

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-85278; File No. SR-CboeBZX-2018-044)

March 8, 2019

Self-Regulatory Organizations; Cboe BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, to Amend BZX Rule 14.11(c) (Index Fund Shares)

I. Introduction

On June 21, 2018, Cboe BZX Exchange, Inc. (“Exchange” or “BZX”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend BZX Rule 14.11(c) to permit either the portfolio holdings of a series of Index Fund Shares or the index underlying a series of Index Fund Shares to satisfy the listing standards under BZX Rules 14.11(c)(3), (4), and (5). The proposed rule change was published for comment in the Federal Register on July 11, 2018.<sup>3</sup> On August 23, 2018, pursuant to Section 19(b)(2) of the Act,<sup>4</sup> the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change.<sup>5</sup> On September 28, 2018, the Exchange filed Amendment No. 1 to the proposed rule change, which amended and replaced the proposed rule change as originally filed.<sup>6</sup> On October 5, 2018, the Commission published notice of Amendment No. 1 and instituted proceedings pursuant to Section 19(b)(2)(B)

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 83594 (July 5, 2018), 83 FR 32158.

<sup>4</sup> 15 U.S.C. 78s(b)(2).

<sup>5</sup> See Securities Exchange Act Release No. 83919, 83 FR 44083 (August 29, 2018).

<sup>6</sup> Amendment No. 1 is available at: <https://www.sec.gov/comments/sr-cboebzx-2018-044/srcboebzx2018044-4468884-175849.pdf>.

of the Act<sup>7</sup> to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.<sup>8</sup> On December 21, 2018, pursuant to Section 19(b)(2) of the Act,<sup>9</sup> the Commission designated a longer period within which to issue an order approving or disapproving the proposed rule change, as modified by Amendment No. 1.<sup>10</sup> The Commission has received one comment letter on the proposed rule change from the Exchange.<sup>11</sup> This order disapproves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposed Rule Change, as Modified by Amendment No. 1<sup>12</sup>

BZX Rule 14.11(c) sets forth the listing standards for Index Fund Shares. Currently, the Exchange determines whether a series of Index Fund Shares meets the initial and continued listing standards under BZX Rules 14.11(c)(3), (4), and (5) by assessing the underlying index. The Exchange now proposes to permit either the portfolio holdings of a series of Index Fund Shares or the index underlying a series of Index Fund Shares to satisfy the initial and continued listing standards under BZX Rules 14.11(c)(3), (4), and (5). As a result, the proposal would allow the Exchange to generically list a series of Index Fund Shares where the generic listing standards are satisfied by either its portfolio holdings or its underlying index.

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<sup>7</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>8</sup> See Securities Exchange Act Release No. 84378, 83 FR 51745 (October 12, 2018) (“Order Instituting Proceedings”).

<sup>9</sup> 15 U.S.C. 78s(b)(2).

<sup>10</sup> See Securities Exchange Act Release No. 84948, 83 FR 67785 (December 31, 2018).

<sup>11</sup> See letter from Kyle Murray, Assistant General Counsel, Cboe Global Markets, Inc. to Brent J. Fields, Secretary, Commission, dated November 16, 2018 (“Exchange Letter”).

<sup>12</sup> For a full description of the proposal, see Amendment No. 1, supra note 6.

The Exchange also proposes to amend BZX Rules 14.11(c)(1)(C),<sup>13</sup> 14.11(c)(8),<sup>14</sup> and 14.11(c)(9)(B)(i)(b)<sup>15</sup> to eliminate certain references to the term portfolio such that the amended provisions would refer only to the underlying index.<sup>16</sup> As proposed, all other references to “index or portfolio” or “portfolio or index” in BZX Rule 14.11(c) would mean the index underlying a series of Index Fund Shares or the portfolio holdings of a series of Index Fund Shares.

The Exchange represents that it has in place surveillance procedures that are adequate to properly monitor trading in Index Fund Shares in all trading sessions and to deter and detect violations of Exchange rules and applicable federal securities laws.<sup>17</sup> In addition, the Exchange

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<sup>13</sup> BZX Rule 14.11(c)(1)(C) currently defines the term “Reporting Authority” to mean, in part, the official source for calculating and reporting information relating to a series of Index Fund Shares, including, but not limited to, any current index “or portfolio” value. The Exchange proposes to delete the term “or portfolio” from this provision.

<sup>14</sup> BZX Rule 14.11(c)(8) currently provides, in part, that the Exchange may list and trade Index Fund Shares based on one or more foreign or domestic indexes “or portfolios” and that each issue of Index Fund Shares based on each particular index “or portfolio, or combination thereof,” shall be designated as a separate series and shall be identified by a unique symbol. The Exchange proposes to delete the terms “or portfolios” and “or portfolio, or combination thereof,” from this provision.

<sup>15</sup> BZX Rule 14.11(c)(9)(B)(i)(b) currently provides, in part, that the Exchange will consider the suspension of trading in and will initiate delisting proceedings for a series of Index Fund Shares if the value of the index “or portfolio” of securities on which the series of Index Fund Shares is based is no longer calculated or available, or an interruption to the dissemination of the value of the index “or portfolio” of securities persists past the trading day in which it occurred, or the index “or portfolio” on which a series of Index Fund Shares is based is replaced with a new index “or portfolio” unless certain conditions are met. The Exchange proposes to delete the terms “or portfolio” from this provision.

<sup>16</sup> According to the Exchange, in these provisions, the term “index or portfolio” currently refers to the index underlying a series of Index Fund Shares and is not intended to refer to the portfolio holdings of a series of Index Fund Shares. See Amendment No. 1, supra note 6, at 11 and Exchange Letter, supra note 11, at 6.

<sup>17</sup> See Amendment No. 1, supra note 6, at 12.

states that it does not believe that the proposal will result in any meaningful additional costs associated with regulatory review, but to the extent that it does, the Exchange either already has or will dedicate sufficient additional resources to perform such reviews.<sup>18</sup>

### III. Discussion

Under Section 19(b)(2)(C) of the Act, the Commission shall approve a proposed rule change of a self-regulatory organization if the Commission finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to such organization.<sup>19</sup> The Commission shall disapprove a proposed rule change if it does not make such a finding.<sup>20</sup> Under the Commission’s Rules of Practice, the “burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder . . . is on the self-regulatory organization that proposed the rule change.”<sup>21</sup>

The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding, and any failure of a self-regulatory organization to provide this information may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Act and the applicable rules and regulations.<sup>22</sup>

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<sup>18</sup> See Amendment No. 1, supra note 6, at 10 and Exchange Letter, supra note 11, at 6.

<sup>19</sup> 15 U.S.C. 78s(b)(2)(C)(i).

<sup>20</sup> 15 U.S.C. 78s(b)(2)(C)(ii).

<sup>21</sup> 17 CFR 201.700(b)(3).

<sup>22</sup> See id.

For the reasons discussed below, the Commission is disapproving the proposed rule change, as modified by Amendment No. 1, because the information before the Commission is insufficient to support a finding that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. Specifically, the Commission concludes that it does not have sufficient information to determine that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act, in particular the requirement that a national securities exchange's rules be designed to prevent fraudulent and manipulative acts and practices.<sup>23</sup>

As discussed above, the Exchange currently determines whether a series of Index Fund Shares meets the generic listing standards in BZX Rules 14.11(c)(3), (4), and (5) by assessing the underlying index.<sup>24</sup> The proposal would allow the Exchange to assess either the underlying index or the portfolio holdings in determining whether a series of Index Fund Shares meets the generic listing standards.<sup>25</sup>

The Exchange makes several arguments in support of its proposal. First, the Exchange asserts that its proposal would accomplish the policy goals underlying the listing standards for Index Fund Shares.<sup>26</sup> The Exchange asserts that, after a series of Index Fund Shares is listed on the Exchange, both the index constituents and the portfolio holdings are equally viable for

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<sup>23</sup> 15 U.S.C. 78f(b)(5).

<sup>24</sup> See supra Section II.

<sup>25</sup> See id. The generic listing standards for Index Fund Shares impose quantitative requirements on the components of the underlying index (including, for example, market value requirements, trading volume requirements, and concentration limitations) that are designed to help ensure that the underlying index is not susceptible to manipulation.

<sup>26</sup> See Amendment No. 1, supra note 6, at 6 and Exchange Letter, supra note 11, at 4.

evaluating whether the shares are susceptible to manipulation.<sup>27</sup> According to the Exchange, the portfolio holdings are arguably a better means for making this determination than the underlying index because the portfolio holdings reflect the actual assets held by a series of Index Fund Shares, whereas the index constituents are just the assets that the series is designed to track.<sup>28</sup>

Under the proposal, if the index underlying a series of Index Fund Shares fails to meet the generic listing standards, the Exchange could still generically list and trade this product as long as the portfolio is constructed to comply with the generic listing standards. The Exchange acknowledges that allowing the portfolio holdings to satisfy the generic listing standards could raise concerns that a series of Index Fund Shares may potentially be based on an index that does not meet the generic listing standards and therefore may be susceptible to manipulation.<sup>29</sup>

The Exchange has not demonstrated how it would be consistent with the Act for the Exchange to generically list and trade a series of Index Fund Shares that tracks an index that may be susceptible to manipulation. Index Fund Shares are designed to track the performance of an index.<sup>30</sup> If the portfolio meets the generic listing standards but the index does not (i.e., a scenario that is not currently permissible, but would be permissible under the proposal), and the

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<sup>27</sup> See Amendment No. 1, supra note 6, at 5 and Exchange Letter, supra note 11, at 2. The Exchange states that its generic listing standards began applying on both an initial and continuous basis in January 2018. See Amendment No. 1, supra note 6, at 5. The proposal would provide the Exchange with the flexibility to choose to apply the generic listing standards to either the portfolio holdings or the underlying index (both at the time of initial listing and at any time thereafter), even though the Exchange acknowledges that for initial listing, the underlying index constitutes a better means for determining whether a series of Index Fund Shares would be susceptible to manipulation, because the underlying index constituents are much more fully developed and less theoretical than the portfolio of a yet to be launched fund or a sample portfolio, respectively. See Amendment No. 1, supra note 6, at 5 and Exchange Letter, supra note 11, at 2.

<sup>28</sup> See Amendment No. 1, supra note 6, at 6 and Exchange Letter, supra note 11, at 4.

<sup>29</sup> See Amendment No. 1, supra note 6, at 9 and Exchange Letter, supra note 11, at 3.

<sup>30</sup> See Amendment No. 1, supra note 6, at 8 and Exchange Letter, supra note 11, at 5.

performance of the portfolio tracks the performance of the manipulated index, the Exchange did not discuss whether the effects of the index manipulation might be reflected in the price of the Index Fund Shares. The Exchange also did not explain why the potential (if any) for the effects of the index manipulation to be reflected in the price of the Index Fund Shares should not be a concern under Section 6(b)(5) of the Act, which requires that the rules of the Exchange be designed to prevent fraudulent and manipulative acts and practices. As a result, based on the information before the Commission, the Commission is unable to determine that the proposal is consistent with Section 6(b)(5) of the Act.

While the Exchange acknowledges that allowing the portfolio holdings to satisfy the generic listing standards could raise concerns that a series of Index Fund Shares may potentially be based on an index that does not meet the generic listing standards and therefore may be susceptible to manipulation, the Exchange argues that, currently, a series of Index Fund Shares overlying an index that meets the generic listing standards may have portfolio holdings that could theoretically be susceptible to manipulation because the portfolio holdings do not meet the generic listing standards.<sup>31</sup> According to the Exchange, if the current rule is consistent with the Act, then the inverse (i.e., the proposal) would also be consistent with the Act.<sup>32</sup>

The Exchange did not discuss the possible effects of index manipulation or portfolio manipulation on the price of Index Fund Shares, and correspondingly did not demonstrate that the possible consequences of an index manipulation would be the same as, or no worse than, the possible consequences of a portfolio manipulation. The Commission cannot determine whether

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<sup>31</sup> See Amendment No. 1, supra note 6, at 9 and Exchange Letter, supra note 11, at 3.

<sup>32</sup> See Amendment No. 1, supra note 6, at 9 and Exchange Letter, supra note 11, at 3.

the proposal is designed to prevent fraudulent and manipulative acts and practices simply based on the Exchange's assertion that the current rule is consistent with the Act.

To support its proposal, the Exchange also compares Index Fund Shares to Managed Fund Shares, and notes that the generic listing standards for Managed Fund Shares only apply to the portfolio holdings.<sup>33</sup> The Exchange acknowledges the distinction between Index Fund Shares and Managed Fund Shares, which is that Index Fund Shares are designed to track the performance of an index whereas Managed Fund Shares are not.<sup>34</sup> However, in comparing Index Fund Shares to Managed Fund Shares, the Exchange did not address the potential consequences of an index manipulation (as discussed above) that is associated with Index Fund Shares but not Managed Fund Shares. Therefore, based on the information before the Commission, the Commission is unable to determine that the proposal is consistent with Section 6(b)(5) of the Act.

In support of its proposal, the Exchange also argues that any series of Index Fund Shares listed on the Exchange must meet all requirements applicable under the Investment Company Act of 1940, including Rule 35d-1,<sup>35</sup> which according to the Exchange provides assurance that there is significant overlap between the portfolio holdings and the underlying index.<sup>36</sup>

The Exchange did not explain the extent to which generically listed Index Fund Shares would have names that are governed by Rule 35d-1 or why the Exchange believes any overlap that would result from compliance with that rule would be sufficient to satisfy the relevant standard under the Exchange Act.

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<sup>33</sup> See Amendment No. 1, supra note 6, at 8 and Exchange Letter, supra note 11, at 5-6.

<sup>34</sup> See Amendment No. 1, supra note 6, at 8 and Exchange Letter, supra note 11, at 5.

<sup>35</sup> 17 CFR 270.35d-1.

<sup>36</sup> See Amendment No. 1, supra note 6, at 9-10 and Exchange Letter, supra note 11, at 3-4.



The Exchange also did not discuss any other specific requirements that would assure a significant overlap between the portfolio holdings and the underlying index for all current and future generically listed Index Fund Shares. Therefore, based on the information before the Commission, the Commission is unable to determine whether the portfolio composition for all of the Exchange's generically listed Index Fund Shares would necessarily have a significant overlap with the index composition, such that application of the generic listing standards to the portfolio holdings would assure that the index also meets or only narrowly misses the generic listing standards.

Finally, in support of its proposal, the Exchange asserts that the index methodology for an index underlying a series of Index Fund Shares is out of the control of the issuers of the products, and that it is problematic to require an issuer to ensure that the underlying index meets listing standards on an ongoing basis.<sup>37</sup> According to the Exchange, the proposal would provide issuers of Index Fund Shares with a greater degree of control over whether their products meet their ongoing listing obligations.<sup>38</sup>

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<sup>37</sup> See Amendment No. 1, supra note 6, at 7 and Exchange Letter, supra note 11, at 4-5.

<sup>38</sup> See Amendment No. 1, supra note 6, at 7 and Exchange Letter, supra note 11, at 5. In disapproving the proposal, the Commission has considered the proposal's impact on efficiency, competition, and capital formation, see 15 U.S.C. 78c(f), and the Exchange's assertion that its proposal would enhance competition among market participants and create greater investor confidence in exchange-traded products generally because there will be a greater degree of certainty that Index Fund Shares will not be subject to regulatory action or delisting. See Amendment No. 1, supra note 6, at 10-11 and Exchange Letter, supra note 11, at 6. The Exchange did not provide any information to support its assertion that the proposal would enhance competition and did not provide any information to support its assertion that the proposal would create greater investor confidence other than the proposal would provide a greater degree of certainty that Index Fund Shares would not be subject to regulatory action or delisting. But even if this proposal has the potential to enhance competition and create greater investor confidence, for the reasons discussed throughout, the Commission must disapprove the proposed rule

The Commission believes that the Exchange has not demonstrated why issuers' control over a fund's portfolio composition would be responsive to the potential index manipulation issue discussed above. In particular, if the portfolio meets the generic listing standards (because the issuer has control over the portfolio composition and can construct the portfolio to meet the generic listing standards) but the index does not, and the performance of the portfolio tracks the performance of the manipulated index, the Exchange did not discuss whether the effects of the index manipulation might be reflected in the price of the Index Fund Shares, and why the potential (if any) for the effects of the index manipulation to be reflected in the price of the Index Fund Shares should not be a concern under Section 6(b)(5) of the Act.

For the reasons discussed above, the Commission concludes that the record before it does not provide a basis to conclude that the Exchange has met its burden under the Act and the Commission's Rules of Practice to demonstrate that its proposed rule change is consistent with Section 6(b)(5) of the Act.<sup>39</sup>

#### IV. Conclusion

For the reasons set forth above, the Commission does not find, pursuant to Section 19(b)(2) of the Act,<sup>40</sup> that the proposed rule change, as modified by Amendment No. 1, is

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change in light of its inability, on the current record, to find that it is consistent with the Act.

<sup>39</sup> The Order Instituting Proceedings sought comment on several specific issues, including the issue of manipulation of the underlying index. For the reasons discussed above, the Commission does not find that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and therefore the Commission does not believe it is necessary to address the other issues raised in the Order Instituting Proceedings.

<sup>40</sup> 15 U.S.C. 78s(b)(2).

consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and in particular, with Section 6(b)(5) of the Act.<sup>41</sup>

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>42</sup> that the proposed rule change, as modified by Amendment No. 1 (SR-CboeBZX-2018-044), is disapproved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>43</sup>

Eduardo A. Aleman  
Deputy Secretary

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<sup>41</sup> 15 U.S.C. 78f(b)(5).

<sup>42</sup> 15 U.S.C. 78s(b)(2).

<sup>43</sup> 17 CFR 200.30-3(a)(12).