August 4, 2016

SEC Streamlines Exchange Listings for Actively Managed ETFs

On July 22, 2016, the SEC approved proposed listing rule amendments by NYSE Arca, Inc. (available here) and Bats BZX Exchange, Inc. (available here) to provide "generic" listing standards for actively managed ETFs. These generic listing standards, which are effective immediately, permit qualifying actively managed ETFs to bypass the time-consuming Rule 19b-4 approval process administered by the SEC's Division of Trading and Markets. The new generic listing standards should help entrants design new actively managed ETFs and bring them to market more quickly. The length and uncertainty of the Rule 19b-4 process has made launching and listing actively managed ETFs difficult and may have deterred some firms from stepping into the rapidly growing ETF market.

While the assets of actively managed ETFs now represent only a fraction of the $2 trillion invested in all 1940 Act ETFs, NYSE and Bats expect that actively managed ETFs will continue to grow in size and number and the generic listing standards will expedite that growth.

Background. Most new index ETFs qualify for expedited listing under generic listing standards that have been available to the various listing exchanges for more than a decade. However, prior to the SEC's July approvals, exchanges seeking to list actively managed ETFs had to obtain an order from the SEC pursuant to Rule 19b-4 under the Exchange Act. Rule 19b-4 permits an exchange to amend its rules so that the actively managed ETF can be listed on the exchange. Unfortunately, the Rule 19b-4 approval process has proven time consuming, often lasting months or more than a year. In addition, the SEC's Division of Trading and Markets has occasionally imposed restrictions and conditions (*e.g.*, portfolio limitations) on a proposed actively managed ETF that have necessitated changes in product design well into the ETF launch process. The new NYSE and Bats generic listing standards should streamline the design process for actively managed ETFs, as well as eliminate the uncertainty that the Rule 19b-4 SEC staff review has introduced to the process.

Any proposed actively managed ETF that *cannot* satisfy the new generic listing standards will have to rely on an exchange to follow the Rule 19b-4 approval process. Therefore, a sponsor proposing to launch an actively managed ETF should review the new generic listing standards carefully during the product design phase to determine whether the proposed ETF meets the new standards.

Portfolio Requirements. The approved NYSE and Bats generic listing standards are very similar to each other and are based on the generic listing standards applicable to index ETFs. Both sets of new standards establish portfolio requirements and limitations applicable to the types of assets (*i.e.*, equity, fixed-income, cash and derivatives) that an actively managed ETF may hold, including each underlying issuer's minimum market capitalization or minimum debt outstanding, minimum trading volume of eligible securities, portfolio weighting and diversification. These requirements and limitations, which are similar to those for index ETFs, are summarized in the table at the end of this Alert. The generic standards for actively managed ETFs do incorporate a number of changes from the index ETF generic standards. The most noteworthy portfolio elements in the generic standards for actively managed ETFs are as follows:

- The portfolio requirements and limitations must be met initially *and* on a continuing basis (unlike the components of an index ETF, which must be met upon the index ETF's initial listing). Therefore, an actively managed ETF will have to be monitored continuously for compliance with portfolio requirements and limitations under both the 1940 Act *and* the generic listing standards. The exchange's response to an ETF's failure to comply with the listing standards will vary from case to case, depending on the magnitude of the failure and the frequency of the ETF's failures. Significant and non-remediated failures that continue for an extended period may lead to mandatory de-listing.

- No more than 25% of the equity weight of the ETF's portfolio can be invested in leveraged or inverse-leveraged exchange-traded products. In contrast, under existing generic listing standards, index ETFs cannot seek inverse returns greater than 300% of the performance of their reference index, with no corresponding limit on positive leverage versus an index.

- The ETF may hold an unlimited amount of cash and "cash equivalents" (e.g., certain short-term instruments with maturities of less than three months, repurchase agreements, commercial paper and shares of money market funds).

- The ETF may hold a limited amount of non-exchange-traded ADRs. In contrast, under existing generic listing standards, the underlying index of an index ETF is prohibited from including non-exchange-traded ADRs.

Additional Requirements. The approved NYSE and Bats generic listing standards include a requirement that an actively managed ETF must have a stated investment objective, which shall be adhered to under "Normal Market Conditions," as defined by the exchange. In general, Normal Market Conditions means the absence of trading halts in the applicable financial markets, operational issues that cause the dissemination of inaccurate market information or a systems failure, or *force majeure* events.

The new generic listing standards also require that the website for each actively managed ETF disclose specific information about the ETF's Disclosed Portfolio, to the extent applicable.[1] Finally, the approved NYSE and Bats generic listing standards require that the actively managed ETF share's intraday indicative value ("IIV") must be widely disseminated at least every 15 seconds during regular trading hours instead of during all times that the shares trade on the exchange.

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The SEC's approval of generic listing standards for actively managed ETFs is welcome regulatory relief. The new generic listing standards should help new entrants bring actively managed ETF products to market more quickly and without the uncertainty and delays of the Rule 19b-4 process. The fact that NYSE and Bats have pursued SEC approval of the new standards indicates that the exchanges are optimistic about the growth prospects of actively managed ETFs, and are ready to compete for the listings of qualifying ETFs.

For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray contact.

Actively Managed ETF Portfolio Requirements and Limits[1]

	US Equities	Non-US Equities	Fixed-Income	Derivatives
Weighting/minimum market cap (equity) or minimum original principal amount outstanding (fixed income)	90%/$75 million	100%/$100 million	75%/$100 million	90% listed derivatives (notional values) consisting of futures, options, and swaps for which the exchange may obtain information via the ISG from other members or affiliates or for which the principal market is a market with which the exchange has a CSSA[2] No more than 20% OTC derivatives (notional values)
Weighting/trading 6-month avg. volume or notional volume	70%/250,000 shares or $25 million	100%/250,000 shares or $25 million		
Weighted components max.	30% for heaviest, 65% for top-5 heaviest	25% for heaviest, 60% for top-5 heaviest	30% for heaviest, 65% for top-5 heaviest (excluding Treasury and GSE securities)	No more than 65% (notional values) of listed derivatives based on any 5 or fewer underlying reference assets, and no more than 30% (notional values) of listed derivatives based on any single underlying reference asset
Number of issuers	13 if no non-US, with an exception[3]	20, but subject to same exception for US	13 (no minimum if 70% of the portfolio's weight consists of equity securities)	
Issuers	US exchange listed and "NMS Stocks"; ADRs may be exchange traded or non-exchange traded[4]	listed and traded on an exchange that has last-sale reporting	90% (a) issuers are required to file reports per Exchange Act §§ 13 and 15(d); (b) issuers have $700 million worldwide common equity held by non-affiliates; (c) issuers 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 per Exchange Act § 3(a)(12); or (e) issuers are a foreign government or a political subdivision of foreign country No more than 20% non-agency, non-GSE, and mortgage-related/other ABS	

[1] General:

- No more than 25% of the equity weight of the ETF's portfolio can be invested in leveraged or inverse-leveraged exchange-traded products.
- ETF may hold an unlimited amount of cash and "cash equivalents" (e.g., certain short-term instruments with maturities of less than three months, repurchase agreements, commercial paper and shares of money market funds).
- ETF must have a stated investment objective, which shall be adhered to under Normal Market Conditions, as defined by the exchange.
- ETF must disclose daily on its website following information about the Disclosed Portfolio: ticker symbol, CUSIP or other identifier, a description of the holding, identity of the asset upon which the derivative is based, the strike price for any options, the quantity of each security or other asset held as measured by select metrics, maturity date, coupon rate, effective date, market value, and percentage weight of the holding in the portfolio.
- ETF's IIV must be widely disseminated at least every 15 seconds during Regular Trading Hours rather than during all times that ETF's shares trade on the exchange.

[2] If derivatives are used to gain exposure to individual equities and/or fixed income securities, or to indexes of equities and/or fixed income securities, the aggregate gross notional value of such exposure must comply with the equity and fixed income limits.

[3] No minimum number of component stocks if one or more series of Derivative Securities Products or Linked Securities either: (i) constitute components of the portfolio or (ii) account for 100% of the equity weight of the portfolio.

[4] No more than 10% of the equity weight of the portfolio shall consist of non-exchange traded ADRs.