SEC approves new continued listing standards for ETFs

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Abstract

Purpose – *To introduce and analyze recent amendments to the rules of three US securities exchanges to add specific continued listing standards applicable to exchange-traded funds (ETFs).*

Design/methodology/approach – *Provides an introduction and summary overview of the topic, summarizes the scope of the rule changes, discusses the industry reaction to the proposed rule changes and the regulator's response, notes the applicability of the rule changes to ETFs relying on their own fund-specific regulatory relief, and identifies compliance dates.*

Findings – *Each of three US securities exchanges filed separate proposals to amend their listing standards to add specific continued listing standards for ETFs. Notwithstanding various concerns expressed in comment letters from key industry participants, by March 2017 the Securities and Exchange Commission (SEC) approved all three proposals in substantially the form proposed.*

Practical implications – *ETF sponsors should note that significant compliance enhancements may be required to ensure proper and continuous testing of securities in an ETF's underlying index and/or portfolio in lieu of testing for compliance solely at the time of initial listing or at the time of an investment decision. The rule changes are scheduled to take effect by October 1, 2017.*

Originality/value – *Practical analysis from a premier financial services law firm on the issues presented by the ETF rule changes.*

Keywords *Securities and Exchange Commission (SEC), Bats global markets, Continued listing standards, Exchange traded fund (ETF), Nasdaq, NYSE Arca*

Paper type *Technical paper*

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Since their US introduction in 1993, exchange-traded funds (ETFs) – which have grown to over 1,800 products with holdings of over $2.7 trillion[1] – have operated under exemptive relief from many of the Securities and Exchange Commission (SEC) rules otherwise applicable to mutual funds. New types of ETFs continue to test the limits of ETF regulation and exemptions[2]. As an exchange-traded product (ETP), ETFs are subject to stock exchange rules and listing standards in addition to SEC rules.

While ETFs generally may comply with generic exchange listing standards or standards specific to a particular ETF on an ongoing basis, current practice has required that index ETFs comply only at the time of initial listing. However, under the SEC-approved proposals discussed below, continued monitoring and application of listing standards would be required for all ETFs, which may cause additional compliance costs and obligations. In the midst of a race to the bottom for ETF fees[3], those additional costs could be significant.

Summary overview

From September 2016 through January 2017, each of NYSE Arca, Inc. (Arca), Bats BZX Exchange, Inc. (Bats), and NASDAQ Stock Market LLC (Nasdaq) (collectively, Exchanges) filed separate proposals to amend their generic listing standards to add specific continued listing standards for ETFs and other types of exchange-traded products[4], and to specify the delisting procedures for ETFs in the event of non-compliance with such continued listing standards. The proposals apply continued listing standards to passively-managed (or index) ETFs and actively-managed (or active) ETFs that are listed in reliance on their own 19b-4 Order (defined below), as well as those ETFs listed in reliance on an Exchange's generic listing standards. The SEC received several comment letters from key industry participants, including the Investment Company Institute and three of the four largest US ETF sponsors, which raised significant concerns and urged the Exchanges to withdraw the proposals or the SEC to disapprove them. Notwithstanding the commenters' concerns, in March 2017 the SEC approved Arca's[5] and Bats'[6] proposals in substantially the form proposed, and had previously approved Nasdaq's proposal in substantially the form proposed[7]. ETF sponsors should note that significant compliance enhancements may be required to ensure proper and continuous testing of securities in an ETF's underlying index and/or portfolio in lieu of testing for compliance solely at the time of initial listing or at the time of an investment decision. The amended rules are scheduled to take effect by August 1, 2017 (for Nasdaq) or October 1, 2017 (for Arca and Bats).

Scope of the rule changes

In 2016, the SEC approved new generic listing standards for each of the Exchanges to permit the listing and trading of active ETFs[8]. Although these generic listing standards were in many ways modeled upon the Exchanges' generic listing standards for index ETFs, one notable difference was that the 2016 active ETF standards applied on a continuous basis, not just at the time of the ETF's initial listing (as had been the case for the index ETF standards)[9]. As discussed in greater detail below, testing for compliance with the generic listing standards on a continuous basis presents several operational and compliance challenges. In connection with approving a continued listing standard within the active ETF generic listing standards, the SEC staff requested that the Exchanges develop proposals to amend their index ETF generic listing standards to include a similar continued listing standard.

Beginning with Nasdaq's proposal filed in September 2016, each of the Exchanges proposed to amend their listing rules to specify new continued listing standards that would apply to index ETFs relying on the generic listing standards. The proposals also apply continued listing standards to any index ETFs or active ETFs listed pursuant to their own 19b-4 Orders (non-generically-listed ETFs). Arca and Nasdaq further proposed to amend the requirement to delist an ETF if, following the initial 12-month period following commencement of trading on the Exchange, there are fewer than 50 record and/or beneficial holders of the ETF for 30 or more consecutive trading days, by deleting the threshold "30 or more consecutive trading days". This requirement has been difficult to meet for certain newer or smaller ETFs, and the deletion of the 30 or more consecutive trading days threshold will make this requirement more challenging for these ETFs.

The Exchanges also proposed to amend their rules to specify ETF notification requirements related to failure to comply with the continued listing standards. Specifically, the Exchanges' rules are being amended to require an ETF to promptly notify its listing Exchange after the ETF becomes aware of any non-compliance with an applicable continued listing standard. As proposed, the Exchanges would, to the extent the non-compliance is not cured, initiate delisting proceedings for an ETF if any of its continued listing standards are not continuously maintained, subject to the delisting procedures set forth in the Exchange's rules. ETFs are currently subject to the delisting procedures of the Exchange on which they are listed, and these procedures give the Exchanges discretion to offer non-compliant ETFs the opportunity to submit a plan to regain compliance. Such plans are typically due to the Exchange within 45 days of notification of non-compliance. If such a plan is accepted, non-compliant ETFs are afforded a cure period to regain compliance. The Exchange Orders apply this same procedure to an ETF's non-compliance with the continued listing standards.

Industry pushback on the proposed rule changes

Several key industry participants commented on the proposals, and most focused on four key concerns[10]. First, commenters questioned how an index ETF, especially one that uses indexes established and maintained by unaffiliated third parties, would comply with the proposed rules, and how the Exchanges would enforce them[11]. Commenters asserted that it would be unrealistic to anticipate that an ETF could ensure that an unaffiliated index complies with the initial listing standards on an ongoing basis, and expressed concern that an index ETF, through no action of its own, could see certain of the constituent securities of the unaffiliated index fall below the listing requirements. One commenter stated its view that even if a third-party index provider was amenable to changes to an underlying index that would allow an ETF to regain compliance with the continued listing standards, it is unlikely that the ETF would be able to formulate a compliance plan within the deadline required by the Exchanges' delisting procedures (*i.e.*, within 45 days of notifying the Exchange of non-compliance)[12].

Second, commenters argued that the proposals would unfairly discriminate against ETFs because the proposals would result in differential treatment of ETFs as compared to other exchange-listed securities (e.g., common stock)[13]. Commenters noted that the continued listing standards for equity securities generally differ from the initial listing standards, whereas the proposed ETF continued listing standards would be the same as the initial listing standards[14].

Third, commenters asserted that the proposals provide no explanation or evidence regarding the potential manipulation of ETFs under the current rules, or how the proposals would reduce the potential for manipulation[15]. One commenter also noted that significant compliance enhancements could be required to ensure proper and continuous testing of securities held in an ETF's underlying index and/or portfolio, and questioned how this type of testing would enhance investor protection[16].

Lastly, commenters noted that the potential for ETFs, through no action of their own, to be delisted raises very serious economic consequences for investors and the ETFs themselves[17].

The SEC response to industry comments

In approving the proposals, the SEC noted in the Exchange Orders that "the development, implementation, and enforcement of standards governing the initial and continued listing of securities on an exchange are activities of critical importance to financial markets and the investing public". The SEC further noted, "[o]nce a security has been approved for initial listing, continued listing criteria allow an exchange to monitor the status and trading characteristics of that issue to ensure that it continues to meet the exchange's standards for market depth and liquidity so that fair and orderly markets can be maintained".

The SEC noted its belief that "a variety of means are available to [ETFs] to monitor for a product's compliance with the continued listing standards". For example, the SEC noted that "information regarding the composition of a third-party index may be publicly available, or may be obtained from the index provider pursuant to provisions in the index licensing agreement, so that the [index ETF] can monitor its compliance on an ongoing basis. If an index approaches the thresholds set forth in the continued listing standards, the [index ETF] may decide to engage in discussions with the index provider regarding potential modifications to the index so that the [index ETF] can continue to be listed on the Exchange". Requiring index ETFs to take the additional step of monitoring their underlying indexes for continuous compliance with the generic listing standards adds a new compliance burden where none existed previously, potentially adding cost and complexity to an ETF's operations. The SEC noted that if an index provider is unwilling to modify the index in order to comply with an Exchange's listing requirements, the Exchange may submit a proposal for an ETF-specific 19b-4 Order to continue to list the ETF based on the index. However, it should be noted that this process typically takes several months and may subject the ETF to heightened scrutiny from the SEC staff as to why the ETF should be permitted to depart from the generic listing standards – thus raising doubt as to whether such a proposal would be approved depending on the facts and circumstances of the proposal.

With respect to commenters' questions regarding the Exchanges' enforcement of the proposed continued listing requirements, the SEC noted that the Exchanges are proposing to apply their existing delisting procedures, rather than adopting new delisting procedures, while noting that the proposals' requirement that ETFs notify an Exchange of a failure to comply with the continued listing standards would supplement the Exchange's own surveillance of its listed ETF issuers.

With respect to commenters' concerns that the proposed listing standards would treat ETFs fundamentally differently than other types of listed equity securities, the SEC noted that listed common stock is subject to certain listing standards that are the same on an initial and continuing basis, and that the generic listing standards that address the index composition of certain other types of index-based ETPs already apply equally on an initial and ongoing basis.

Finally, with respect to commenters' questions regarding the purpose of the proposals and their impact on the potential for manipulation and investor protection, the SEC noted that, in approving a wide variety of ETP listing standards, including standards that apply to underlying indexes or portfolios, the SEC "has consistently explained that these standards, among other things, are intended to reduce the potential for manipulation by assuring that the ETP is sufficiently broad-based, and that the components of an index or portfolio underlying an ETP are adequately capitalized, sufficiently liquid, and that no one stock dominates the index". According to the SEC "[f]or exchange listing standards to effectively achieve their goals, including to effectively address the potential for manipulation of a listed ETP, their application cannot be linked to only a single point in time (*i.e.*, the time of initial listing). Instead, they must be applied on an ongoing basis".

Continued listing standards also apply to ETFs relying on a 19b-4 Order

With respect to non-generically listed products that rely on their own 19b-4 Order, the proposals amend applicable Exchange rules to state that all statements or representations in a 19b-4 Order regarding the following constitute continued listing requirements:

- the description of the index, portfolio, or reference asset (as applicable to a specific ETF);
- limitations on index, portfolio holdings, or reference assets (as applicable to a specific ETF); or
- the applicability of Exchange listing rules (including, for example, statements and representations related to the dissemination of the intraday indicative value and index value, as applicable).

Implementation dates

Because the Nasdaq proposal was earlier approved by the SEC in January 2017, Nasdaq is scheduled to implement its rule changes by August 1, 2017. The proposals from Arca and Bats were approved by the SEC in March 2017, thus Arca and Bats are each scheduled to implement their proposed rule changes by October 1, 2017.

Notes

1. Dave Michaels, Here Come ETF Regulations (and Why the Industry Is Happy About It), Wall Street Journal, Mar. 6, 2017.

2. For further information, please refer to the following Dechert OnPoints (available at: www.dechert.com/publications): SEC Adopts New Rules and Rule Amendments to Require Registered

Open-End Investment Companies to Establish Liquidity Risk Management Programs and Permit Them to use "Swing Pricing"; SEC's Proposed Modernized Reporting Regime: Effects on ETF Sponsors; and US SEC Seeks Public Comment on the Listing, Trading and Selling of Exchange Traded Products.

3. Sarah Max, Race to the Bottom: How Low Can ETF Fees Go?, Barron's, Oct. 15, 2016.
4. Although the proposals apply to the Exchanges' rules governing various types of exchange-traded products (ETPs), this article focuses primarily on the proposals' impact on ETFs.
5. Securities Exchange Act Release No. 80189 (Mar. 9, 2017) (Arca Order). Arca's proposal was first filed in January 2017.
6. Securities Exchange Act Release No. 80169 (Mar. 7, 2017) (Bats Order). Bats' proposal was first filed in November 2016.
7. Securities Exchange Act Release No. 79784 (Jan. 12, 2017) (Nasdaq Order, together with the Arca Order and Bats Order, Exchange Orders). Nasdaq's proposal was first filed in September 2016.
8. For further information, please refer to Dechert OnPoint: NYSE ARCA and BATS Adopt Generic Listing Standards for Active Exchange-Traded Funds, Which May Expedite Fund Launches. Nasdaq subsequently adopted substantial identical standards.
9. The Exchanges' generic listing standards set forth quantifiable criteria for compliance, which are designed to: (i) ensure that securities with substantial market capitalization (or par amount outstanding) and trading volume account for a substantial portion of the weight of an index or portfolio underlying a ETF; (ii) provide transparency regarding the components of an index or portfolio underlying a ETF; (iii) ensure that there is adequate liquidity in the ETF itself; and (iv) provide timely and fair disclosure of useful information that may be necessary to price the ETF. To the extent any ETF cannot meet the conditions of the applicable generic listing standards, the Exchange on which the ETF seeks to list can propose an ETF-specific rule change pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 (Exchange Act), which is subject to SEC approval (19b-4 Order).
10. *See*, *e.g.*, Letters to Brent J. Fields, Secretary, SEC, from David W. Blass, General Counsel, Investment Company Institute, dated January 12, 2017 ("ICI Letter"); and Samara Cohen, Managing Director, US Head of iShares Capital Markets, Joanne Medero, Managing Director, Government Relations & Public Policy, and Deepa Damre, Managing Director, Legal & Compliance, BlackRock, Inc., dated February 14, 2017 ("BlackRock Letter").
11. *See, e.g.,* ICI Letter.
12. *See* BlackRock Letter.
13. *See, e.g.,* ICI Letter.
14. *See, e.g.,* ICI Letter.
15. *See, e.g.,* ICI Letter.
16. *See* BlackRock Letter.
17. *See, e.g.,* ICI Letter.

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