Published on *The National Law Review* https://natlawreview.com

SEC Staff Provides Conditional No-Action Assurance for Index Funds Unable to Comply with Diversification Requirements Due to Large Index Constituents

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On June 24, 2019, the staff of the SEC issued a no-action letter stating that it would not recommend enforcement action if an index-based fund exceeds the diversification limits of Section 5(b)(1) of the Investment Company Act of 1940 with respect to investments in individual issuers to the extent necessary to approximate the composition of the fund's index. The request for no-action assurance was submitted on behalf of sponsors of index-based mutual funds and ETFs concerned with the growth during the past year of a few constituents of certain broad-based, float-adjusted and market capitalization-weighted large cap U.S. equity indices to each represent more than 5% of the affected index and, in the aggregate, close to, or in some cases more than, 25% of the affected index. The incoming letter asserted that the requested relief would benefit the affected funds and their shareholders by: (1) minimizing tracking error; (2) allowing each fund to be managed consistent with its investment strategy and, for an affected ETF, its exemptive relief; (3) avoiding the expense associated with a shareholder vote to convert the fund to non-diversified status; and (4) avoiding portfolio management disruption.

To rely on the SEC staff's no-action position, an index-based fund must: (1) update its registration statement to reflect the fund's ability to exceed Section 5(b)(1)'s diversification limits and describe the associated risks; and (2) provide notice of the fund's updated diversification policy to shareholders. The no-action relief concerns specifically—and therefore, should be understood as being limited to—a fund that seeks to track the performance of a broad-based index created by an unaffiliated index provider not solely for the fund's use by investing all or substantially all of its assets in securities that comprise the index in approximately the same proportion as those securities are weighted in the index.

Read the SEC staff's no-action letter

Read The incoming letter

National Law Review, Volume IX, Number 213