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Exchange-Traded Funds Alert

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SEC Approves Extension of Implementation Date for ETF Continued Listing Standards

by J. Stephen Feinour, Jr. and Miranda Sturgis

In response to industry concerns, the U.S. Securities and Exchange Commission (SEC) has approved rule change proposals (the Proposals) submitted by NYSE Arca, Inc. (Arca),[1] The Nasdaq Stock Market LLC (Nasdaq)[2] and Bats BZX Exchange, Inc. (Bats) (collectively, the Exchanges)[3] to extend the implementation date for new continued listing standards applicable to exchange-traded funds (ETFs) to Jan. 1, 2018. The continued listing standards were previously scheduled to become effective on Oct. 1, 2017; however, key industry participants, including ETF sponsors, advocacy groups and index providers, expressed concern over the feasibility of finalizing their implementation of procedures and systems necessary to ensure compliance with the new requirements and resolving open interpretive questions prior to that date, and urged for a delay in implementation.[4] The rule changes will affect index-based ETFs listed pursuant to the Exchange's generic listing standards, as well as both index-based and actively managed ETFs listed in reliance on orders issued by the SEC's Division of Trading and Markets pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 (the Exchange Act).[5] Prior to the rule changes, the generic listing standards for index-based ETFs only applied at the time of the ETF's initial listing and did not require continuous compliance monitoring. Once the amended rules are implemented, index-based ETFs will be required to satisfy certain criteria on an ongoing basis in order to continue to list and trade their shares on the Exchanges.[6] Failure to adhere to the new standards could result in delisting of an ETF's shares from its Exchange.

BACKGROUND

ETFs, like other exchange-traded products, are required to adhere to specific quantitative criteria with respect to their underlying indexes or portfolio holdings, among other obligations, pursuant to applicable listing standards promulgated by the Exchanges in accordance with Section 19(b) of the Exchange Act in order to list and trade their shares. In general, the listing standards for ETFs impose requirements on an index-based ETF's underlying index or an actively managed ETF's portfolio holdings relating to market capitalization, trading volume, component weighting and principal amount outstanding, as well as issuer and diversity requirements, among other requirements. The SEC previously approved the amendments, which were proposed by the Exchanges at the SEC's request, to adopt the new continued listing standards and to clarify the procedures the Exchanges will undertake when an ETF is noncompliant with applicable listing standards.[7] Subsequent to the approvals, the Exchanges submitted rule change proposals requesting an extension of the implementation date for the continued listing standards in response to concerns expressed by ETF issuers regarding their ability to build and test new systems and procedures designed to ensure compliance with the continued listing standards by the Oct. 1, 2017 deadline.

On July 11, 2017, the Investment Company Institute (ICI) submitted a comment letter detailing the compliance challenges presented by the new rules and advocating for an extension of the implementation date.[8] In its letter, the ICI notes that, as adopted, the rule changes did not provide sufficient details regarding how certain aspects of the continued listing standards are to be applied by ETF issuers or the processes available to issuers to remediate noncompliance. The ICI letter also highlighted the fact that certain requirements imposed by the rules relate to circumstances or events outside of the ETF's control and compliance with those obligations would require discussions and negotiations with third parties.

DISCUSSION

In their requests for delayed implementation of the new rules, the Exchanges reiterate concerns raised in the ICI letter, including the need for issuers to work through compliance questions and incorporate the Exchanges' clarifications of certain provisions of the rules into their new compliance protocols. In support of the delay, the Proposals note that ETF issuers have requested additional time to continue to engage directly with the Exchanges in order to better understand the application and interpretation of certain elements of the continued listing standards. Additionally, issuers indicated in conversations with the Exchanges that they need more time to engage with third-party service providers, including index providers, to develop procedures to obtain required index-related information on an ongoing basis so they can test for compliance with applicable continued listing rules. This may require renegotiation of contractual arrangements, such as index licensing agreements, to reflect new obligations to provide data necessary for monitoring compliance with the listing standards. Finally, after key interpretive questions are resolved and all of the necessary compliance infrastructure is in place, ETFs will require time to test and refine these new compliance systems and procedures to ensure that they are effective and efficient.

Both Nasdaq and Bats have issued frequently asked questions (FAQs) responding to questions raised by issuers as they complete their development of processes and systems to verify and evidence compliance with the new requirements.[9] The FAQs respond to certain questions raised in the ICI letter and other matters raised by issuers in discussions with the Exchanges. Bats also submitted an interpretive filing with the SEC providing guidance with respect to compliance with the new standards.[10] For example, this guidance would clarify that the new standards require index-based ETFs to test for compliance upon any rebalance, reconstitution or other material change to the index or reference asset, as applicable, and no less frequently than on a quarterly basis. In addition, the Proposals note that the Exchanges will continue their ongoing dialogue with ETF issuers leading up to the Jan. 1, 2018 implementation date and expect to publish additional guidance clarifying the application of the new rules as necessary.

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[1] https://www.sec.gov/rules/sro/nysearca/2017/34-81775.pdf.

[2] https://www.sec.gov/rules/sro/nasdaq/2017/34-81773.pdf.

[3] https://www.sec.gov/rules/sro/batsbzx/2017/34-81777.pdf.

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[4] See, e.g., Letter, dated July 11, 2017, from Dorothy Donohue, Acting General Counsel, Investment Company Institute to Brent J. Fields, Secretary, Securities and Exchange Commission, available at https://www.sec.gov/comments/sr-nasdaq-2016-135/nasdaq2016135-1846208-155175.pdf.

[5] ETFs may list and trade their shares without seeking specific listing approval under Rule 19b-4 if they satisfy the Exchanges' generic listing standards. To the extent an ETF cannot meet the applicable requirements of the generic listing standards, the ETF must obtain specific approval from the SEC's Division of Trading and Markets permitting the listing and trading of its shares.

[6] The generic listing standards for actively managed ETFs already impose compliance obligations that apply to an ETF's portfolio holdings on a continuous basis. Furthermore, under the amended rules the following matters discussed in a Rule 19b-4 filing must be met on a continuous basis: statements or representations regarding the index composition; the description of the portfolio or reference assets; limitations on portfolio holdings or reference assets; dissemination and availability of index, reference asset and intraday indicative values (as applicable); and the applicability of Exchange listing rules specified in such filing. Recent listing approvals issued under Rule 19b-4 anticipated this move, and already include representations regarding continuous compliance with such standards.

[7] See https://www.sec.gov/rules/sro/nysearca/2017/34-80189.pdf (Arca); https://www.sec.gov/rules/sro/nasdaq/2017/34-79784.pdf (Nasdaq); and https://www.sec.gov/rules/sro/batsbzx/2017/34-80169.pdf (Bats).

[8] See note 4 supra.

[9] See http://cdn.batstrading.com/resources/listings/FAQs%20-%20New%20Cont%20List%20Standards%20FINAL.pdf (Bats); see also https://listingcenter.nasdaq.com/Material_Search.aspx?mcd=LQ&cid=142&sub_cid=&years=2017,2016,2015,2017,2016,2015,2014,2013,2012,2011,2010,2009,2008,2007,2006,2005,2004,2003,2002&criteria=1&materials (Nasdaq).

[10] See http://cdn.batstrading.com/resources/regulation/rule_filings/approved/2017/SR-BatsBZX-2017-61.pdf.