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*Practice Groups:*

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# Exchanges Adopt Generic Listing Standards for Actively Managed ETFs

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## Introduction

Earlier this year, the Securities and Exchange Commission ("SEC") approved new rules proposed by Bats BZX Exchange, Inc. ("Bats") and NYSE Arca, Inc. ("Arca") that establish generic listing standards ("Active Generics") for qualifying actively managed exchange-traded funds ("ETFs").[1] The Active Generics dramatically streamline and simplify the Exchanges' listing process for firms looking to bring actively managed ETFs to market. Actively managed ETFs may list under the Active Generics if they satisfy the criteria described below.[2]

## Existing Listing Regime

Currently, securities exchanges are required to file a "proposed rule change" pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 ("1934 Act") with the SEC prior to listing a "new derivative securities product," the definition of which includes ETFs.[3] As ETF sponsors can attest, the Rule 19b-4 process typically requires significant time and resources and introduces uncertainty as to whether a particular investment strategy will be permitted at all. It involves extensive dialogue among the ETF sponsor and its legal counsel, the SEC, and the Exchanges to develop bespoke rules to govern the ETF, including the types of investments the ETF may make. This process routinely takes between six and 12 months or more to complete.

Fortunately, Rule 19b-4 permits the Exchanges to adopt generic rules that exempt certain products from the definition of "new derivative securities product," thereby removing the requirement for the products to be reviewed and approved on a case-by-case basis. In fact, generic listing standards have long been available to index-based ETFs but not to actively managed ETFs, and this disparity is arguably partially responsible for the emergence of "smart beta" ETFs, as it encouraged fund sponsors, particularly those who use quant-based investment processes, to develop index-based ETFs with "smart beta" strategies in lieu of actively-managed ETFs.

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[1] Securities Exchange Act Rel. No. 24-78005 (June 7, 2016) (SR-BATS-2015-100) ("Bats Proposal"); Securities Exchange Act Rel. No. 34-78016 (June 8, 2016) (SR-NYSEArca-2015-110) ("Arca Proposal"). On September 23, 2016, the SEC approved similar rules proposed by NASDAQ Stock Market, LLC ( together with Bats and Arca, the "Exchanges"). Securities Exchange Act. Rel. No. Release No. 34-78616 (Aug. 18, 2016) (SR-NASDAQ-2016-104).

[2] Actively managed ETFs that already list may continue to do so under the rules crafted during their Rule 19b-4 listing process. New actively managed ETFs that do not satisfy the Active Generics may still seek to list under the Rule 19b-4 listing process.

[3] Rule 19b-4(e).

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## The New Generic Listing Standards

The Active Generics focus primarily on: (i) the ETF's portfolio composition and (ii) the ETF's public disclosures. A relying ETF has to comply with the Active Generics both at the time of listing and on a continuous basis.

### *Portfolio Composition*

The Active Generics establish various restrictions on the types and quantities of equity securities, fixed-income securities, and derivatives instruments that the ETF may hold. The restrictions are principally designed to ensure that the bulk of portfolio holdings are assets that can be readily valued and obtained for arbitrage transactions.[4] The following charts summarize the key limitations on the types of assets that such ETFs may hold.[5]

| Equity Portion of the ETF Portfolio | |
|---|---|
| **U.S. Equity Portion** | **Non-U.S. Equity Portion** |
| • At least 90% of the equity weight must be issued by companies with market value of at least US$75 million.<br>• At least 70% of the equity weight must have:<br>    • Monthly trading volume of at least 250,000; or<br>    • Average notional value of monthly trades of at least US$25 million over the prior six months.<br>• No single stock can represent more than 30% of the equity portion.<br>• No five stocks together can represent more than 65% of the equity portion.<br>• No more than 10% of the equity portion can be invested in nonexchange-traded ADRs.<br>• All of the stocks must be listed on a national securities exchange and be NMS Stocks.[6] | • All of the stocks must be issued by companies with market value of at least US$100 million.<br>• All stocks must have:<br>    • Monthly trading volume of at least 250,000; or<br>    • Average notional value of global monthly trades of at least US$25 million over the prior six months.<br>• No single issuer can represent more than 25% of the equity portion.<br>• No five issuers together can represent more than 60% of the equity portion.<br>• All of the stocks must be listed and traded on an exchange that has last-sale reporting. |
| • If the equity portion of the ETF is comprised of only U.S. stocks, the ETF generally must hold at least 13 different stocks.<br>• If the equity portion of the ETF includes non-U.S. stocks, the ETF generally must hold at least 20 different stocks.<br>• No more than 25% of the equity portion can be invested in leveraged or inverse leveraged products. | |

The Active Generics do not restrict investments in shares of other ETFs.

[4] Bats Proposal, at 20-21

[5] These limitations are not exhaustive. You should consult counsel to construct a portfolio that complies with the Active Generics.

[6] NMS Stocks means "any security [other than an option] for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." Rule 600 of Regulation NMS

**Fixed-Income Portion of the ETF Portfolio**

- At least 75% of the fixed-income weight must have minimum original principal outstanding of at least US$100 million.
- At least 90% of the fixed-income weight must come from issuers that:
  - Are subject to periodic reporting requirements under the 1934 Act;
  - Have outstanding equity held by non-affiliates with global market value of at least US$700 million;
  - Have global outstanding fixed income with remaining principal amount of at least US$1 billion;
  - Qualify for an exemption under Section 3(a)(12) of the 1934 Act; or
  - Are foreign sovereigns or subdivisions or foreign governments.
- No single fixed-income security (excluding U.S. Treasury or government-sponsored entity ("GSE") securities) can represent more than 30% of the fixed-income portion.
- No five fixed-income securities together (excluding U.S. Treasury or GSE securities) can represent more than 65% of the fixed-income portion.
- Private mortgage-backed securities and other asset-backed securities cannot represent more than 20% of the fixed-income portion.
- If the equity portion of the portfolio is less than 70% of the total weight of the portfolio, the ETF must hold fixed-income securities from at least 13 different nonaffiliated issuers.

**Derivatives Portion of the ETF Portfolio**

<table>
<tr><th>Listed Derivatives</th><th>Over-the-Counter ("OTC") Derivatives</th></tr>
<tr><td>
<ul>
<li>At least 90% of the listed derivatives weight must:
<ul>
<li>Have information available to the Exchanges via the Intermarket Surveillance Group; or</li>
<li>Be listed on an exchange that has a comprehensive surveillance sharing agreement with the Exchanges.</li>
</ul></li>
<li>Gross notional value of listed derivatives based on one reference asset cannot represent more than 30% of the portfolio.</li>
<li>Gross notional value of listed derivatives based on five or fewer reference assets cannot represent more than 65% of the weight of the portfolio.</li>
</ul>
</td><td>
<ul>
<li>Gross notional value of all OTC Derivatives cannot represent more than 20% of the weight of the portfolio.</li>
</ul>
</td></tr>
</table>

In addition to the investments described above, under the Active Generics, an ETF may hold an unlimited amount of cash and cash equivalents. Cash equivalents are defined as short-term instruments with maturities of less than three months, including U.S. government securities, repurchase and reverse repurchase agreements, bank time deposits, and money market funds. Ironically, however, contemporaneous with the adoption of the Active Generics, the SEC staff began to take the position that an ETF holding only cash and cash equivalents has implicitly and *per se* opted to be governed by Rule 2a-7 under the Investment Company Act of 1940 and therefore must operate as a money market fund in compliance with Rule 2a-7. Of course, ETFs *cannot* comply with Rule 2a-7 because they do not redeem individual shares. As a result, notwithstanding the approval of the Active Generics, ETFs currently cannot make unlimited investments in cash and cash equivalents.

### *Public Disclosures*

The other key aspects of the Active Generics concern public disclosures. First, a relying ETF's daily website disclosures must include, for each portfolio asset, as applicable:

(i) the ticker symbol, CUSIP, or other identifier;

(ii) a description of the holding;

(iii) the identity of the assets underlying any derivatives;

(iv) the strike price for any options;

(v) the quantity of the asset;

(vi) the maturity date;

(vii) the coupon rate;

(viii) the effective date;

(ix) the market value; and

(x) the weight of the holding, as a percentage of the overall portfolio.[7]

Accordingly, nontransparent, actively managed ETFs do not currently qualify for listing under the Active Generics. Second, a relying ETF must calculate and widely disseminate its Intraday Indicative Value every 15 seconds, every trading day, from 8:30 a.m. until 4:00 p.m. Eastern Time.[8]

## Impact

Some actively managed ETF strategies are likely well-positioned to take advantage of the Active Generics. ETF sponsors are likely to welcome the generic standards, as they remove an expensive and time-consuming impediment to quickly and cost-efficiently bringing actively managed ETFs to market and reduce the barriers to entry for firms looking to enter the actively managed ETF space. Indeed, some commenters have predicted that the Active Generics will facilitate a "second wave" of ETF innovation and growth.[9] There is evidence that such growth is already underway. By some estimates, September 2016 saw the second highest monthly number of new actively managed ETF launches ever.[10]

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[7] Bats Proposal, at 44; Arca Proposal, at 7-8.

[8] "Regular Trading Hours" or the "Core Trading Session," as defined under Bats BZX Rule 1.5(w) and NYSE Arca Equities Rule 7.34, respectively.

[9] *See, e.g.,* "ETF Watch: New SEC Rule Seen Helping Active ETFs" *ETF.com* (July 22, 2016), http://www.etf.com/sections/daily-etf-watch/etf-watch-active-etfs-may-get-helping-hand.; "SEC's New Rule May Boost Active ETFs," *Zacks Equity Research* (July 25, 2016), http://www.nasdaq.com/article/secs-new-rule-may-boost-active-etfs-cm654306.

[10] *See* Ron Rowland, "ETF Stats for September 2016: Big Month for Active Management," *Seeking Alpha* (Oct. 19, 2016), http://seekingalpha.com/article/4013034-etf-stats-september-2016-big-month-active-management.

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We tend to share the view that the Active Generics will facilitate the development of actively managed ETFs. In addition, increasing investor demand for transparent, low-cost products, such as ETFs, may compound the growth effects of the Active Generics.


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