETFs, Wall Street Journal, May 5, 2019

[6] U.S. active managers evaluating launching nontransparent ETF products, Cerulli Associates, April 2019

Structuring a nontransparent ETF

The SEC approved the nontransparent ETF model because it was structured in a way that satisfied two key principles:

1. Investors would benefit from it.
2. The ETF shares could be accurately priced by a third party.

The nontransparent ETF method that the SEC approved, referred to as the Precidian model, called for the ETF to appoint a "trusted agent" who has access to all of the ETF portfolio holdings. This allows the trusted agent to accurately price the ETF shares and support market liquidity.

Because the portfolio make-up is kept confidential, other trading firms are prevented from "front-running" and bidding up the price of the underlying securities or other assets before the nontransparent ETF can buy them. And just like a mutual fund, the public is made aware of ETF holdings on a quarterly basis.

Other methods of nontransparency are being reviewed by the SEC. "While the Precidian model sets precedent, it's likely that other methods will be accepted in the future," stated Sean McKee, KPMG's National Practice Leader for Public Investment Management. "Several other fund companies have already filed nontransparent ETF applications with the SEC that use methods differing from Precidian's. It will be interesting to see how the SEC rules. But it seems unlikely that it will only allow one method for operating a nontransparent ETF. "

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> National Practice Leader for Public Investment Management, KPMG LLP

Top four things fund managers should anticipate

Regardless of whether you're currently managing a passive ETF, mutual fund, alternative investment, or hedge fund, or are just breaking into the ETF space, here are some things to consider before forming and operating a nontransparent ETF:

More responsibility
It takes more work and entails greater responsibility to coordinate trading activities with an actively managed ETF than it does with traditional, passive ETFs.

Potentially less support
Your current service providers (e.g., custodian, fund accounting, transfer agent) may not yet be prepared to support nontransparent ETFs. This is something you'll need to confirm before forming a nontransparent ETF.

Less management revenue
Actively managed ETFs generate comparatively less fee revenue than actively managed mutual funds with the same amount of assets under management. So it's critical to optimize your operating model and keep a close eye on expenses.

A longer application process
The length of the application process for ETFs often varies by the complexity and types of asset anticipated to be held in the ETF. So, for example, a strategy to hold derivatives, leverage, hedging, and nonpublic securities assets in an ETF will likely result in a longer time period to gain SEC approval (or may fail to gain approval altogether).

Despite these potential obstacles, nontransparent ETFs can give you access to a larger investor base or propel your current investment strategy to greater success by putting active management strategies into an ETF wrapper. "However, simply putting an underperforming investment strategy into an ETF wrapper is certainly no guarantee of success," cautioned Jim Penman, Director, Advisory, KPMG. "You need to do a thorough analysis of all factors to make sure it's an appropriate move." (See "Keys to scoring with an ETF").

Keys to scoring with an ETF

While there are no guarantees for ETF success, there are steps to take that may increase the likelihood of scoring a touchdown:

- Understand the ETF landscape thoroughly, including your competitors' strengths, weaknesses, and tactics.
- Offer a unique, differentiated product that connects with investors, and develop a compelling "elevator speech" to explain the product to appropriate audiences.
  - —Make sure your ETF has broad appeal, even if it's in a niche market. An ETF that's only appropriate for a few large clients can lead to problems down the road.
- Realistically assess the fixed costs and run rate it will take to launch and maintain the ETF for at least 18 months (or until it gains traction). In addition, consider the amount and timing of seed capital to show activity in the fund, versus seeding the entire amount at launch.
- Make sure that you have the right talent, experience, and track record to execute on the investment strategy you've selected.
- Lock in your operations, technology, sales platforms, and custodian/distribution contracts.
  - —No matter how good your product is, your ETF is likely to fall short of the goal line unless you can find a way to get it distributed.
- Create a competitive and predictable fee structure.
- Build in options that allow you to be more nimble and agile than your competitors.

Executing an effective two-minute drill

It’s anticipated that nearly all active fund managers will at least consider offering their active investment strategies as ETFs, and many have already started the process. So if you’re thinking about entering the nontransparent ETF market, you’ll want to move quickly and put your plan in place before the space becomes too crowded.

“Time is of the essence. Waiting even 18 months may to too late,” cautioned Penman. “The special ETF market you’re targeting may be saturated by then.”

So it’s time for you to go into the two-minute drill. This means determining how to best structure your nontransparent ETF so it’s well positioned to gain SEC approval, line up your service providers and distribution channels, determine who your potential investors are, and formulate your marketing plan.

Being the first to market with a new ETF asset class or industry subsector can work to your advantage and help you potentially take a leading position in that investment strategy.

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Serving the ETF and mutual fund marketplace
KPMG's reputation in the ETF industry is well recognized, and we have provided long-standing support to mutual funds and ETF providers alike with tax, audit, risk management, regulatory and accounting services. Our highly experienced, cross-functional ETF team:

— Is currently engaged in in-depth discussions with several active fund managers about the steps needed to enter the nontransparent ETF market

— Assists both passive and active ETF managers in establishing, marketing, and distributing ETF products and growing ETF assets

— Works with funds and fund managers with respect to ETF and mutual fund product development, operating model efficiencies, project management, service provider selection, technology and operational enablement, and fee structuring.

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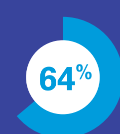

of the top 25 U.S. money managers

Source: KPMG Analytics 2019

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For more information about KPMG's ETF-related services, please see our ETF Playbook: Drawing up a game plan for ETF success or contact:

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