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SEC Approves Generic Listing Standards for Active ETFs

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New standards are expected to simplify and expedite the process of launching an actively managed ETF.

On July 22, the ***US Securities and Exchange Commission (SEC)*** issued orders approving proposals by Bats BZX Exchange, Inc. and NYSE Arca, Inc. to adopt generic listing standards for shares of actively managed exchange-traded funds (Active ETFs).[1] The Orders, which are substantively identical, are expected to ease the regulatory burden and decrease the amount of time associated with bringing Active ETFs to market.

Listing with an Exchange

As a general matter, listing an ETF with an exchange can be accomplished by

- meeting the exchange's generic listing standards, which generally include provisions pertaining to the market value, trading volume, diversification, and weightings of the ETF's components; or

- having the exchange file an application with the SEC's Division of Trading and Markets pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 (Exchange Act) that, if granted, will permit the ETF's shares to be listed and traded on the exchange.[2]

Prior to the Orders, generic listing standards were only available to passively managed ETFs (i.e., ETFs that seek to track the performance of a specified index). Thus, issuers of Active ETFs will now be able to take advantage of a simplified, predictable listing process instead of having to undertake the expensive and sometimes uncertain Rule 19b-4 process. The Rule 19b-4 process, which subjects proposed Active ETFs to an additional layer of regulatory review, is widely recognized as a cumbersome process that can take several months and introduce uncertainty into the design of and timeframe for launch of an Active ETF. By eliminating the need to go through the Rule 19b-4 process, the Orders may significantly streamline the process of launching an Active ETF, provided that the Active ETF can meet the new generic listing standards.

The Rule 19b-4 process will still be available for those Active ETFs that cannot or do not wish to meet the generic listing standards. In addition, existing Active ETFs that have already obtained orders under Rule 19b-4 may wish to consider whether relying instead on the generic listing standards under the Orders would provide more or less flexibility with respect to portfolio management.

The Listing Standards

Under the Orders, Active ETFs seeking to rely on the generic listing standards are required to meet the following requirements at the time of listing and on a continuing basis:

Type of Security	Listing Standard	Details
Equity Securities[3] - US Component Stocks,[4] Non-US Component Stocks,[5] and Derivatives Securities Products and Index-Linked Securities[6]	Minimum market value	At least 90% of the portion of the ETF's portfolio that is invested in equities must be composed of equities with a minimum market value of at least $75 million. Each non-US equity stock must have a minimum market value of at least $100 million.
	Minimum trading volume	At least 70% of the portion of the ETF's portfolio that is invested in equities must be composed of equities with a minimum monthly trading volume of 250,000 shares, or minimum notional volume traded per month of $25 million, averaged over the last six months. Each non-US equity stock must have a minimum global monthly trading volume of 250,000 shares, or minimum global notional volume traded per month of $25 million, averaged over the last six months.
	Weightings	The most heavily weighted stock must not exceed 30% of the portion of the ETF's portfolio that is invested in equities and, to the extent applicable, the five most heavily weighted component

		stocks must not exceed, in the aggregate, 65% of the portion of the ETF's portfolio that is invested in equities. The most heavily weighted non-US component stock must not exceed 25% of the equity weight of the portion of the ETF's portfolio that is invested in equities and, to the extent applicable, the five most heavily weighted non-US component stocks must not exceed 60% of the portion of the ETF's portfolio that is invested in equities.
	Minimum number of components	Where the equity component of the portfolio does not include non-US component stocks, the portfolio must include a minimum of 13 component stocks, subject to certain exceptions. Where the equity portion of the portfolio includes non-US component stocks, the portfolio must include a minimum of 20 component stocks, subject to certain exceptions.
	Exchange listing	US equity securities in the portfolio must be listed on a national securities exchange and must be NMS Stocks[7] as defined in Rule 600 of Regulation NMS under the Exchange Act. Each non-US equity stock must be listed and traded on an exchange that has last-sale reporting.
	ADRs	American Depositary Receipts (ADRs) in a portfolio may be exchange-traded or non-exchange-traded. However, no more than 10% of the portion of the ETF's portfolio that is invested in equities is permitted to consist of non-exchange-traded ADRs.
	Limits on leveraged and inverse	Not more than 25% of the portion

	leveraged products	of the ETF's portfolio that is invested in equities may consist of leveraged and/or inverse leveraged Derivatives Securities Products or Index-Linked Securities Products.
Fixed Income Securities[8]	Minimum original principal amount outstanding	Components that in the aggregate account for at least 75% of the portion of the ETF's portfolio that is invested in fixed income securities each must have a minimum original principal amount outstanding of $100 million or more.
	Weightings	No fixed income security (excluding Treasury securities and government-sponsored entity (GSE) securities) may represent more than 30% of the portion of the ETF's portfolio that is invested in fixed income securities, and the five most heavily weighted component fixed income securities in the portfolio (excluding Treasury securities and GSE securities) must not in the aggregate account for more than 65% of the portion of the ETF's portfolio that is invested in fixed income securities.
	Minimum number of issuers	An underlying portfolio (excluding exempted securities) that includes fixed income securities must include a minimum of 13 non-affiliated issuers, provided, however, that there must be no minimum number of non-affiliated issuers required for fixed income securities if at least 70% of the weight of the portfolio consists of equity securities.
	Issuer requirements	Component securities that in the aggregate account for at least 90% of the portion of the ETF's portfolio that is invested in fixed income securities must be either (a) from issuers that are required to file reports pursuant to Sections 13 and 15(d) of the

		Exchange Act; (b) from issuers that have a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more; (c) from issuers that have outstanding securities that are notes, bonds debentures, or evidence of indebtedness having a total remaining principal amount of at least $1 billion; (d) exempted securities as defined in Section 3(a)(12) of the Exchange Act; or (e) from issuers that are a government of a foreign country or a political subdivision of a foreign country.
	Other limits	Non-agency, non-GSE, and privately issued mortgage-related and other asset-backed securities must not account, in the aggregate, for more than 20% of the portion of the ETF's portfolio that is invested in fixed income securities.
Cash and Cash Equivalents[9]	No limitation on percentage of portfolio invested in cash or cash equivalents.	
Listed Derivatives[10]	No limitation on percentage of portfolio invested in listed derivatives, but portfolio holdings are subject to the following requirements:	
	Intermarket Surveillance Group requirement	In the aggregate, at least 90% of the weight of holdings invested in futures, exchange-traded options, and listed swaps must, on both an initial and continuing basis, consist of futures, options, and swaps for which the exchange may obtain information via the Intermarket Surveillance Group (ISG) from other members or affiliates of the ISG or for which the principal market is a market with which the exchange has a comprehensive surveillance sharing agreement. (For purposes of calculating this limitation, a portfolio's investment in listed derivatives will be calculated as the aggregate gross notional value of

		the listed derivatives.)
	Weighting requirements	The aggregate gross notional value of listed derivatives based on any five or fewer underlying reference assets must not exceed 65% 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 must not exceed 30% of the weight of the portfolio (including gross notional exposures).
Over-the-Counter Derivatives[11]	Percentage limitation	No more than 20% of the assets in the portfolio may be invested in OTC derivatives. For purposes of calculation of this limitation, a portfolio's investment in OTC derivatives will be calculated as the aggregate gross notional value of the OTC derivatives.

Additional Requirements

Active ETFs relying on the generic listing standards are also required to comply with the following requirements:

1. Website Disclosures. The ETF must disclose on its website certain information regarding its portfolio including, as applicable, the following:

2. Investment Objective. Each ETF must have a stated investment objective, which must be adhered to under normal market conditions.[12] As a practical matter, this does not introduce any new obligations on the ETFs that will use the generic listing standards.

3. Portfolio Indicative Value. A portfolio indicative value must be widely disseminated by one or more major market data vendors at least every 15 seconds during regular trading hours, rather than during all times that the shares trade on the exchange. Operationally, this is no different than how all ETFs are currently set up.

- Ticker Symbol
- CUSIP or other identifier
- Description of the holding
- Identity of the asset upon which the derivative is based
- Strike price for any options
- Quantity of each security or other asset held as measured by select metrics
- Maturity date
- Coupon rate
- Effective date

- •Market value
- •Percentage weight of the holding in the portfolio

Conclusion

Because listing in accordance with the generic listing standards of the Orders may have the effect of significantly streamlining the process of launching an Active ETF, sponsors of Active ETFs should consider taking into account the above-described standards as they develop new products. It is worth noting that the Orders solve only one of the three significant regulatory barriers to entry for Active ETFs—the 19b-4 process. New Active ETFs will still be required to file an application with the SEC to be granted exemptions from certain provisions of the Investment Company Act with which they functionally are not able to comply (e.g., trading at net asset value). In addition, the Orders do not solve the problem of portfolio transparency, which has been a disincentive for many active managers thinking of launching ETFs.[13] Finally, issuers of existing Active ETFs should consider whether to continue relying on the orders they have obtained under Rule 19b-4 or whether it would be advantageous to rely instead on the generic listing standards of the Orders.[14]

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[1] Self-Regulatory Organizations; BATS Exchange, Inc.; Order Approving a Proposed Rule Change, as Modified by Amendment No. 6, to Amend BATS Rule 14.11(i) to Adopt Generic Listing Standards for Managed Fund Shares (July 22, 2016); Self-Regulatory Organizations; NYSE Arca, Inc.; Order Granting Approval of Proposed Rule Change, as Modified by Amendment No. 7 Thereto, Amending NYSE Arca Equities Rule 8.600 to Adopt Generic Listing Standards for Managed Fund Shares (July 22, 2016). The orders are referred to collectively herein as “Orders.” On July 25, 2016 NASDAQ Stock Market LLC filed a substantively identical rule proposal with the SEC. See NASDAQ Stock Market LLC; Proposal to Amend Nasdaq Rule 5735 to Adopt Generic Listing Standards for Managed Fund Shares (July 25, 2016).

[2] Under the Exchange Act, exchanges are required to obtain SEC approval for the listing or trading of any new ETF. Rule 19b-4 under the Exchange Act, however, creates an exception from this requirement for ETF shares that meet generic listing standards that have already been approved by the SEC. The Rule 19b-4 process is separate and in addition to the relief ETFs are required to obtain from the SEC exempting them from certain provisions of the Investment Company Act of 1940.

[3] Equity Securities consist of US Component Stocks, Non-US Component Stocks, Derivatives Securities Products, and Index-Linked Securities listed on a national securities exchange.

[4] A US Component Stock is an equity security registered under Sections 12(b) or 12(g) of the Exchange Act or an ADR, the underlying equity security of which is registered under Sections 12(b) or 12(g) of the Exchange Act.

[5] A Non-US Component Stock is an equity security not registered under Sections 12(b) or 12(g) of the Exchange Act and that is issued by an entity that (a) is not organized, domiciled or incorporated in the United States, and (b) is an operating company (including REITs and income trusts, but excluding investment trusts, unit trusts, mutual funds, and derivatives).

[6] Derivatives Securities Products include shares of ETFs, portfolio depository receipts, and trust issued receipts; Index-Linked Securities Products include securities linked to the performance of indexes and commodities, such as exchange-traded notes.

[7] Any security or class of securities (other than options) for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.

[8] Fixed Income Securities are debt securities that consist of notes, bonds, debentures or evidence of indebtedness that include, but are not limited to, US Department of Treasury securities, government-sponsored entity securities (GSE Securities), municipal securities, trust preferred securities, supranational debt and debt of a foreign country or a subdivision thereof, investment grade and high yield corporate debt, bank loans, mortgage and asset backed securities, and commercial paper.

[9] Cash Equivalents include short-term instruments with maturities of less than 3 months. Short-term instruments include the following: (i) US Government securities, including bills, notes and bonds differing as to maturity and rates of interest, which are either issued or guaranteed by the US Treasury or by US Government agencies or instrumentalities; (ii) certificates of deposit issued against funds deposited in a bank or savings and loan association; (iii) bankers' acceptances, which are short-term credit instruments used to finance commercial transactions; (iv) repurchase agreements and reverse repurchase agreements; (v) bank time deposits, which are monies kept on deposit with banks or savings and loan associations for a stated period of time at a fixed rate of interest; (vi) commercial paper, which are short-term unsecured promissory notes; and (vii) money market funds.

[10] Listed Derivatives include futures, options and swaps on commodities, currencies and financial instruments (e.g., stocks, fixed income, interest rates, and volatility) or a basket or index of any of the foregoing.

[11] Over-the-Counter (OTC) Derivatives include forwards, options and swaps on commodities, currencies and financial instruments (e.g., stocks, fixed income, interest rates, and volatility) or a basket or index of any of the foregoing.

[12] The Orders define "normal market conditions" as circumstances including, but not limited to the absence of: trading halts in the applicable financial markets generally; operational issues causing dissemination of inaccurate market information or systems failure; or force majeure type events such as natural or man-made disaster, act of God, armed conflict, act of terrorism, riot or labor disruption, or any similar intervening circumstance.

[13] Indeed, growth in the number and net assets of index based ETFs has far outpaced that of Active ETFs. See Investment Company Institute, 2016 Investment Company Fact Book 200-201 (2016).

[14] To the extent an Active ETF wishes to begin relying on the generic listing standards instead of a previously-obtained Rule 19b-4 order, it may wish to consider coordinating with the listing exchange in advance to effect such change.

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