SEMI-TRANSPARENT EXCHANGE-TRADED FUNDS

A Revolution in Active Management

By Nichole M. Kramer
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It’s hard to believe that just over a year ago we were discussing the initial mechanics of non-transparent exchange-traded funds (ETFs). At the time we concluded that it was just a matter of “when,” rather than “if,” these pending non-transparent models would receive regulatory approval. Approximately six months after publication of “Non-Transparent Exchange Traded Products: A Revolution 25 Years in the Making,”1 the Securities & Exchange Commission (SEC) approved Precidian’s non-transparent ActiveShares® methodology. On December 10, 2019, the SEC granted approval to a set of “semi-transparent” ETF models: Blue Tractor, NYSE/Natixis, T. Rowe Price, and Fidelity’s Proxy Portfolio models.

Although Precidian led the way for active managers to utilize an ETF wrapper, it has since been followed by others. The four SEC-approved opaque/semi-transparent models offer a certain level of transparency, anywhere from 50 percent to 95 percent, without divulging a fund manager’s secret sauce. Pending filings from Eaton Vance (February 2019) and Invesco (September 2019) create the possibility that we may see additional choices for asset managers in the future.

UPDATES

ACTIVESHARES® (PRECIDIAN)
Precidian Investments’ ActiveShares® received a nod for SEC approval on April 4, 2019. ActiveShares® final relief changed very little from the time we initially reviewed the model to the effective exemptive application approval notice issued on May 20, 2019. Most of the changes were related to fine tuning language around disclosures that would set the precedent for the other models seeking approval. Except for two important distinctions, the ActiveShares® model is mechanically similar to a traditional transparent ETF (see figure 1). The first is the role of the Authorized Participant Representative (APR). The APR, acting as an agent on behalf of the Authorized Participant (AP), will access a confidential daily file from the trust, which will enable the APR to obtain and then deliver the underlying securities to the fund, thus keeping the strategy fully confidential. It is important to note that the APR cannot be affiliated with the issuer/sponsor or the AP.

The second is the verified indicative intra-day value (VIIV), which is the pricing calculation based on the bid/ask midpoint, disseminated at one-second intervals throughout the day. Today’s traditional ETFs calculate the indicative intraday value (IIV) on the last price at 15-second intervals. The benefit of the VIIV is to avoid stale pricing, which often is associated with using the last price as the basis for the indicative value. ActiveShares® are designed for increased reliability in VIIV calculation, because they contain only U.S. listed securities, which mitigates issues surrounding the tracking of foreign holdings.

SHIELDED ALPHA®SM (BLUE TRACTOR)
Blue Tractor’s Shielded Alpha®SM patent pending3 algorithm allows the fund manager to mask its strategy by generating different weightings for the holdings within the creation/redemption basket each night (see figure 2). According to Blue Tractor’s last filing,5 the benefit of this model is that the daily creation basket will contain 100 percent of the actual holdings of the underlying portfolio. This means that there will never be a security in the basket that is not...
a Proxy Portfolio that is derived from a fundamental optimization of a different composition and weighting than the fund’s actual holdings, via proprietary software developed in conjunction with Axioma. The software will closely replicate the intraday performance of the fund without disclosing the composition of the actual fund holdings (see figure 3). In addition to this Proxy Portfolio that will be used for the creation/redemption basket, each day “the fund will disclose the percentage weight overlap (termed “Proxy Overlap”) between the holdings of the prior business day Proxy Portfolio compared to the holdings of the fund that formed the basis for the fund’s calculation of NAV at the end of the prior business day.”

It should be noted that restricted securities can or may be lagged within the Proxy Portfolio. The application is silent to a time range for the lag and to the amount of securities that can be restricted for inclusion in the Proxy Portfolio. NYSE states that the optimization tool has complete flexibility here as long as it tracks the actual portfolio.

**ACTIVE ETFs (T. ROWE PRICE)**

T. Rowe Price (TRowe) is relatively new to the ETF arena, and prior to the development of the semi-transparent ETF had been hesitant to step into the ETF space. “Fund managers, who want to protect the privacy of their investment-choosing strategy, view the disclosures as a threat.” With the final filing of its version of the semi-transparent ETF, TRowe offers a Proxy Portfolio methodology. TRowe is currently evaluating whether or not it will license the methodology to other managers (see figure 4).

**CONTENTS: ACTIVELY MANAGED SOLUTION™/PERIODICALLY-DISCLOSED ACTIVE ETFs™ MODEL**

This daily generated file is then delivered to the National Securities Clearing Corporation as the daily creation basket. The PM (or the custodian) controls the upload of the nightly holdings to the cloud-based algorithm, enabling the PM to shield the portfolio’s alpha strategy. The Blue Tractor ETF wrapper also allows the PM the ability to “manage the creation basket” by either overweighting or underweighting particular holding(s) in the daily creation basket in order to lower trading costs, enhance tax efficiencies, and fully shield portfolio trading when building a new position or exiting from one.

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In an effort to streamline the offering utilizing a form of Proxy Portfolio, much of the language is similar to the other model methodologies. However, once the cover is lifted, slight nuances and name differences are revealed. Whereas NYSE/Natixis utilizes proprietary software to generate the optimized portfolio for the proxy, T. Rowe’s methodology states that its Proxy Portfolio will have a “minimum weightings overlap of 80% with the fund’s portfolio at the beginning of each trading day.” In practice, this may be higher according to the filing. Like NYSE/Natixis, “the fund will disclose the percentage weight overlap, or Proxy Overlap, between the holdings of the prior business day Proxy Portfolio and the holdings of the fund that formed the basis for the fund’s calculation of NAV at the end of the prior business day.” In addition, unlike the other proxy approaches, T. Rowe expects that an intraday estimate of each fund’s NAV (INAV) will be disseminated every 15 seconds, as traditional ETFs do today.

**ACTIVELY MANAGED ETF (FIDELITY)**

Fidelity’s Actively Managed ETF also falls into the Proxy Portfolio model category. Fidelity has stated in the final exemptive application that its model will be available to license, joining Precidian, Blue Tractor, and NYSE/Natixis.

In this model, Fidelity is coining the term “Tracking Basket” for its Proxy Portfolio. The Tracking Basket, used for the creation/redemption basket, will be constructed using a mathematical optimization process (see figure 5). Though different from the fund’s portfolio, “it is designed to closely track its daily performance.” The fund will disclose the percentage of weighting overlap (i.e., proxy overlap) between the Tracking Basket and the actual portfolio. Interestingly, “the Tracking Basket may include Representative ETFs, which would be US exchange-traded ETFs selected for inclusion in the Tracking Basket such that when aggregated with the other Tracking Basket Components, the Tracking Basket corresponds to the Fund’s overall holdings exposure.” Pursuant to the application, “the Representative ETF percentage may constitute no more than 50% of the Tracking Basket’s assets on each business day.” Fidelity believes that, in practice, it may be closer to 5 percent to 20 percent. ETFs can significantly improve the Tracking Basket’s ability to mirror fund performance, but they will not count in terms of the overlap calculation. Thus, Fidelity’s model may have improved relative tracking, despite having a lower overlap percentage. The exemptive relief makes note that there would be a daily disclosure of the Tracking Basket’s INAV in addition to the proxy overlap percentage. Fidelity may publish an INAV on the fund’s actual portfolio as well.

Fidelity’s model differs from other models with regard to the disclosure lag. Whereas the other approved models typically disclose holdings on a quarterly lag, Fidelity’s own policy for its proprietary products is to release holdings each month on a 30-day lag. Fidelity’s model is designed to be run using each sponsor’s (licensee’s) ‘40 Act disclosure policy (at least quarterly), meaning the...
firm utilizing this model has the choice of a monthly or quarterly disclosure of the holdings.

**NEW FILINGS**

**CLEARHEDGESM METHOD (EATON VANCE)**

It’s no secret that Eaton Vance (EV) opened the door for non-transparent active management models. Its NextShares® exchange-traded managed fund model was the beginning of the active non-transparent revolution. So it came as no surprise to see a new non-transparent ETF model filed by EV on February 20, 2019. Eaton Vance’s new patented methodology is called the ClearhedgeSM Method (Clearhedge) and is a variation of the Proxy Portfolio methodology. Clearhedge will generate a daily disclosed create/redeem basket portfolio and a NAV Reference Portfolio (NAVRP), both of which may or may not be the same as the current portfolio holdings, but more than likely would not because it is not a requirement. Like the other Proxy Portfolio methods, the NAVRP is “expected to be highly correlated with the performance of the fund’s NAV portfolio.” However, that is where the similarities end (see figure 6).

In addition to disclosing the daily create/redeem basket portfolio and NAVRP, Clearhedge would establish a facility through market makers (MMs). MMs looking to arbitrage a fund’s shares could enter into a NAV Hedge Completion Swap (NAVHCS) with the fund. The NAVHCS is a special-purpose total return swap transaction whereby fund and MM counterparty would exchange payments based on the relative total returns of a reference amount of the fund’s current portfolio holdings (not disclosed) and the NAVRP (disclosed) based on second-to-second variations in the two portfolios’ intraday performance. Using NAVHCS, an MM could manage the intraday “basis risk” between the (known) NAVRP and the (unknown) portfolio holdings, providing MMs with the potential for a tighter hedge and a more efficient arbitrage process.

In addition, to further “facilitate efficient share arbitrage, the Fund would disseminate a Basket Instrument Reference

### Figure 6

**CLEARHEDGESM METHOD MODEL**

- Create/Redeem Basket
- NAV Reference Portfolio
- Basket Instrument Reference Portfolio
- Fund Holdings

- Disclosed
- Not Disclosed

Hedge Positions in Fund Shares
Hedge Positions in Basket Instruments

*Holdings for these portfolios may or may not be the underlying actual holdings of the fund.*

### Figure 7

**HEDGE COMPLETION SWAPS MODEL**

1. **Market Maker buys (sells) fund shares**
2. **Market Maker sells (buys) offsetting position in NAV Reference Portfolio**
3. **Market Maker enters Into NAV Hedge Completion Swap**
4. **Market Maker enters into Basket Instrument Hedge Completion Swap**

For illustration purposes only.
Portfolio and provide for MMs to enter into a Basket Instrument Hedge Completion Swap (BIHCS) with the Fund. In a BIHCS, the fund and the MM would exchange payments "based on the relative total returns of a reference amount of specified Basket Instruments and a specified Basket Instrument Reference Portfolio, which would consist of market instruments trading at the NAV Calculation Time and during active trading hours of the Basket Instruments." A BIHCS is designed to assist MMs in hedging the risk of positions in non-U.S. securities included in create/redeem baskets over the time interval between the U.S. market close and the securities' normal trading hours.

Figure 7 illustrates how this would work in both situations.

Clearhedge’s application notes that the fund can decide to either lag the release of actual portfolio holdings monthly or quarterly. In addition, the application allows for the underlying securities to consist of a broader range of securities than the strictly domestic securities noted in the approved applications to date. Eaton Vance’s Clearhedge model will be available for licensing once it has been approved by the SEC.

**ACTIVELY MANAGED SUBSTITUTE BASKET (INVESCO)**

When ETF giant Invesco filed a semi-transparent model with the SEC in September 2019, it was no surprise that its methodology would include some proprietary optimization. The model it is proposing is also a Proxy Portfolio, which it terms a Substitute Basket (SB) (see figure 8). The SB will exclude certain securities held in the portfolio, such as those the portfolio manager(s) is/are actively looking to purchase or sell, or securities that, if disclosed, could increase the risk of front-running or free-riding ("Protected Securities").

The SB will be created utilizing an optimization process to closely track the performance of the fund's portfolio. "The correlation between the SB and the Fund's portfolio will be derived from the fundamental and statistical relationship between the SB and the Fund, based on a substantial overlap in the portfolio holdings, while maintaining the Active Share Differential." It is important to note that the SB may not always consist of a significant subset of the securities held in the actual portfolio. It will be constructed to exhibit an active share differential of 5 percent to 30 percent. According to the filing, the Active Share Differential is a measure of the percent-age of holdings in a portfolio that differs from a reference portfolio (e.g., a benchmark index), which takes into account differences in the weights of holdings included in both portfolios. It is calculated by taking the sum of the absolute differences between the weight of each holding in the Fund’s portfolio and the weight of each holding in the Substitute Basket and dividing by two.

The amount of the Active Share Differential will be driven by particular strategies and asset classes; a fund portfolio manager will have ultimate decision rights on the Active Share Differential. It’s important to note that Invesco’s model may approach 95-percent transparency when the PM maintains an active share differential of only 5 percent. This differential would be published on the fund’s website on a daily basis.

Invesco will allow APs to create and redeem ETF shares in-kind, thus allowing APs to hedge their risk and "price" their market exposure. To realign the SB with the fund holdings, Invesco is proposing to use an affiliated broker-dealer (B/D) to act as agent for the AP. This affiliated B/D would receive the SB and trade the subset of the SB that does not overlap with the fund to purchase/sell the protected securities on behalf of the AP without disclosing the identity of those securities to the AP ("Protected Trades"). Invesco states in the application that its proposed arrangement will enable the fund to receive the securities it desires without APs and MMs learning the full details of the Fund’s portfolio or trading strategies. Invesco believes this arrangement will appeal to APs and MMs, resulting in greater participation by investors, more efficient trading of Shares, a more effective arbitrage mechanism and better results for Fund shareholders.

Invesco is proposing to provide intraday price certainty as well as striking and publishing a NAV at least twice during the business day at intervals determined by the investment advisor (see figure 9). Striking multiple NAVs will provide multiple creation and redemption windows for the AP throughout the trading day. In Invesco’s view, the proposed
SUBSTITUTE BASKET MODEL

*Holdings are on a 30-day lag following the quarter end. For illustration purposes only.

Substitute Basket, combined with the in-kind mechanism and the multiple NAV feature, will improve the arbitrage mechanism and allow APs to transact in fixed income instruments and foreign securities (the models that the SEC has approved thus far only allow investments in domestic equity securities and foreign markets that trade contemporaneously with U.S. markets). The AP will have the option to purchase or redeem ETF shares at either NAV, depending on the time of the day when the creation/redemption request is received. The B/D will provide full disclosure of the Protected Securities to the AP on a delayed basis as part of its best execution report, “understanding that a Fund will always process purchases and sales consistent with the next NAV struck following the purchase or sale request,” just like ETFs today. Invesco also proposes full holdings to be disclosed 30 days after quarter end at a minimum.

Invesco’s application did not indicate any licensing. Like T. Rowe Price, Invesco is evaluating whether or not it will license once approved.

CONSIDERATIONS

While waiting for the SEC to review the newest filings, we have identified five key areas for review:

**Bid/ask spreads:** For these semi-transparent models, an MM’s pricing will be based on a published intraday value. In some cases, this value is priced based on the actual fund holdings, while others are priced based on a Proxy Portfolio. Although the architects of these models claim this pricing to be sufficient, many fear it is still not the same as pricing a basket of known securities in a volatile market, as is done by many MMs with today’s fully transparent baskets. Academically, spreads could widen to compensate for the additional risk involved in hedging unknown securities. From the time that an AP is long or short the ETF in the open market, to the time it takes to submit a create/redeem request to then execute the corresponding basket, the AP must put on a hedge to protect against market risk. For fully transparent ETFs, the AP knows the full basket and can either immediately go long/short the individual components after it takes a position in the ETF, or find a “proxy” ETF based on a holdings overlap/correlation analysis. In the case of semi-transparent ETF models, the AP may need to find a “proxy” ETF to go long/short as its hedge, but because the AP is not privy to the semi-transparent ETF holdings, it may have to identify the “proxy” ETF hedge simply by strategy (growth/value/small-cap/large-cap, for example). This is imperfect and may open up the AP to additional risk if that hedge doesn’t correlate well with the true semi-transparent ETF basket during the exposed time period. This too may result in wider ETF spreads to compensate for that risk. It is yet to be determined whether or not this becomes more problematic in these semi-transparent structures.

**Race to zero (ActiveShares®):** The role of the APR will require an additional party to the creation/redemption process. One of the finer details being worked out with the ActiveShares® model is the APR commissions. The additional cost, which may be passed along to the AP (and ultimately to the entity placing the order if the AP is routing the order for a third party), may be reflected by a wider spread, or potentially as a disincentive for those entities providing liquidity for the ETF. The form of commission—a per share basis versus a rate based on notional value—is still to be determined, both for efficiency and to prevent the flow of any information that may lead to reverse engineering of the fund’s strategy.

**APR–fund manager relationship (ActiveShares®):** The APR role in ActiveShares® won’t have any economic relationship or fiduciary duty to the fund manager. The economic relationship for an APR is with the AP. The APR is acting as an agent for the AP, either as a clearing broker-dealer or an introducing broker-dealer.

**Wirehouses/platforms:** Intermediary platform listing is a critical component of asset growth. The due diligence process for an intermediary to list a new
### SEC Exemptive Relief Approvals and Filings

<table>
<thead>
<tr>
<th>Purchasing and Redeeming</th>
<th>Received SEC Exemptive Relief Approvals</th>
<th>Pending</th>
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<tr>
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<td>ActiveShares®</td>
<td>Shielded AlphaSM ETF*</td>
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<tr>
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<td>Actual portfolio holdings</td>
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**Table 1**

**Disclosure frequency**

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<th>Proxy to portfolio overlap potential</th>
<th>Quarterly</th>
<th>Quarterly</th>
<th>Quarterly</th>
<th>Quarterly</th>
<th>Monthly or Quarterly</th>
<th>Monthly or Quarterly</th>
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<td>100%***</td>
<td>90–100%</td>
<td>0–100%</td>
<td>80–100%</td>
<td>50–100%</td>
<td>0–100%</td>
<td>70–95%</td>
<td></td>
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</tbody>
</table>

* This is not a requirement of the trust/advisor and it is believed that the market participants and arbitrageurs will use the components securities and weightings provided to calculate intraday values.

** Fidelity may disseminate the INAV on actual holdings.

*** ActiveShares® is 100 percent replication.

ETF typically requires a fund manager to complete a request for information and include the registration statement along with a factsheet. Depending on the distribution platform, anywhere from one to three years of live performance, along with an assets under management threshold (typically ranging from $25 million to $75 million) may be required before a fund is considered for platform inclusion. The intermediary also may look at other factors, such as the reliability of the model in producing reasonable spreads, the trading volume of a specific fund, and the fit between fund strategy and non-transparent or semi-transparent methodology. The expected timeline for acceptance and onboarding to a distribution platform for qualifying funds typically can range anywhere from six months to one year. There may be early advantages for those sponsors that are launching funds to be sold through their own proprietary distribution channels.

**Conversion:** One additional consideration for open-end fund managers is whether to convert a current fund into a semi-transparent ETF. With the market at all-time highs, converting a mutual fund to an ETF could have “potential negative tax consequences resulting from mutual funds sitting on large unrealized capital gains.”[^31] This could be a major issue for the conversion process but a necessary step for these active managers to “seed” their semi-transparent ETFs. As pointed out in a 2019 paper by Brown Brothers Harriman in partnership with K&L Gates, “Managers should work with their tax advisors and regulators to better understand how any unrealized gains can be treated in an ETF reorganization.” A fund with a large number of outstanding shares may help mitigate the volume/spread issues discussed above, however, failure to determine if any securities are at risk of a taxable event could result in a negative consequence to shareholders.^[^32] Keep in mind that if an active manager is considering a conversion of a mutual fund to one of the new models, it will need to obtain board approval and there will need to be a proxy vote and approval to consolidate the classes into a single share class, as well as additional administrative and legal costs. In addition, the mutual fund portfolio will need to be compliant with applicable exemptive relief, as well as comply with applicable exchange listing rules.

**RECAP**

In light of the approvals and recent filings, table 1 shows similarities and differences between models.

**CONCLUSION**

Asset managers now have a choice of models to consider for launching their active strategy in an ETF wrapper, but a few additional steps are still in process. Specifically, additional approvals to list on an exchange will be required from...
the Trading and Markets division of the SEC, which can take up to 240 days. On September 23, 2019, the Self-Regulatory Organizations of Cboe BZX Exchange, Inc. (Cboe) instituted proceedings to determine whether to approve or disapprove a proposed rule change to adopt BZX Rule 14.11(k) to permit the listing and trading of managed portfolio shares for the ActiveShares® model. On December 17, 2019, the SEC extended its consideration of the rule change to February 20, 2020, to review the request for American Century, an ActiveShares® product. In addition, on December 12, 2019, CBOE filed a proposed rule change to permit listing of Fidelity’s semi-transparent model with a Proxy structure.33 On December 12, 2019, NYSE Arca, Inc. filed its own rule change to permit listing of Invesco’s Substitute Basket models, this will provide even more alternatives for investment managers to potentially choose from. Ultimately, the model or models that may be embraced by market participants are still unknown and will take some time to determine. One thing is certain, the revolution in active management continues to march forward.

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ENDNOTES


7. Ibid.

8. Ibid.


14. Ibid.


18. Ibid.

19. Ibid.

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edgar/data/1076598/000094039419000345/clearhedge40app.htm.

21. Ibid.

22. Ibid.

23. Ibid.


25. Ibid.

26. Ibid.

27. Ibid.

28. Ibid.

29. Ibid.


32. Ibid.


37. See https://www.sec.gov/Archives/edgar/data/35336/000119312519314931/d842423d40app.htm (Fidelity), https://www.sec.gov/Archives/edgar/data/52388/000171060719000159/exemptiveorder12919.htm (NYSE), and https://www.sec.gov/Archives/edgar/data/1668791/000113743920000002/btexemapp01022020.htm (Blue Tractor).

