

Morgan Lewis

Precidian
Investments

NEW PATHS FORWARD:

Precidian's Activeshares® and The Conversion Of Mutual Funds To ETFs

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Overview

- Precidian's ActiveShares® and What You Need to Know
- Mutual Fund to ETF Conversions



PRECIDIAN INVESTMENTS

- Only ETF structure to effectively combine the efficiencies of an ETF with the benefits of a mutual fund
- Provide active managers with the ability to generate alpha while creating significant improvements in efficiency (lower administrative costs, increased manager flexibility, & enhanced tax efficiency)
- Listed on regulated exchanges, ActiveShares® provide all investors with unlimited entry and exit points during any trading day at customer-determined prices
- Efficient markets can be made
 - A per share Verified Intra-day Indicative Value (VIIV) is provided every second based upon the actual portfolio holdings, enabling Market Makers to create highly-correlated portfolios
 - APs can create and redeem in-kind on a pro-rata basis, at any time during the day
- Creations & Redemptions are executed by the AP Representative (APR) as agent, on a pro-rata in-kind basis in the AP's Confidential Account at the APR, ensuring that the identity of portfolio securities is protected and the asset manager's proprietary investment strategies remain protected (quarterly disclosure of portfolio constituents)

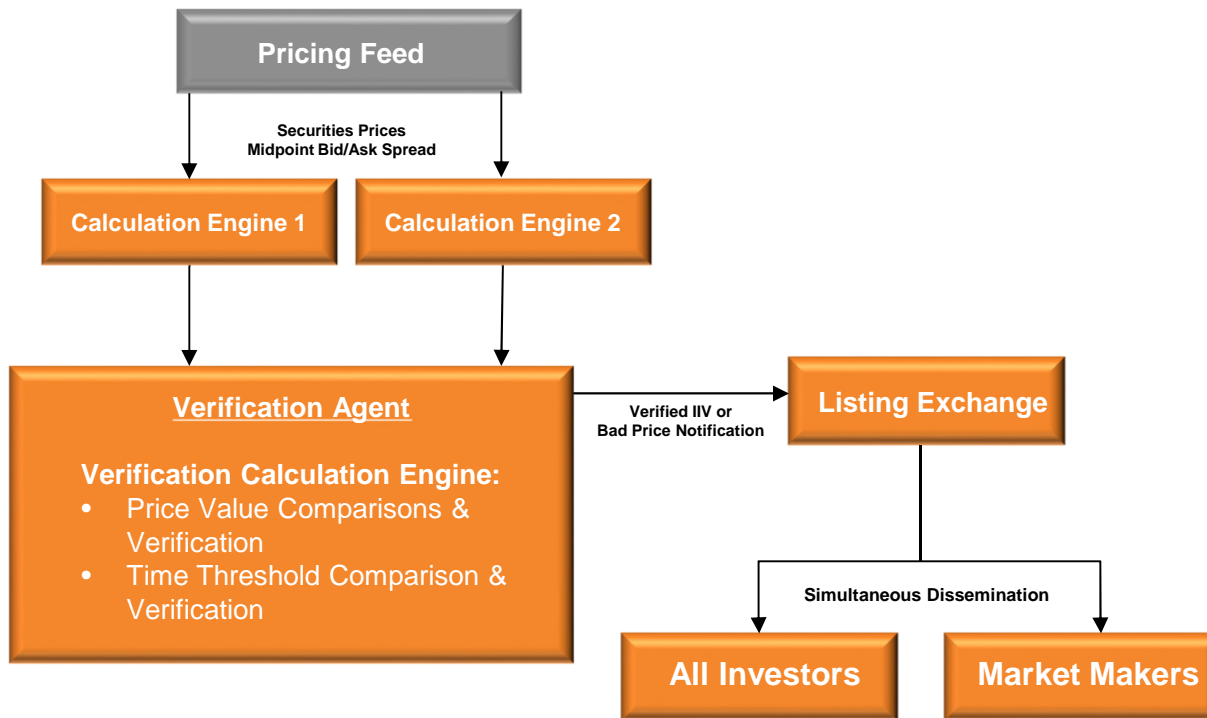
ActiveShares[®] – A Better Manager & Investor Experience

- Asset Manager's day-to-day responsibilities remain unchanged but flexibility is increased dramatically
 - Cost savings from elimination of extensive account maintenance (i.e., TA)
 - In-kind creations limit cash drag
 - Ability to distribute securities in-kind helps eliminate embedded capital gains & ensures trading flexibility
 - Cost savings & tax efficiencies = possibility of enhanced returns & margin expansion
- Investors enjoy added flexibility over traditional funds
 - Real-time access to funds – unlimited entry and exit points during trading hours
 - No lock-up period and associated load for early exit
 - Held in brokerage account & may be purchased on margin
 - Greatly simplifies investor choice by eliminating different share classes and providing a single price point for access
 - Can utilize options and order-types to control risk

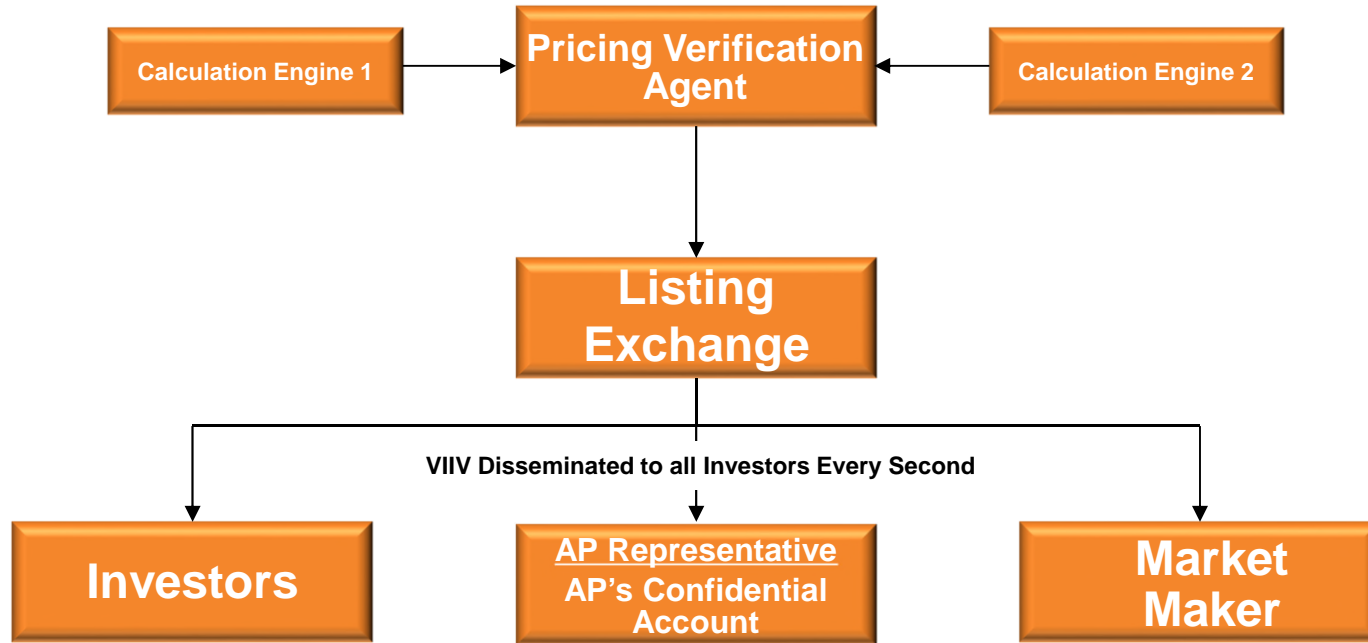
ActiveShares[®] – Ensuring Efficient Markets

- APs & MMs receive ample information and have abundant flexibility to make efficient markets
 - Prospectus disclosure provides fund strategy and universe of securities
 - Verified Intra-Day Indicative Value (VIIV) provides a per-share value of the actual portfolio, disseminated every second of the trading day
 - VIIV enables APs & MMs to adjust their hedge in real-time
 - The ability to create & redeem at any point during the day will ensure efficient markets
 - Small creation/redemption baskets significantly limits risk
- APs & MMs will utilize all of the same trading strategies they currently employ for all ETFs
- Since average ETF trades are approximately 500 shares, most ETF trading strategies don't include arbitrage, rather, a variety of trading strategies are employed including:
 - Macro Hedging utilizing Index Futures & Index ETFs
 - Correlation Hedging using proprietary trading strategies
 - Dispersion Trading across trading desk and/or entire firm platform

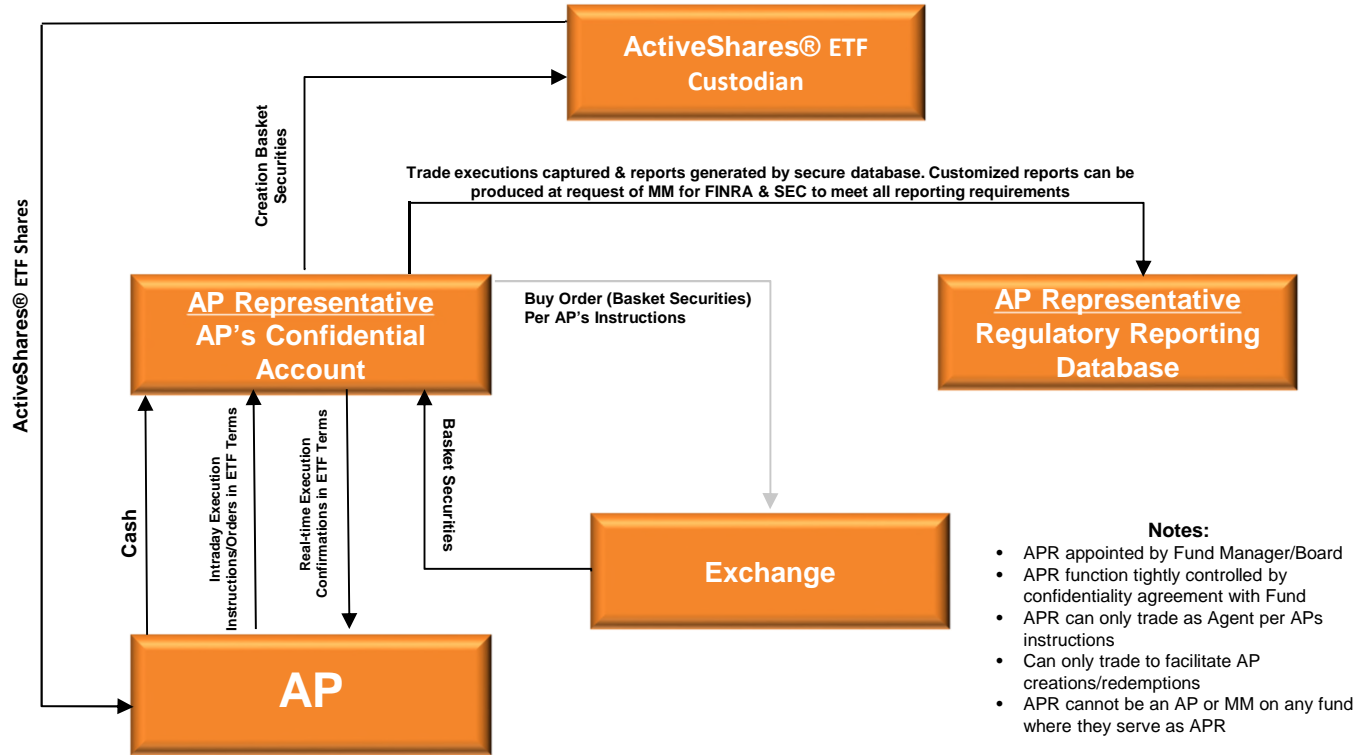
ActiveShares[®] ETF – Verified Intraday Indicative Value (VIIV)



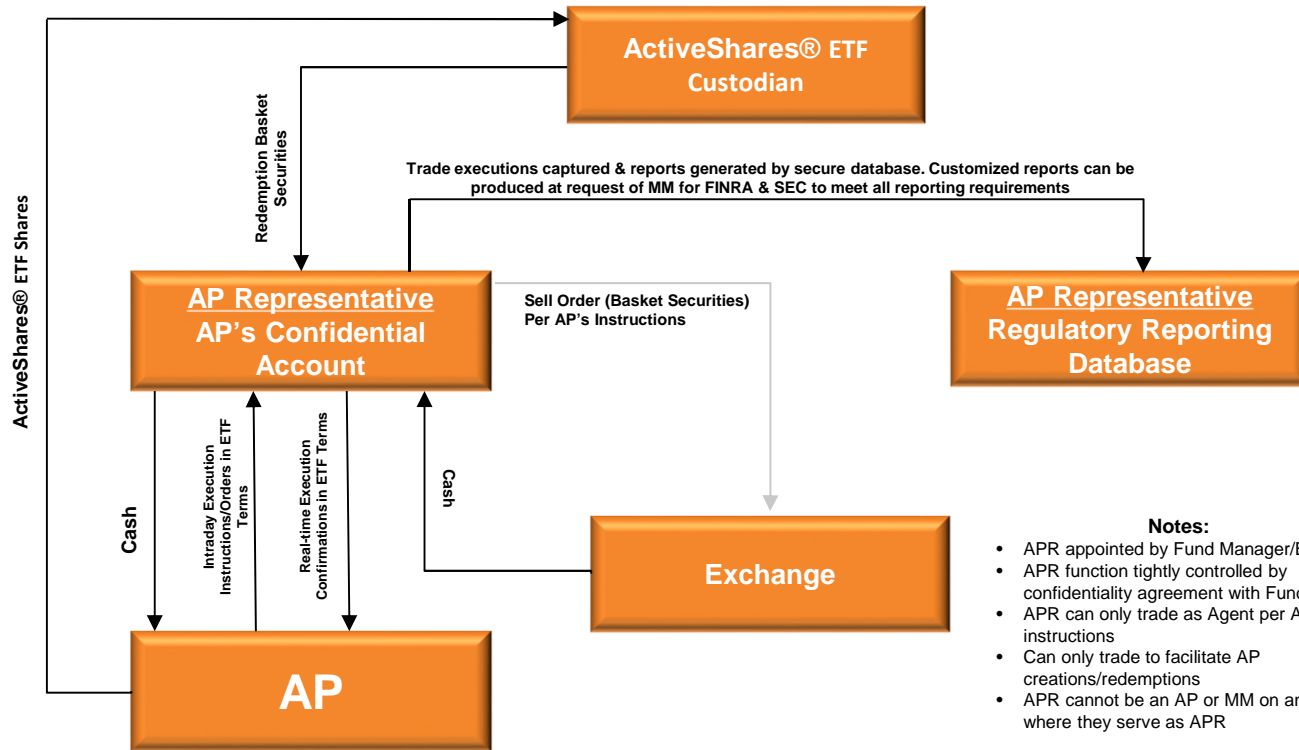
ActiveShares[®] ETF – Verified Intraday Indicative Value Information Flow



ActiveShares® ETF – In-Kind Creations



ActiveShares® ETF – In-Kind Redemptions



Notes:

- APR appointed by Fund Manager/Board
- APR function tightly controlled by confidentiality agreement with Fund
- APR can only trade as Agent per APs instructions
- Can only trade to facilitate AP creations/redemptions
- APR cannot be an AP or MM on any fund where they serve as APR

Taxation

- ETFs can defer recognizing built-in gains in their portfolios by delivering securities in-kind to satisfy redemption requests.
 - Section 852(b)(6) of the Internal Revenue Code, provides that no gain is recognized by a “regulated investment company” (a term that includes most ETFs and mutual funds) when the fund delivers securities in-kind to a shareholder upon demand of the shareholder for redemption from the fund.
 - There is no specific rule for tax purposes proscribing the composition of the redemption basket (i.e., low-basis lots can be selected).
- Non-redeeming shareholders of the ETF are not tagged with gain at the time when the securities are transferred in-kind to the redeeming shareholder (AP).
- A shareholder, however, ultimately recognizes such built in gain when they dispose of their shares in the ETF.

Adopting the ActiveShares® Structure

- Like all ETFs, there are certain regulatory approvals needed, or in the case of Rule 14e-5, recommended, to operate under the ActiveShares® structure. These include:
 - An SEC order under the 1940 Act. The SEC is permitting applicants to file a “short form” application that contains information about the specific applicants and incorporates the structural discussion from the application for the Precidian order. (see Investment Company Act Rel. No. 33477)
 - Exemptive or no-action relief from various sections of, and rules under, the Exchange Act (we believe the SEC staff is going to issue one or more “class” letters that anyone using the ActiveShares® structure can rely on).
 - A rule 19b-4 filing by the Listing Exchange for each ActiveShares® ETF.
 - Exemptive Relief from Exchange Act Rule 14e-5 (see Precidian ETF Trust II, May 22, 2019)

Required Disclosure – Prospectus, Website, Marketing Material

- Legend disclosure
- A plain-English description of the following information:
 - Where an investor can get access to the verified intraday indicative value (“VIIV”);
 - That the methodology for calculating the VIIV is available on the fund’s website; and
 - That the VIIV is intended to provide investors and other market participants with a highly correlated per share value of the underlying portfolio that can be compared to the current market price.
- A description, in more detail and in plain-English of the following:
 - Although the VIIV is intended to provide investors with enough information to allow for an effective arbitrage mechanism that will keep the market price of the Fund at or close to the underlying NAV per Share of the Fund, there is a risk (which may increase during periods of market disruption or volatility) that market prices will vary significantly from the underlying NAV of the Fund;
 - ETFs trading on the basis of a published VIIV may trade at a wider bid/ask spread than ETFs that publish their portfolios on a daily basis, especially during periods of market disruption or volatility, and therefore, may cost investors more to trade; and
 - Although the Fund seeks to benefit from keeping its portfolio information secret, market participants may attempt to use the VIIV to identify a Fund’s trading strategy, which if successful, could result in such market participants engaging in certain predatory trading practices that may have the potential to harm the Fund and its shareholders.

Legend Disclosure

- **This ETF is different from traditional ETFs.**
- Traditional ETFs tell the public what assets they hold each day. This ETF will not. This may **create additional risks** for your investment. For example:
 - You may have to pay more money to trade the ETF's shares. This ETF will provide less information to traders, who tend to charge more for trades when they have less information.
 - The price you pay to buy ETF shares on an exchange may not match the value of the ETF's portfolio. The same is true when you sell shares. These price differences may be greater for this ETF compared to other ETFs because it provides less information to traders.
 - These additional risks may be even greater in bad or uncertain market conditions.
- The differences between this ETF and other ETFs may also have advantages. By keeping certain information about the ETF secret, this ETF may face less risk that other traders can predict or copy its investment strategy. This may improve the ETF's performance. If other traders are able to copy or predict the ETF's investment strategy, however, this may hurt the ETF's performance.
- For additional information regarding the unique attributes and risks of the ETF, see section [X – i.e. the later discussion on VIIV and the risks of the ETFs] below.

Required Disclosure – Website Only

- The specific methodology for calculating the VIIV.
- After an offering of Shares commences a Fund's website must include the following additional quantitative information which **must be updated on a daily basis:**
 - On a per Share basis, the prior Business Day's NAV and market closing price or mid-point of the bid/ask spread at the time of calculation of such NAV, and
 - A calculation of the premium or discount of the market closing price or bid/ask price against such NAV.
- Any other information regarding premiums/discounts that ETFs registered under the Investment Company Act of 1940 may be required to provide (operates as a catchall disclosure obligation for information relating to premiums and/or discounts).

Required Disclosure – Website Only

- Prominent disclosure of where and how to find the continuously updated VIIV.
- A historical comparison of each Business Day's final VIIV to that Business Day's NAV.
- Once a Fund has completed a full fiscal year, it must disclose the median bid-ask spread for each Fund's most recent fiscal year based on the National Best Bid and Offer at the time of calculation of NAV (or such other spread measurement as may be required for other ETFs registered under the Act).
- If the Adviser determines pursuant to the VIIV Procedures that a portfolio security does not have readily available market quotations, which could be the situation when, for example, an Exchange institutes an extended trading halt in a portfolio security, that fact, along with the identity and weighting of that security in the Fund's VIIV calculation, will be publicly disclosed on the Fund's website.

New Responsibilities

- The Funds will adopt uniform procedures governing the calculation and dissemination of the VIIV and each Fund's Adviser will bear responsibility for the oversight of that process ("VIIV Procedures").
- Any changes to the VIIV Procedures will be submitted to the Board for review.

New Responsibilities

- For at least the first three years after launch of each Fund, the Adviser will promptly call a meeting of the Board (and will present to the Board for its consideration, recommendations for appropriate remedial measures) and the Board will promptly meet if, for 30 or more days in any quarter or 15 days in a row
 - the absolute difference between either the market closing price or the Bid/Ask Price, on one hand, and NAV, on the other, exceeds 1.00%, or
 - the bid/ask spread exceeds 1.00%.
- In such a circumstance, (and at least annually) the Board will consider the continuing viability of the Fund, whether shareholders are being harmed, and what, if any, action would be appropriate to among other things, narrow the premium/discount or spread, as applicable.
- The Board will then decide whether to take any such action.
- Potential actions may include, but are not limited to,
 - changing lead market makers,
 - listing the Fund on a different Exchange,
 - changing the size of Creations Units,
 - changing the Fund's investment objective or strategy, and
 - liquidating the Fund.

Precidian ActiveShares® SEC Documents

- Final Exemptive Application: <https://www.sec.gov/Archives/edgar/data/1499655/000114420419018151/0001144204-19-018151-index.htm>
- SEC Notice: <https://www.sec.gov/Archives/edgar/data/1499655/999999999719002543/filename1.pdf>
- SEC Order: <https://www.sec.gov/Archives/edgar/data/1499655/999999999719004621/filename1.pdf>
- SEC Rule 19b-4 Notice on Cboe's Proposed Listing Rule for ActiveShares: <https://www.sec.gov/rules/sro/cboebzx/2019/34-86157.pdf>

Mutual Fund to ETF Conversion

- Two Primary Methods for Conversion
 - Convert the mutual fund to an ETF
 - No change to the legal entity
 - Reorganize/merge the mutual fund into a new shell entity structured as an ETF
 - New legal entity

Conversion Option

The conversion of an open-end fund into an ETF is a relatively straightforward process, but novel.

- Existing Fund to obtain exemptive relief to operate as an ETF, and more specifically as an ActiveShares[®] ETF
 - The novel nature of this type of conversion may slow the exemptive process
- Amend organizational documents to permit operation as an ETF
 - This step may require shareholder approval
- Amend Fund registration statement to reflect changes, e.g., changes in redemption process

Conversion Option (con't)

- Obtain Board approval for conversion – best interest standard
 - Approve consolidation of share classes; amend Rule 18f-3 Plan
- Adjust operations and service provider arrangements to support ETF operations
 - This likely will require revising the Fund's existing compliance program
- Ensure shareholders can hold converted ETF shares through a brokerage account
- Determine if changes to Fund portfolio are required;
 - Submit a Rule 19b-4 request

Taxation: Conversion from a Mutual Fund to ETF

- Shareholders are effectively exchanging their mutual fund shares for the new ETF shares that carry different rights.
- Generally a tax-free transaction under Section 1036 of the Internal Revenue Code.
 - No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

Reorganization Option

- Obtain exemptive order for ActiveShares® ETF shell
 - Expedited application Using ActiveShares® ETF application = time savings
 - Incorporates Precidian's application
 - Custom exemptive application
 - Intellectual property considerations
- File registration statement with SEC to establish ETF
 - Same investment objectives, policies and restrictions as the mutual fund
 - ETF governing documents should allow for ETF's operations (i.e., redemption process)

Reorganization Option (con't)

- Can the shell ETF be created as a new series of the existing mutual fund trust?
 - Need to review organizational documents
 - Difference between a N-1A filing (requires SEC acceleration) and a 75 day 485(a) filing
- Obtain a rule 19b-4 filing by the Listing Exchange for each ActiveShares[®] ETF
 - No generic listing standards for active, non-transparent ETFs
- Review whether shareholder approval is required
 - State law- changing material rights of shareholders
 - Rule 17a-8
 - SEC staff comments

Reorganization Option (con't)

- Board approval considerations
 - State law fiduciary duties
 - Rule 17a-8 best interest and no dilution findings
 - Discussion of the differences between a mutual fund and ETF
 - Redemption rights – loss of ability to transact with fund
 - Intra-day liquidity benefits
 - Tax benefits
- Board approval of exemptive order and registration statement filings.

Reorganization Option (con't)

- Other Considerations:
 - Share Class consolidation considerations
 - Board training on the ETF structure and operations
 - Compliance with specific ActiveShares® ETF obligations
 - N-1A disclosure
 - VIIV Procedures
 - New Board responsibilities
 - ETF-related changes to compliance manual
 - Impact on distribution model
 - 12b-1 fees are not generally used

Taxation: Reorganization from a Mutual Fund to ETF

- Typically the Reorganization would consist of:
 - the formation of a new Shell ETF
 - the Existing Mutual Fund transferring all of its assets and liabilities to the new Shell ETF
 - the Existing Mutual Fund receiving shares in the new Shell ETF in the exchange
 - followed by the complete liquidation of the Existing Mutual Fund
- Treated as a tax-free 'F' reorganization.
- To the extent APs are used in the Reorganization to seed the new Shell ETF with the Existing Mutual Fund securities, the APs will need to serve as "agents" rather than as "principals" (i.e., the APs do not become the beneficial tax owners of the securities).

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QUESTIONS?

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John McGuire counsels clients on investment company and investment adviser regulatory issues and related issues affecting broker-dealers and transfer agents. He also assists clients with forming and acquiring investment companies and investment advisers. John routinely handles matters involving the establishment, representation, and counseling of exchange traded investment companies (ETFs), their advisers, and listing markets.

Additionally, John advises clients on regulatory and transactional matters, including development of new products and services; federal and state registration and compliance issues; Securities and Exchange Commission (SEC), FINRA, and state investigations and enforcement actions; mergers and acquisitions involving investment companies and investment advisers; interpretive and “no-action” letter requests; SEC exemptive orders; and related matters. John previously worked on some of the key ETF legal milestones, including the first fixed-income ETFs, the first 12(d)(1) relief for ETFs, actively managed ETFs, leveraged and inverse ETFs, and the first ETF in a master-feeder structure.

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Laura E. Flores' practice focuses on the regulation of investment companies and investment advisers. Laura regularly represents exchange-traded funds (ETFs), mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, and investment advisers. She counsels both well-established clients and clients that are new to the industry on a variety of regulatory, transactional, compliance and operational issues, including the development of new financial products and services, federal and state registration issues, the preparation and implementation of compliance programs, business combinations involving investment companies and investment advisers, interpretive and "no-action" letter requests, requests for Securities and Exchange Commission exemptive relief, and regulatory examinations. Laura also counsels investment advisory clients on matters, including advertising and communications with the public, investment adviser registration, and separately managed account (or wrap fee) programs. Laura also has significant experience representing "liquid alt" funds, funds that invest through offshore subsidiaries, and funds that utilize QFII/RQFII quotas to invest directly in securities issued and traded in China.

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Christopher Menconi advises investment companies, including mutual funds and exchange-traded funds (ETFs), and their investment advisers and boards of directors on regulatory, compliance, organizational and operational matters. He also advises insurance companies on the regulation of variable insurance products under the federal securities laws.

Chris regularly counsels clients on organizing, registering and operating investment companies. He assists investment companies and their advisers with the development of new products and services, the design of compliance programs, and the structure and negotiation of mergers and acquisitions. He works with regulators on behalf of his clients to obtain interpretive and “no-action” guidance as well as exemptive relief. He also advises boards of directors, including independent directors, on their duties under federal and state law. His clients include passive and active ETFs, multiple series and multi-class funds, funds of funds, manager of managers funds, alternative strategy funds and insurance-dedicated funds.

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Sean Graber advises companies in the securities industry on investment management matters. Investment advisers, mutual funds, closed-end funds, private investment companies, registered funds of hedge funds, and exchange-traded funds seek his advice on organizational issues, registration, and ongoing regulatory compliance matters. He also serves as counsel to the boards of directors of mutual funds, and he advises insurance companies on regulatory matters relating to variable insurance products.

Sean counsels clients on regulatory and transactional investment management matters. These include the development of new products and services, US federal and state registration and compliance issues, and US Securities and Exchange Commission (SEC) enforcement actions. He advises clients on mergers and acquisitions involving investment companies and investment advisers, and addresses interpretive and “no-action” letter requests, SEC exemptive orders, and related matters.

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Richard C. LaFalce counsels clients on the creation and taxation of private and pooled investment vehicles such as mutual funds, REITs, ETFs, hedge funds, Opportunity Zone Funds, and other investment-related entities. He frequently advises clients on the taxation of financial products, general corporate and international tax matters, and UBIT. Before joining Morgan Lewis, Rich was an assistant branch chief in the Internal Revenue Service Office of Chief Counsel, Financial Institutions and Products.

Rich advises clients on general corporate tax matters, the taxation of financial products, unrelated business taxable income (UBTI), information reporting, and international tax planning. He also counsels companies on international tax issues including compliance with the Foreign Account Tax Compliance Act (FATCA) and the Foreign Investment in Real Property Tax Act (FIRPTA).

Rich frequently assists clients in their interactions with the IRS including obtaining Private Letter Rulings and other guidance.

Stuart Thomas

Mr. Thomas began his career on Wall Street in 1989 with Merrill Lynch. He spent his first 10 years there working as a U.S. International Equity Salesman, Senior Deal Manager on the Equity Syndicate Desk, and as Manager of the Convertible Sales & Marketing Desk before moving to Morgan Stanley. While at Morgan Stanley, Mr. Thomas was widely credited with creating their retail exchange-traded fund business. He served as Manager of the ETF Sales and Trading Department until his promotion in January 2002 to First Vice President, Director of Equity Capital Markets Sales. On behalf of the World Gold Council, he started World Gold Trust Services in August 2002 to create, manage, and market the first U.S. commodity-backed equity traded on an exchange. In November 2004 SPDR Gold Shares (GLD) was launched on the NYSE.

Dan McCabe

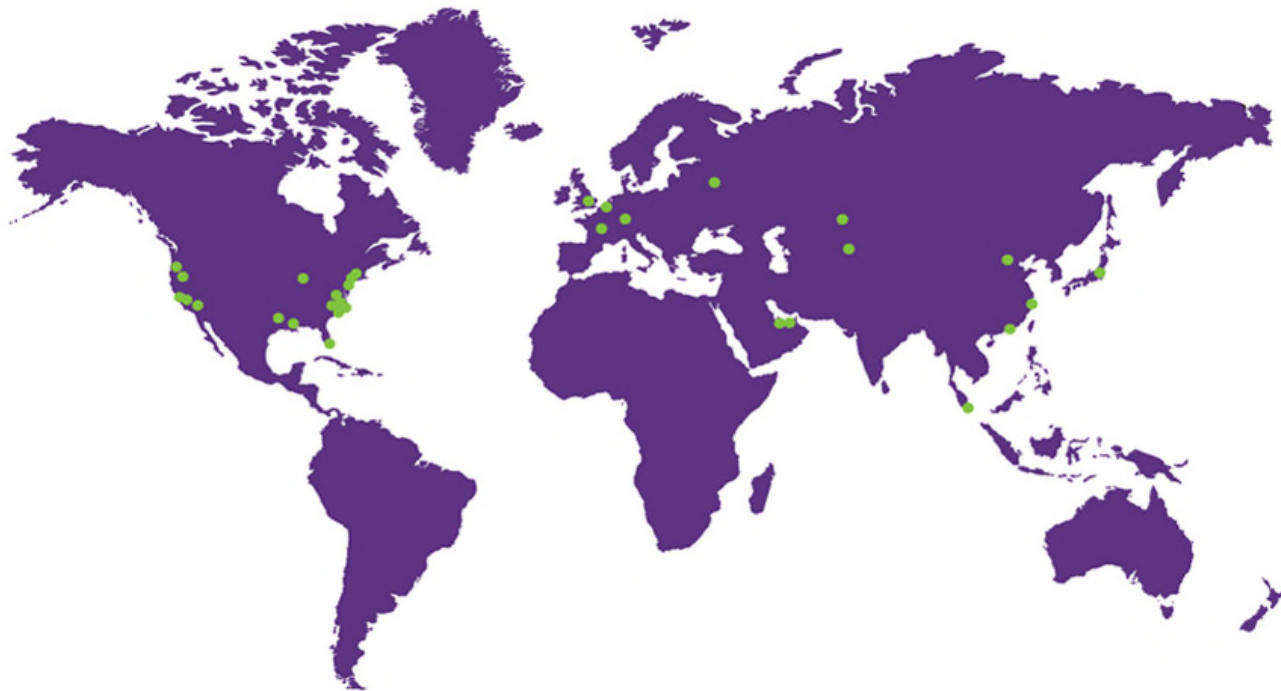
Prior to joining Precidian Investments, Dan served as CEO of Bear Hunter Structured Products LLC, an NYSE and AMEX specialist firm. Dan joined Bear Hunter in 1997 as vice president of Structured and Derivative Products, where he ultimately ran portfolio trading and managed the firm's overall exposure in ETFs. He has a background in institutional sales, options trading and index arbitrage with Walsh Greenwood, Merrill Lynch and WG Trading.

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Asia Pacific
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Middle East
North America

Our Locations

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Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
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