NEWS ANALYSIS

ETFs as Tax Dialysis Machines
by Lee A. Sheppard

It all started with bitcoin. You asked your elderly dad whether he’d bought any bitcoin, and he wouldn’t divulge any information. That made you worry that he might have bought five, six, or even seven figures’ worth. At the market top, of course.

So you broke into your dad’s computer to look at his browsing history. It took a while to get him out of the house. He let the country club membership slide after they raised prices to $200 a round. He refuses to golf at the public course, even after you got him a new putter. Instead you took advantage of his regular doctor’s appointment. His passwords were easy to find — they were on sticky notes attached to the computer.

What you found was disturbing.

It wasn’t porn. That would have been cheaper. Much, much cheaper.

Nope, lo these many years, your dad has been a mark. His investment habits have been financing the alimony obligations of two generations of brokers and hedge fund managers.

First there was the day trading. Then the high-frequency traders got him. He just sat there, submitting his limit orders, while the algorithms picked him off like ducks at the county fair target shooting booth. Only they came away with serious money rather than a big pink plush teddy bear. So your dad and all the other individual dupes retreated from the equity markets, and the algorithms were left to fight each other.

Then there were the exchange-traded funds (ETFs). That seemed okay, because at least GLD kept your dad away from the bullion dealer. Now, regulators worry that a flurry of ETF redemptions could blow up the system, but insofar as retail investors were concerned, they’re a good thing. They’re tradable mutual funds without the dividend-scraping fees, offered by the big respectable houses. But wouldn’t you know it, the pros arbitraged them, too. Anything that’s traded can be shorted. ETFs are vulnerable to front-running.

But the SEC, which is supposed to be protecting your dad from sharks, welcomes arbitrage, which it believes keeps ETF unit prices honest. Now the SEC has given ETF sponsors the ability to sell to the public without seeking special exemptions, in the form of a new final rule 6c-11 (84 F.R. 57162). Recent SEC actions also expand opportunities for tax-free in-kind redemptions by equity ETFs.

At the recent American Bar Association Section of Taxation meeting in San Francisco, the Investment Management Committee discussed the implications of the new SEC ruling permitting less price transparency on the part of actively managed ETFs. Two tax lawyers, Roger Wise of Willkie Farr & Gallagher LLP and Jacqueline Gordon of Stradley Ronon Stevens & Young LLP, were joined by a securities lawyer, Georgia Bullitt of Willkie Farr & Gallagher.

Earlier in the year, Fordham University School of Law and the Gabelli Funds sponsored a conference about the tax rules governing mutual funds and ETFs. Gabelli Funds founder Mario Gabelli personally opposes the tax gambit that is the subject of this article.

ETF Background

Takeaway: ETFs are replacing mutual funds.

Your dad bought SPDRs. The first ETF, State Street’s Standard & Poor’s Depository Receipt (SPDR), was a trust that held all of the issues in the S&P 500. Some larger SPDR investors could engage in transactions in kind with the trust. Only they came away with serious money rather than a big pink plush teddy bear. So your dad and all the other individual dupes retreated from the equity markets, and the algorithms were left to fight each other.

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ETFs are exchange-listed, tradable alternatives to open-end mutual funds. Most function like index funds. No actual fund need exist; some ETFs are derivatives. ETFs trade on the New York Stock Exchange and Nasdaq. Mutual fund shares can only be redeemed at specific times, whereas ETF units can be bought and sold whenever markets are open. There is now $4 trillion invested in ETFs.

If an ETF is an investment company — that is, it invests in securities and is listed on a U.S. exchange — it has to register with the SEC under the Investment Company Act of 1940 (15 U.S.C. section 80-3(a)). If it is also organized as a corporation, it may elect to be treated as a regulated investment company under the tax law. RICs are corporations that are nominally taxable but wash out their income with distributions (section 852(a)). ETFs don’t make distributions, but rely on in-kind redemptions. Even then, there has to be some relief from the SEC rules to allow ETFs to be publicly offered, Bullitt explained.

Principally, ETF units have to be allowed to trade at a price other than net asset value (NAV). Market prices of ETF shares are supposed to track the underlying assets. When ETFs were a new thing, unit prices diverged, sometimes widely, from NAV. That’s where hedge funds came in. They arbitrated the price difference between the ETF units and the underlying NAV.

Like mutual funds, ETFs value their portfolio holdings daily. Because SEC rules require ETFs to disclose their holdings, they attract hedge funds and other sophisticated investors who want to front-run them, including their own largest investors, who are legally empowered to trade with them in ways that would otherwise be prohibited for insiders.

Bullitt explained that brokers make money lending ETF shares to hedge funds who want to short them. Of course, the cheapest way for brokers to obtain shares to lend is from margin accounts. Remember, you don’t own the shares in your margin account, and your agreement with the broker permits the broker to use them in its business, including lending them and re-hypothecating them. “One of the big moneymakers is on the short side,” said Bullitt. Mutual funds can’t be traded, so they can’t be shorted.

So the SEC authorized some holders (called “authorized participants”) to deal in ETF shares to ensure that the share price stays close to NAV. That’s a form of arbitrage, too, but the SEC encourages it in the name of investor protection. Under the new final rule, ETFs are no longer subject to SEC Regulation M, which prohibits issuers from doing things to support the price of their shares. ETFs have to be allowed to redeem their own shares, and redemption can be considered a price support.

ETFs need exemptions from prohibitions on insider dealings to be able to re-balance their portfolios and monitor the market price of their units (rule 17e-1). Authorized participants that are 5 percent holders were exempted from this prohibition under special SEC orders granted to some ETF sponsors. Many broker/dealers are authorized participants with contractual arrangements to transact with their ETFs, justified by giving up the vote (the SEC has not ruled on this practice). Ordinary investors have to buy their ETF units on an exchange.

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Only authorized participants are allowed to create ETF units and have them redeemed by the ETF. Authorized participants are large institutional shareholders that are permitted to contribute securities in exchange for ETF units,
called “creation units,” and acquire securities in redemption of units. That is, they have special permission to transact at other than market prices.

Why does the SEC permit creation units and in-kind redemptions? It believes that these practices keep market prices for ETF units close to NAV. Gee, isn’t the market supposed to police that? Aren’t we supposed to believe that the securities markets are the best price mechanism?

The SEC permits ETFs and their authorized participants to tinker with their public unit prices. If the ETF market unit price is less than NAV, the authorized participant could buy cheaper ETF units in the market for cash, reducing supply, and request redemption for a higher value. If the ETF market unit price is more than NAV, the authorized participant could buy the underlying securities and contribute them at NAV in exchange for creation units, which it would then sell in the market.

“This idea of arbitrage was, and still is, critical to the SEC for approving this product,” said Bullitt, adding that when the SEC approved SPDRs, arbitrage was seen as an investor protection mechanism. But now, with the new rule, the SEC is extending the same relief to actively managed and nontransparent actively managed ETFs.

As of Christmas Eve, under new rule 6c-11, ETFs will not have to obtain specific SEC permission to operate. The SEC hopes that all mutual funds will move to an exchange-traded option, Bullitt commented, but that depends on arbitrage mechanisms that the SEC views as necessary to keep unit prices close to NAV.

The ETF industry got everything it asked for in the final rule, Bullitt explained. But index ETFs will now have to disclose their actual holdings. The new SEC rules would permit all ETFs and their authorized participants to use custom baskets when tendering securities for in-kind redemptions. Under the new rule, there is no minimum for creation unit size. Some creation units are enormous, representing as much as 25 percent of the ETF’s portfolio.

Nonetheless, ETFs and brokers aren’t supposed to do things that prejudice other shareholders. “This is pretty monumental,” said Bullitt. The SEC basically delegated fiduciary responsibility to the ETF sponsors themselves, and expects them to exercise it in a responsible manner.

In-Kind Redemptions

Takeaway: Tax-free in-kind redemptions have become essential to the ETF business model.

Section 852(b)(6) is a General Utilities rule for RICs. If a distribution in kind is made to a fund shareholder, the built-in gain on the distributed property is not taxed to the fund or allocated to the remaining shareholders. Some semblance of that gain may be taxed to the redeemed shareholder when it sells the property. The shareholder’s basis in its fund shares does not match the fund’s basis in its portfolio assets. No tax rules require inside and outside basis to match.

The original intent was to allow illiquid mutual funds to make emergency distributions of securities when cash redemption demands could not be met. Mutual funds stand ready to regularly redeem their unit holders in cash. Mutual funds are fond of using section 852(b)(6) to wash out built-in gain on portfolio assets, preventing their retail shareholders from being taxed on fund gains.

ETFs have made this statute an integral part of their business model, with the help of the SEC. They routinely defer taxable gain on securities they plan to dispose of by making in-kind redemptions. Even actively traded ETFs that churn their portfolios regularly don’t distribute gains to unit holders. They depend on in-kind redemptions to wash out gains.

In a planned redemption, an authorized participant (usually a broker/dealer) purchases a custom basket of shares in the market. The broker then tenders its shares to the ETF in exchange for creation units, which are immediately redeemed for previously agreed ETF assets. The custom basket contains securities the ETF wants; the redemption basket contains securities the ETF doesn’t want. The broker hedges its exposure to the contributed securities with a short sale while the transfer clears.

Whenever an index ETF needs to re-balance its portfolio, authorized participants are there to help. Previously, only the three big early sponsors — BlackRock, State Street, and Vanguard — had special SEC permission to make these trades all
the time. Other ETFs could make redemptions only for purposes of re-balancing.

Thus, the ETF could shift taxable gain to the authorized participant, which didn’t provide this service for free. It was compensated by the difference between variable weighted average price on the short sale and market price on the closing day of the trade. It can be expensive to tie up capital for two days for six basis points. It’s akin to a short-term loan, and the numbers can be very large. A regular bank lender would worry about the size of the loan and the exposure to the risk of price changes in the securities, which could easily erase the profit on the loan. Broker/dealers are used to these risks, and also have the opportunity to front-run the ETF on these transactions.

Vanguard is in the vanguard of this strategy. Its ETFs are organized as share classes of its RICs, and the firm has a patent on it, which describes the tax minimization strategy (No. 6,879,964 B2). Trouble is, securities laws don’t allow mutual funds to issue two classes of shares (15 U.S.C. section 80a-18(f); rule 18f-3). But Vanguard obtained relief from the SEC, in the form of an order that is like a letter ruling (Vanguard Index Funds et al., Investment Company Act Release No. 24789, 65 F.R. 79439 (Dec. 19, 2000)). Even after the new rule goes into effect, Vanguard will still depend on its own relief order.

So a Vanguard equity mutual fund uses its linked ETF to make in-kind redemptions to make mutual fund gains disappear. Technically, because the ETF is part of the RIC, which the tax law regards as a single fund, gains (or the lack of recognition of gains) are shared among the classes. The tax benefit is shared between the unit holders of the fund and its ETF, Wise noted.

Vanguard’s linked ETFs regularly pick up appreciated securities from their linked mutual funds and use them for redemptions, so that mutual fund shareholders incur no tax on the appreciation. Taxable mutual fund investors’ Forms 1099-DIV no longer display capital gain distributions. Bloomberg compared Vanguard’s patented process for shedding gains to flipping a light switch (Bloomberg, May 1, 2019).

At the Fordham conference, Robert Gordon of Twenty-First Securities called ETFs linked to mutual funds “a tax dialysis machine.”

Abuse of in-kind redemptions was discussed in these pages nearly a decade ago. (Prior analysis: Tax Notes, Mar. 14, 2011, p. 1235.) But in the interim, in-kind redemptions became turbocharged as authorized participants drastically minimized their holding period of the custom basket to reduce their own costs of hedging their exposure.

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Those were “heartbeat” trades. Bloomberg found $98 billion of heartbeat trades in 2018. Heartbeat trades are so named not merely because of their short duration but also because of their large size, making blips in fund inflow and outflow data look like EKG monitors. A heartbeat trade looks like any other friendly, planned in-kind creation and redemption, except that the authorized participant’s exposure to the tendered basket could be shorter than 24 hours. Heartbeat trades can be so big that only the biggest players, like Goldman Sachs and Credit Suisse, can be authorized participants (Bloomberg, Mar. 29, 2019).

Sometimes a heartbeat trade involves exchanges of shares of the same issuer. The tax law defaults to specific identification of shares, and like-kind exchanges are not permitted, so different lots of the same issue are treated as different assets. If the steps are not respected, the trade could be a wash sale, so losses would be disallowed (section 1091). So these trades do not merely represent deferral of gain, but could also mean perpetual avoidance of gain, Bob Gordon observed. Gordon, who himself is in the business of selling tax strategies, frets that heartbeats give the statutory tax break a bad name.

One huge Vanguard heartbeat trade involved Monsanto, of which Vanguard’s Total Stock Market Index Fund held $1.3 billion worth of shares. When Monsanto agreed to be acquired by Bayer for $56 billion, Monsanto would be out of the index, and the fund was looking at an enormous gain. An authorized participant came along to do a $1 billion heartbeat trade, in which the linked ETF disposed of both its Monsanto shares and the mutual fund’s Monsanto shares.
ETFs don’t brag about these deals; Bloomberg looks at fund flow data to ferret them out. Bloomberg believes that this fund alone used heartbeats to shelter $6.5 billion of capital gains in 2018 (Bloomberg, May 1, 2019).

“The heartbeat trade allows ETF market-making broker/dealers to front-run rebalance trades. While the benefits of the tax savings are enormous, they may come at the cost of eroding a high-turnover strategy’s edge, or alpha,” Elisabeth Kashner of FactSet Research Systems, a research firm, wrote in a report. Index funds that have to re-balance for changes in the index are especially vulnerable. “Market on-close execution invites front running,” Kashner wrote.

ETF and linked mutual fund unit holders pay no taxes, but that can come at the expense of the fund being front-run by an authorized participant. “ETF strategies that require frequent or significant rebalancing or reconstituting bring with them the risk that the potential outperformance of the strategies gets eaten up by front-running on the trading floor,” Kashner, who coined the heartbeat moniker, wrote. “While heartbeat flows can wash out capital gains, they can’t erase the impact of information leakage... Keep this in mind: heartbeat flows aren’t free. Their costs can be seen in depressed performance.”

The IRS could stop heartbeat trades, according to Joseph Opich of Paul Hastings LLP, who spoke at the Fordham conference. Tax advisers like a two-day holding period for an authorized participant. “ETF strategies that require frequent or significant rebalancing or reconstituting bring with them the risk that the potential outperformance of the strategies gets eaten up by front-running on the trading floor,” Kashner, who coined the heartbeat moniker, wrote. “While heartbeat flows can wash out capital gains, they can’t erase the impact of information leakage... Keep this in mind: heartbeat flows aren’t free. Their costs can be seen in depressed performance.”

The IRS could stop heartbeat trades, according to Joseph Opich of Paul Hastings LLP, who spoke at the Fordham conference. Tax advisers like a two-day holding period for an authorized participant. Tax advisers freaked out when ETFs and their broker/dealers figured out how to make a heartbeat trade close in less than a day, so they imposed the 48-hour hold (Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001)).

IRS letter rulings don’t seem to permit custom basket redemptions. IRS letter rulings permitting in-kind redemptions by closed-end funds were premised on the taxpayer representations that a pro rata, representative basket of fund holdings be distributed in redemption. The taxpayer must represent that the basis of distributed securities is no more than 1 percentage point lower than the percentage of assets distributed by the fund (LTR 200536002, LTR 200509013, LTR 200414043, LTR 200341014).

In partnership parlance, this requirement ensures that there is no stuffin disproportionate gain to the redeemed holder. Nonetheless, fund advisers view this representation as not required by statute, so they rarely seek rulings for in-kind redemptions by ETFs, which are open-end funds. (For discussion, see Ethan Yale, “Mutual Fund Tax Overhang,” 38 Va. Tax Rev. 397 (July 2019).)

At the ABA, Wise explained that the IRS could conceivably recharacterize a custom basket redemption as a sale by the ETF of the underlying securities to the authorized participant for cash, or treat the authorized participant as an agent of the ETF (Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Esmark v. Commissioner, 90 T.C. 171 (1988), aff’d, 886 F.2d 1318 (7th Cir. 1989)). Why is agency relevant? Section 852(b)(6) technically requires that a redemption be at the demand of the shareholder. Either of these treatments would treat the ETF as the cash seller of its own securities, making its shareholders taxable on the gains.

The SEC doesn’t enforce the tax law. Here’s what we said eight years ago: The SEC likes to think that basket exchanges keep ETFs honest by ensuring that ETF units trade at prices close to NAV. In this view, arbitrageurs who pounce on differentials serve a valuable price discovery function. That may or may not be true, but these exchanges clearly are a tax shelter and should be shut down. Then price discovery can proceed without being goosed by the tax law.

“These transactions permit current and future fund shareholders to inappropriately defer tax on their economic gains and give ETFs and other mutual funds with ETF share classes a significant tax advantage over other investment vehicles,” Jeffrey Colon of Fordham University School of Law wrote. More to the point, for unit holders, in-kind redemptions essentially turn ETFs into IRAs. (Colon, “The Great ETF Tax Swindle: The Taxation of In-Kind Redemptions,” 122 Penn St. L. Rev. 1 (Fall 2017)).

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At the Fordham conference, Colon questioned the SEC’s price discovery rationale for permitting arbitrage in ETF units. SEC-registered RIC ETFs
hold publicly traded assets that they have to disclose. We know what that stuff is worth, but the SEC evidently believes in “smart beta.” ETF units now trade for prices close to NAV, so that the main involvement for hedge funds and institutional investors is front running and shorting ETF constituent securities. Private sector unit price policing is no longer necessary and SEC actions to empower authorized participants are no longer justified.

Although ETF investors pay tax on gains in their units when they sell them, the gain on securities distributed in in-kind redemptions will not be included in their gain on their units. A RIC does not operate like a partnership. There is no necessary relationship between the fund’s gains on its portfolio and a unit holder’s gains on his units. Subchapter M is not subchapter K. Although some policymakers may want funds to operate like partnerships, even the commodities ETFs organized as partnerships are unable to comply with all the partnership rules without homemade simplifying conventions (sections 704(c), 7704(c)(3)).

Colon made several alternative suggestions for curbing in-kind distribution abuse, of varying degrees of complexity. Section 852(b)(6) could be repealed. Colon doesn’t think this is realistic, because the SEC views in-kind redemptions as an important relief mechanism when a fund has to liquidate a large position, or is facing redemption requests and is short of cash. If the statute were repealed, ETFs would migrate to retirement accounts, like mutual funds, he noted.

Alternatively, section 852(b)(6) relief could require a basis reduction in the ETF’s remaining securities for gain transferred on an in-kind redemption. In-kind redemptions achieve effects comparable to stuffing departing partners by investment partnerships, which the IRS hasn’t been able to curb. The IRS might be able to make RIC antibuse regulations like the partnership rules, which would be complicated and probably wouldn’t work, because even compulsory asset revaluation would not solve the allocation and timing questions (sections 704(c), 734, 743, 754; reg. section 1.704-3(a)(10)(i), -3(e)). The above-cited closed-end fund rulings try to prevent stuffing, but they do not bind other taxpayers. (Prior analysis: Tax Notes, Aug. 12, 2013, p. 639.)

The IRS could make RIC regulations like the partnership carryover basis rules, which would be impractical because RICs can’t track investor basis (section 733). Colon cautioned that double taxation could occur, and what do you know, preventing double taxation would require that all in-kind distributions, not just redemptions, be free of tax at the fund level (section 731(a)). “Mixing elements from the separate-entity treatment of subchapter M, where there is no attempt to match inside and outside basis, and the aggregate treatment that generally applies in subchapter K is unwise,” Colon concluded.

In introducing the new rule, SEC Chair Jay Clayton used the phrase “Main Street investors” to describe ETF investors, so it is fair to say their tax break enjoys political protection. Under the new rule, ETFs that require custom baskets for redemption transactions no longer need special permission to use them. The ETFs most affected by the new rule track the S&P 500 and bond indexes, meaning that they don’t have to re-balance often. Leveraged ETFs still must seek SEC permission to operate (Bloomberg, Sept. 26, 2019).

What difference does it make when only a quarter of all listed equities are in taxable hands? Taxable individual investors seem to have migrated to ETFs. Zachary Mider of Bloomberg looked at investor estimates from Cerulli Associates and Deutsche Bank and concluded that as many as half of equity ETF units were held by taxable investors. Mutual funds are more likely to be held in retirement accounts. Mider pointed to a BlackRock survey indicating that most ETFs were held for over a year. He even trawled through 400 ETF SEC disclosures to find $211 billion worth of capital gains covered by in-kind redemptions in 2018 alone, some of which was short-term gain converted to long-term gain.

Nontransparent ETFs

Takeaway: The SEC is making the in-kind redemptions problem worse. Some types of ETFs still need special SEC permission to operate, even after the new final rule goes into effect. ETFs that don’t want to reveal their holdings every day still need the commission to vote on an exemption (rule 22c-1). SEC relief orders for actively managed ETFs have been conditioned on full daily transparency.
of all their holdings, which 270 active ETFs do. Index ETFs need only disclose the daily performance of the index, so their sampling techniques were unknown to outsiders. The SEC believes daily portfolio transparency disciplines market prices for ETF units and keeps them close to NAV. The new rule requires prominent, free daily disclosure of holding from all ETFs, including index ETFs.

ETF sponsors believe daily transparency is an invitation to shorts. The ETF sponsors that requested relief from daily transparency had to promise the SEC that some other form of arbitrage between ETF units and underlying securities was possible. T. Rowe Price and Fidelity are still waiting for permission to operate nontransparent actively managed ETFs.

Precidian has obtained the commission’s vote for relief from required daily transparency after a four-year wait. It had to file a public application, with notice and comment, so competitors could argue against giving it relief. One SEC commissioner, Robert Jackson, a Democrat, voted against Precidian’s application for relief, noting that transparency has been a hallmark of ETFs and urging the staff to keep an eye on it. Investors like transparency.

Precidian hopes to keep short-selling hedge funds at bay and has licensed its technology to other ETF sponsors. Otherwise, the Precidian structure is designed to take advantage of in-kind redemptions, Bullitt explained. The board and management promised the SEC that they would keep an eye on trading and take steps to keep unit prices in line with NAV. So Precidian would continuously wash out its gains through in-kind redemptions.

The authorized participant would purchase a pro rata basket of the securities in Precidian’s portfolio on a blind basis through the authorized participant representative, which then contributes them to the fund in exchange for creation units, which would be redeemed for a basket of securities the actively managed ETF did not want. Precidian promised the SEC that the ETF’s holdings would all be readily valued U.S. large-capitalization issuers. No custom baskets would be permitted, on either Precidian’s approval or the pending applications.

That is, the authorized participant must communicate with the ETF only through the representative, which functions like an escrow agent. Only the representative knows what securities are being bought. Bullitt explained that the fund provides the creation basket criteria to the representative, which submits an order through a special system. But then the authorized participant gives the representative execution instructions to purchase the securities and submits a restricted list for cash in lieu of securities.

‘The SEC has certainly opened the floodgates,’ Robert Gordon commented about the SEC action.

Those extra steps are intended to preserve the legal fiction that the representative is the authorized participant’s agent, not the ETF’s agent, in the view of securities and tax lawyers. Again, agency is important to the tax result. The authorized participant’s redemption request would be irrevocable. After the redemption, the representative sells the securities on behalf of the authorized participant. The representative delivers cash to close out both trades. All this happens in a two-day period.

“The SEC has certainly opened the floodgates. I’m sure we’ll now see some creative diversification strategies using section 852(b)(6),” Bob Gordon commented about the SEC action.