NEW LISTING RULES ADOPTED FOR ETFS RELYING ON RULE 6C-11 – EXCHANGES' ETF LISTING COMPLIANCE BURDENS REDUCED

Date: 5 May 2020

U.S. Investment Management Alert

As the December 23, 2020 compliance date for the Securities and Exchange Commission (SEC) approved rule 6c-11 under the Investment Company Act of 1940, as amended (ETF Rule) approaches, the vast majority of exchange-traded funds (ETFs) are preparing to launch and operate without first obtaining an exemptive order from the SEC. In approving the ETF Rule, the SEC intended to "create a consistent, transparent, and efficient regulatory framework for the regulation of most ETFs and help level the playing field for [ETF] market participants."[1] As part of a desire to also streamline and reduce the continued listing standards for ETFs, each of the major U.S. stock exchanges and markets—CBOE BZX Exchange, Inc. (CBOE), The Nasdaq Stock Market LLC (Nasdaq), and NYSE Arca, Inc. (NYSE Arca) (collectively, the Exchanges)—proposed new generic listing standards to permit the listing of shares of ETFs that operate in reliance on the ETF Rule (relying ETFs). The SEC approved the proposed rule changes for CBOE to adopt Rule 14.11(l), Nasdaq to adopt Rule 5704, and NYSE Arca to adopt Rule 5.2-E(j)(8), each governing the listing and trading of shares of relying ETFs (each, a new listing rule). Each new listing rule is anticipated to become effective prior to the compliance date of the ETF Rule.

The ETF Rule requires that relying ETFs must remain listed on an Exchange.[2] Each new listing rule greatly simplifies the compliance by relying ETFs with their continued listing standards to remain listed. Much of the benefit from each new listing rule reflects the efficiencies obtained under the ETF Rule—a lack of distinction between index-based and actively managed ETFs, no intraday indicative value (IIV) publication requirement, and no index or portfolio component liquidity requirement. The new listing rules differ slightly in order and form for each Exchange but are substantially similar in their requirements. Accordingly, the material requirements that are consistent among each of the new listing rules are summarized below.

NO IIV REQUIREMENT

In addition to relief provided to the Exchanges from quarterly reporting on actively managed ETFs,[3] ETF issuers will be pleased to learn that none of the new listing rules includes an IIV publication requirement.[4] While ETFs that continue to rely on their exemptive orders will continue to be required to publish an IIV, this development in each new listing rule directly reflects the SEC's general historical view of IIV as useless, at best, and potentially misleading, at worst.[5]

NO DISTINCTION BETWEEN INDEX-BASED AND ACTIVELY MANAGED ETFS

Each new listing rule principally states that the Exchange will list for trading ETF shares of only those ETFs that are defined as "exchange traded funds" under the ETF Rule and are relying ETFs. Thus, each new listing rule

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effectively adopts the ETF Rule's lack of distinction between actively managed and fully transparent ETFs (index-based or passively managed ETFs).

CONTINUED LISTING REQUIREMENTS – MINIMUM SHARES OUTSTANDING, FIREWALLS, AND DE-LISTING

In addition to requiring compliance with the ETF Rule, each new listing rule also lists several requirements that ETF shares must meet on an initial and continued listing basis. These additional requirements are similar to those present in the preexisting generic listing standards applicable to index-based and actively managed ETFs. As an initial matter, each Exchange will establish a minimum number of ETF shares required to be outstanding at the time trading commences.[6]

Further, each new listing rule requires both index-based and actively managed ETFs to create and maintain an effective informational barrier or "firewall." With respect to index-based ETFs, the broker-dealer or fund adviser maintaining the index must erect a "firewall" around personnel who have access to information concerning adjustments to the index, and the index must be calculated by a third party who is not a broker-dealer or fund adviser. With respect to an actively managed ETF whose investment adviser is affiliated with a broker-dealer, the investment adviser must erect and maintain a "firewall" between itself and the broker-dealer concerning the access to information for the composition of and/or changes to the portfolio.

Each new listing rule itemizes a number of circumstances that may warrant the suspension of trading or removal (i.e., delisting), such as noncompliance with the respective new listing rule or with the ETF Rule, having fewer than 50 beneficial holders of shares after a post-commencement period of 12 months,[7] and any other conduct that the Exchange deems disabling.

CONTINUED LISTING REQUIREMENTS – REPORTING AUTHORITY OBLIGATIONS AND EXCHANGE LIABILITY INSULATION

Each new listing rule also contains provisions that do not directly impact a relying ETF but rather the Exchanges themselves. These provisions likewise track similar provisions provided in preexisting generic ETF listing rules.

For example, each new listing rule requires that any entity that advises a reporting authority with respect to material nonpublic information regarding the applicable index for an index-based ETF, or the applicable portfolio for an actively managed ETF, must be subject to procedures designed to prevent the use and dissemination of such material nonpublic information. Additionally, each new listing rule contains a limitation on liability for the applicable Exchange.[8]

TRANSITION TO THE NEW LISTING RULES

Each new listing rule provides that ETF shares that had previously been approved for listing on the Exchange, pursuant to preexisting generic listing requirements,[9] or pursuant to the approval of a proposed rule change or subject to a notice of effectiveness by the SEC, may be considered for listing solely under the respective new listing rule only if such ETF is eligible to operate as a relying ETF. Typically, existing ETF issuers will need to inform their primary listing Exchange of their desire to comply with the relevant new listing rule. The Exchanges will then work with that ETF issuer to transition away from their current listing standards to the applicable listing

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rule, including establishing the date for such transition. Whatever the date of such a transition, the ETF must assure that it is in fact a relying ETF on that date.

Any requirements for listing as specified in each Exchange's preexisting generic listing requirements that differ from the requirements of the respective new listing rule will no longer be applicable to a relying ETF. Thus, an index-based relying ETF, if it transitions to a new listing rule, will no longer have to monitor the liquidity of the components of its referenced index.[10] Similarly, an actively managed relying ETF, if it transitions to a new listing rule, will no longer be required by the Exchanges to monitor the liquidity of each of its portfolio holdings.[11]

CONCLUSION

Each new listing rule paves the way for the streamlined listing and continued listing of ETF issuer shares on the Exchanges. Each of the new listing rules are substantially similar in their requirements and differ only slightly in order and form. Any ETF that is defined as an “exchange traded fund” under the ETF Rule and is a relying ETF will be able to list ETF shares on the Exchanges pursuant to each new listing rule. However, ETF issuers will be responsible for the construction and maintaining of “firewalls” to prevent the use and dissemination of material nonpublic information. In sum, each new listing rule will now enable ETF issuers relying on the ETF Rule to maintain their Exchange listing in a simpler and more cost effective fashion by reducing exchange listing reporting requirements. This, in turn, will also simplify an ETF's compliance with the continuing ETF Rule requirement that such relying ETF maintain its Exchange listing.

FOOTNOTES

[1] *See* Exchange-Traded Funds, 84 Fed. Reg. 57,162, 57,166 (Oct. 24, 2019) (to be codified at 17 C.F.R. pts. 210, 232, 239, 270, 274) [hereinafter Adopting Release].

[2] *See* 270.6c-11(a) (definition of “Exchange-traded fund”).

[3] Each Exchange is no longer required to submit to the SEC quarterly reports covering actively managed ETF shares (e.g., CBOE Rule 14.11(i); Nasdaq Rule 5735(b); Commentary .01 to NYSE Arca Rule 8.600-E). This is because the newly required ETF issuer data filing obligations under the ETF Rule have effectively replaced this. *See, e.g.*, SEC Rel. No. 34-88566 (Apr. 6, 2020) [hereinafter CBOE Release] at 17–18; SEC Rel. No. 34-88561 (Apr. 3, 2020) [hereinafter Nasdaq Release] at 18; SEC Rel. No. 34-88625 (Apr.13, 2020) [hereinafter NYSE Arca Release] at 20.

[4] *See* CBOE Release, *supra* note 3, at 16. While neither the Nasdaq Release nor the NYSE Arca Release explicitly state that the new listing rules will not include a requirement for IIV dissemination for a series of ETF shares to be listed on the Exchange (like the CBOE Release does), the rules themselves do not include such a requirement.

[5] *See, e.g.*, Adopting Release, *supra* note 1, at 62–67.

[6] Each new listing rule also brings forward ETF share trading and market surveillance rules that the preexisting generic index-based and actively managed ETF listing rules also contained. Each new listing rule provides or is compatible with other listing rules that provide that transactions in ETF shares will occur through each Exchange's specific trading hours and require a minimum price variance of US$0.01 (penny trading). *See, e.g.*, NYSE Arca

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Rule 7.6-E (penny trading); NYSE Arca Release, *supra* note 3, at 15. Each new listing rule also requires that each Exchange implement and maintain written surveillance procedures for ETF shares. *See* proposed CBOE Rule 14.11(l)(2)(C); proposed Nasdaq Rule 5704(c); proposed NYSE Arca Rule 5.2-E(j)(8)(g).

[7] Note that unlike Nasdaq and NYSE Arca, CBOE requires holdings by fewer than 50 beneficial owners *for 30 or more days* (following the 12 months after commencement of trading). Proposed CBOE Rule 14.11(l)(4)(B)(i)(c).

[8] Each new listing rule states that neither the Exchange nor any of its agents will be held liable for damages, claims, losses, or expenses caused by any errors, omissions, or delays in calculating or disseminating any information relating to the purchase, redemption, or trading of ETF shares resulting from any negligent act or omission by the Exchange or its agents; any act, condition, or cause beyond their reasonable control; or any error, omission, or delay in the reports of transactions in one or more underlying securities. *See* proposed CBOE Rule 14.11(l)(5); proposed Nasdaq Rule 5704(e); proposed NYSE Arca Rule 5.2-E(j)(8)(d).

[9] *E.g.*, CBOE Rules 14.11(c), (i); Nasdaq Rules 5705(b), 5735(b)(1); NYSE Arca Rule 5.2-E(j)(3); Commentary .01 to Rule 8.600-E.

[10] *See* CBOE Rules 14.11(c)(3)–(4); Nasdaq Rules 5705(b)(3)–(4); Commentary .01 and .02 to NYSE Arca Rule 5.2-E(j)(3).

[11] *See* CBOE Rule 14.11(i)(4); Nasdaq Rule 5735(b); Commentary .01 to Rule 8.600-E.

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