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SEC Approves Generic Listing Standards for Active ETFs

SUMMARY

On July 22, 2016, the U.S. Securities and Exchange Commission (SEC) approved amendments to listing rules proposed by NYSE Arca, Inc. (NYSE Arca)[1] and Bats BZX Exchange, Inc. (BATS)[2] to adopt generic listing standards for actively managed ETFs.[3] Pursuant to these new generic listing standards, effective immediately, actively managed ETFs that satisfy certain specified standards may list and trade on those exchanges without first having to obtain approval from the SEC's Division of Trading and Markets. Instead, actively managed ETFs may now list their shares on those exchanges by following a process similar to the listing process for most index-based ETFs, which requires only a notification to the SEC. The rule changes will allow qualifying actively managed ETFs to avoid the often time-consuming and uncertain Rule 19b-4 listing approval process and come to market with greater speed and certainty.

BACKGROUND

Index-based ETFs (i.e., ETFs that seek to track the performance of an underlying index) that meet generic listing standards have been able to list their shares on an exchange without having to obtain an order from the SEC's Division of Trading and Markets pursuant to Rule 19b-4 under the Securities Exchange Act of 1934. However, unlike their index-based counterparts, actively managed ETFs previously had no equivalent generic listing standards to fast-track their listings in a similar manner; instead, exchanges seeking to list actively managed ETFs first had to obtain approval from the SEC pursuant to Rule 19b-4, a process that often took many months and sometimes required additional limitations or conditions on an ETF's portfolio that necessitated a change to the ETF's proposed portfolio composition. Although it rarely did so, the SEC could also inform the exchange that it would not approve the listing, at which point the exchange would typically withdraw the filing. By approving the new generic listing standards for NYSE Arca and BATS, the SEC has provided greater certainty and accelerated the listing approval process for such ETFs.

Going forward, an actively managed ETF seeking to list its shares on either of those exchanges need only comply with the new generic listing standards to trade its shares, bypassing the traditional Rule 19b-4 approval process. However, actively managed ETFs that do not satisfy the new generic listing standards must have an exchange file separate rule changes with the SEC via the traditional Rule 19b-4 process before listing and trading their shares.

1 *See* 1934 Act Rel. No. 78397 (Jul. 22, 2016), *available at* https://www.sec.gov/rules/sro/nysearca/2016z/34-78397.pdf.

2 *See* 1934 Act Rel. No. 78396 (Jul. 22, 2016), *available at* https://www.sec.gov/rules/sro/bats/2016/34-78396.pdf.

3 On Aug. 18, the Nasdaq Stock Market, LLC filed a similar proposal with the SEC seeking approval of generic listing standards for actively managed ETFs. The SEC has not acted on Nasdaq's proposal as of the date of this article; therefore, the listing standards discussed herein apply only to the NYSE Arca and BATS exchanges.

DISCUSSION

The new generic listing standards of NYSE Arca and BATS are very similar to each other, and are based in large part on the generic listing standards that apply to index-based ETFs listed on those exchanges[4], as well as prior rule changes adopted pursuant to Rule 19b-4 for certain actively managed ETFs.

The generic listing standards impose certain standards on portfolios of actively managed ETFs, which vary according to security or asset type held (i.e., equity, fixed income, derivatives, etc.), including requirements with respect to the underlying issuer's market capitalization, trading volume, portfolio component weighting and principal amount outstanding, as well as issuer and diversity requirements. The generic listing standards require that the portfolio holdings of actively managed ETFs meet certain specified criteria with respect to their equity and fixed income security holdings, as set forth in the chart below. These criteria may effectively restrict certain types of actively managed ETFs from relying on the generic listing standards. For example, actively managed municipal ETFs may have difficulty satisfying these criteria based on the municipal securities they hold.

Additional key characteristics of the generic listing standards include the following:

- **Continuous compliance.** Actively managed ETFs relying on the new generic listing standards must satisfy those standards on an initial and continued basis, requiring investment advisers to implement continuous monitoring for compliance with those standards. Actively managed ETFs that seek to list their shares pursuant to the traditional Rule 19b-4 process similarly must satisfy the criteria specified in their Rule 19b-4 approval orders on an initial and continued basis.

- **Equity holdings.** U.S. equity holdings must be listed on a national securities exchange, and non-U.S. equity holdings must be listed and traded on an exchange that has last-sale reporting. An actively managed ETF may hold up to 10 percent of the equity weight of its portfolio in non-exchange-traded ADRs.

- **Fixed income holdings.** Additional restrictions are placed on fixed income holdings, limiting the types of issuers that must be included in at least 90 percent of the fixed income weight of the portfolio. In addition, non-agency, non-government-sponsored entity, privately issued mortgage-related and other asset-backed securities must not account for, in the aggregate, more than 20 percent of the fixed income weight of the portfolio.

- **Exchange-traded derivative holdings.** With respect to listed derivatives, the generic listing standards impose no limitation on the percentage of an actively managed ETF's portfolio that can be invested in such instruments, provided that at least 90 percent of the weight of the holdings invested in listed derivatives consist of listed derivatives whose principal market is a member of the Intermarket Surveillance Group or is a market with which the exchange has a comprehensive surveillance sharing agreement. In addition, the aggregate gross notional value of listed derivatives based on any five or fewer underlying reference assets shall not exceed 65 percent of the weight of the portfolio (including gross notional exposures), and the aggregate gross notional value of listed derivatives based on any single underlying reference asset shall not exceed 30 percent of the weight of the portfolio (including gross notional exposures).

- **Over-the-counter (OTC) derivative holdings.** The generic listing standards require that no more than 20 percent of the actively managed ETF's assets be invested in OTC derivatives. The aggregate gross notional value of the OTC derivatives should be used for purposes of calculating this limitation. This limitation on OTC derivatives thus impacts an international or global ETF's ability to utilize currency forward contracts to hedge against non-U.S. currency fluctuations.

- **Cash holdings.** There is no limitation on the percentage of an actively managed ETF's portfolio that may be invested in cash or cash equivalents (e.g., repurchase agreements, commercial paper and shares of money market funds). However, such ETFs may only hold short-term instruments with maturities of less than three months.

- **Limited leveraged investments.** An actively managed ETF may not invest more than 25 percent of the equity weight of its portfolio in leveraged or inverse-leveraged exchange-traded products.

- **Other requirements.** The new generic listing standards require an actively managed ETF to have a stated investment objective that it must adhere to under normal market


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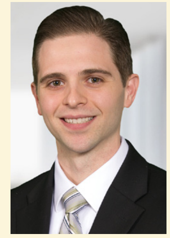
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[4] *See* NYSE Arca Equities Rule 5.2(j)(3); Bats BZX Exchange Rule 11.14(c).

conditions, as defined by an exchange[5]. The new generic listing standards also require an actively managed ETF to disclose on its website certain information regarding its portfolio holdings, such as (1) the ticker symbol, (2) the CUSIP or other identifier, (3) a description of the holding, (4) the identity of the security, commodity, index or other asset upon which a derivative is based, (5) the strike price for any options, (6) the quantity of each security or other asset held as measured by select metrics, (7) the maturity date, (8) the coupon rate, (9) the effective date, (10) the market value and (11) the percentage weight of the portfolio holding.[6]

5 *See* NYSE Arca Equities Rule 8.600(c)(5); Bats BZX Exchange Rule 14.11(i)(3)(E). Normal market conditions would include, but are not limited to, the absence of trading halts in the applicable financial markets generally; operational issues (such as systems failure) causing dissemination of inaccurate market information; or *force majeure*-type events (such as natural or man-made disasters, acts of God, armed conflict, acts of terrorism, riots or labor disruptions, or any similar intervening circumstances).

6 See NYSE Arca Equities Rule 8.600(c)(2)(A)-(K); Bats BZX Exchange Rule 14.11(3)(B)(i)-(xi).

Equity and Fixed Income Security Portfolio Holdings Requirements

<table>
<tr><th>Requirement</th><th>U.S. Equity</th><th>Non-U.S. Equity</th><th>Fixed Income</th></tr>
<tr><td>Minimum market value / original principal amount</td><td>Component stocks accounting for at least 90% of the equity weight of the portfolio each must have a minimum market value of at least $75M[7]</td><td>Non-U.S. component stocks must each have a minimum market value of at least $100M</td><td>Fixed income components accounting for at least 75% of fixed income weight of portfolio each must have a minimum original principal amount outstanding of at least $100M</td></tr>
<tr><td>Monthly trading volume</td><td>Component stocks accounting for at least 70% of the equity weight of the portfolio each must have a minimum monthly trading volume of 250,000 shares, or minimum notional volume traded per month of $25M, averaged over the past six months[7]</td><td>Non-U.S. component stocks must each have a minimum global monthly trading volume of 250,000 shares, or minimum global notional volume traded per month of $25M, averaged over the past six months</td><td>N/A</td></tr>
<tr><td>Component weighting limit</td><td>Most heavily weighted component stock must not exceed 30% of equity weight of portfolio; five most heavily weighted component stocks must not exceed 65% of equity weight of portfolio[7]</td><td>Most heavily weighted non-U.S. component stock must not exceed 25% of equity weight of portfolio; five most heavily weighted non-U.S. component stocks must not exceed 60% of equity weight of portfolio</td><td>No fixed income component can exceed 30% of fixed income weight of portfolio; five most heavily weighted fixed income components must not exceed 65% of fixed income weight of portfolio[8]</td></tr>
<tr><td rowspan="2">Minimum holdings</td><td>If only U.S. component stocks are held, the equity portion of portfolio must include at least 13 component stocks</td><td>If non-U.S. component stocks are held, the equity portion of portfolio must include at least 20 component stocks</td><td rowspan="2">Fixed income portion of portfolio must include at least 13 nonaffiliated issuers; no minimum if at least 70% of weight of portfolio consists of equity securities</td></tr>
<tr><td colspan="2">No minimum if one or more series of Derivative Securities Products or Index-Linked Securities (i) constitute components, or (ii) account for 100% of equity weight of portfolio</td></tr>
</table>

7 Excludes Derivative Securities Products (i.e., exchange-traded products under NYSE Arca Equities Rule 5.2(j)(3) and Rule 8, or Bats BZX Exchange Rule 14.11(c)(3)(A)(i)(a), as applicable) and Index-Linked Securities (or Linked Securities under the Bats BZX Exchange Rules) (i.e., securities that qualify for listing and trading under NYSE Arca Equities Rule 5.2(j)(6) or Bats BZX Exchange Rule 14.11(d), as applicable).

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