ALTERNATIVES

Non-Transparent Active ETFs Get Regulatory Nod

November 15, 2019

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The menu of types and styles of exchange-traded funds available to investors keeps growing. The Securities and Exchange Commission just approved four proposals for a new type of exchange traded fund: non-transparent, active ETFs. David Mann, our Head of Global ETF Capital Markets, explains the implications.

The active exchange-traded fund (ETF) news just keeps coming in! And the choices for investors continues to grow in this space. ETFs are no longer only passive vehicles tracking a broad, capitalization-weighted index. Today, ETFs encompass active and passive styles, cover niche industries and track custom-designed indexes.

Recently, I discussed the passing of the "ETF Rule" and what that could mean for active ETFs—which combine active investment management expertise and capabilities within the benefits of an ETF structure. As a very quick reminder, operationally the ETF Rule treated active and index funds the same. One of the main reasons was because in both cases, there was complete daily transparency of the underlying securities.

These *transparent* active ETFs are quite prevalent in the ETF market today, now totaling almost $100 billion of assets under management (AUM) in the United States. (We would note all of Franklin Templeton's active ETFs fall into this bucket.)

However, these transparent active funds should not be confused with the announcement earlier this year that *non-transparent* ETFs were on the way. That is a topic I also have discussed.

ETFs continue to become more and more popular with all investors. Thus far in 2019, there has been another $250 billion of inflows, bringing the total ETF AUM in the United States to $4.2 trillion.[1] Along the way, "ETF" has come to mean a lot more than "passive, index-tracking fund." ETFs can track a single factor index or a multi-factor index. They do not even need to track an index as long as there was daily transparency on the underlying holdings.

Investors are now going to need to learn about the newest entrant underneath the ETF wrapper.

On November 14, 2019, we learned that another four versions (!) of non-transparent (sometimes called semi-transparent) ETFs are coming. You can find a link to all of those filings here. Our team is reviewing and monitoring all these new ETF structures and is eager to see how they will work in the market.

As a reminder, one of the distinguishing qualities of an ETF is transparency. Every day, you know what holdings are in an ETF and in what weighting. Transparent active ETFs provide daily transparency of their holdings, just as a traditional index ETF does. However, as the name implies, non-transparent active ETFs would not be required to publish holdings daily.

Reading through the details, I keep thinking about the broader context of the entire ETF ecosystem. I would generally break the ETF ecosystem into three main buckets:

- ETF issuers
- ETF Authorized Participants and Market Makers
- ETF investors

For the ETF issuers, the allure here is pretty straight forward: If they can now launch an ETF in non-transparent form that attracts assets, it is a home run. However, that only works if the other two parts of the ETF ecosystem are on board as well.

For the ETF authorized participants and market makers, will their ability to quote these funds throughout the day be negatively impacted by not seeing the daily holdings?

And what about ETF investors? Some investors love ETFs because of the daily transparency, which is obviously lacking in these new products. Others care less about transparency and more about low fees, as is evident in the percentage of 2019 flows that have gone to funds under 10 basis points (currently over 70%).[2]

The current percentage of ETF assets in active strategies has been growing, but is still only 2%. We will be watching if these new forms of ETFs help those percentages increase.

We are believers in the value of active management, so we are eager to see different styles and types of ETFs available in the marketplace and welcome this latest news.

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All investments involve risks, including possible loss of principal. Generally, those offering potential for higher returns are accompanied by a higher degree of risk. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

For actively managed ETFs, there is no guarantee that the manager's investment decisions will produce the desired results. ETFs trade like stocks, fluctuate in market value and may trade at prices above or below their net asset value. Brokerage commissions and ETF expenses will reduce returns. ETF shares may be bought or sold throughout the day at their market price, not their Net Asset Value (NAV), on the exchange on which they are listed. Shares of ETFs are tradable on secondary markets and may trade either at a premium or a discount to their NAV on the secondary market.

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1. Source: Bloomberg, as of October 31, 2019.

2. Source: Bloomberg, as of October 31, 2019. A basis point is a unit of measurement. One basis point is equal to 0.01%.