

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-90819; File No. SR-CboeBZX-2020-036)

December 29, 2020

Self-Regulatory Organizations; Cboe BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change Relating to Rule 14.11, Other Securities, to Modify a Continued Listing Criterion for Certain Exchange-Traded Products

I. INTRODUCTION

On April 29, 2020, 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 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend one of the continued listing requirements relating to certain exchange-traded products (“ETPs”) under BZX Rule 14.11. The proposed rule change was published for comment in the Federal Register on May 7, 2020.³

On June 16, 2020, pursuant to Section 19(b)(2) of the Exchange Act,⁴ 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 disapprove the proposed rule change.⁵ On August 4, 2020, the Commission instituted proceedings to determine whether to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 88795 (May 1, 2020), 85 FR 27254 (“Notice”).

⁴ 15 U.S.C. 78s(b)(2).

⁵ See Securities Exchange Act Release No. 89076 (June 16, 2020), 85 FR 37488 (June 22, 2020). The Commission designated August 5, 2020 as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change.

approve or disapprove the proposed rule change.⁶ On October 28, 2020, the Commission designated a longer period for Commission action on the proposed rule change.⁷ The Commission has received two comment letters on the proposed rule change.⁸

This order disapproves the proposed rule change because, as discussed below, BZX has not met its burden under the Exchange Act and the Commission’s Rules of Practice to demonstrate that its proposal is consistent with the requirements of Exchange Act Section 6(b)(5), and, in particular, the requirement that the rules of a national securities exchange be designed “to prevent fraudulent and manipulative acts and practices” and “to protect investors and the public interest.”⁹

II. DESCRIPTION OF THE PROPOSAL

As described in detail in the Notice and OIP, a continued listing requirement under BZX Rule 14.11 for certain ETPs¹⁰ currently provides that, following the initial 12-month period after commencement of trading on the Exchange, the Exchange will consider the suspension of trading in, and will commence delisting proceedings for, shares of such ETPs for which there are fewer than 50 beneficial holders for 30 or more consecutive trading days (“Beneficial Holders Rule”). The Exchange is proposing to change the date after which an ETP must have at least 50

⁶ See Securities Exchange Act Release No. 89472 (Aug. 4, 2020), 85 FR 48318 (Aug. 20, 2020) (“OIP”).

⁷ See Securities Exchange Act Release No. 90277 (Oct. 28, 2020), 85 FR 69675 (Nov. 3, 2020).

⁸ Comments on the proposed rule change can be found on the Commission’s website at: <https://www.sec.gov/comments/sr-cboebzx-2020-036/srcboebzx2020036.htm>.

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ For purposes of the proposal, the term “ETP” means securities listed pursuant to BZX Rule 14.11(c) (Index Fund Shares), BZX Rule 14.11(i) (Managed Fund Shares), and BZX Rule 14.11(l) (Exchange-Traded Fund Shares (“ETF Shares”)).

beneficial holders or be subject to delisting proceedings under the Beneficial Holders Rule (“Non-Compliance Period”). Specifically, the Exchange seeks to extend the Non-Compliance Period in the Beneficial Holders Rule from 12 months after commencement of trading on the Exchange to 36 months after commencement of trading on the Exchange.

The Exchange asserts that it would be appropriate to increase the Non-Compliance Period from 12 months to 36 months because: (1) it would bring the rule more in line with the life cycle of an ETP; (2) the economic and competitive structures in place in the ETP ecosystem naturally incentivize issuers to de-list products rather than continuing to list products that do not garner investor interest; and (3) extending the period from 12 to 36 months will not meaningfully impact the manipulation concerns that the Beneficial Holders Rule is intended to address.

According to the Exchange, the ETP space is more competitive than it has ever been, with more than 2000 ETPs listed on exchanges. As a result, distribution platforms have become more restrictive about the ETPs they will allow on their systems, often requiring a minimum track record (e.g., twelve months) and a minimum level of assets under management (e.g., \$100 million). Many larger entities also require a one-year track record before they will invest in an ETP. In the Exchange’s view, this has slowed the growth cycle of the average ETP, with the result that the Exchange has seen a significant number of deficiencies with respect to the Beneficial Holders Rule over the last several years. Specifically, the Exchange states that it has issued deficiency notifications to 34 ETPs for non-compliance with the Beneficial Holders Rule in the last five years, 27 of which ultimately were able to achieve compliance while going through the delisting process.

In addition, the Exchange believes that the economic and competitive structures in place in the ETP ecosystem naturally incentivize issuers to de-list products with insufficient investor

interest, and that the Beneficial Holders Rule has resulted in the forced termination of ETPs that issuers believed were still economically viable. The Exchange states that there are significant costs associated with the launch and continued operation of an ETP, and notes that the Exchange has had 69 products voluntarily delist in the last two years. The Exchange also questions whether the number of beneficial holders is a meaningful measure of market interest in an ETP, and believes that an ETP issuer is incentivized to have as many beneficial holders as possible.

The Exchange states that the proposal “does not create any significant change in the risk of manipulation for ETPs listed on the Exchange.” The Exchange “does not believe there is anything particularly important about the 50th Beneficial Holder that reduces the manipulation risk associated with an ETP as compared to the 49th, nor is there any manipulation concern that arises on the 366th day after an ETP began trading on the Exchange that didn’t otherwise exist on the 1st, 2nd, or 365th day.”¹¹ The Exchange also states that it has in place a robust surveillance program for ETPs that it believes is sufficient to deter and detect manipulation and other violative activity, and that the Exchange (or the Financial Industry Regulatory Authority on its behalf) communicates as needed with other members of the Intermarket Surveillance Group. The Exchange believes that “these robust surveillance procedures will further act to mitigate concerns that arise from extending the compliance period for the Beneficial Holders [Rule] from 12 months to 36 months.”¹² Lastly, the Exchange takes the position that other continued listing standards (e.g., with respect to the diversity, liquidity and size of an ETP’s holdings or reference

¹¹ See Notice, supra note 3, 85 FR at 27256.

¹² See id.

assets) “are generally sufficient to mitigate manipulation concerns associated with the applicable ETP.”¹³

The Commission received two comments in support of the proposal.¹⁴ One commenter states that the beneficial owner requirement disproportionately punishes smaller companies without the resources to pay for aggressive distribution, and disincentivizes issuers from launching funds that can prove themselves purely by investment merit over the long term,¹⁵ although the commenter provides no data to support that assertion. This commenter believes that the purpose of the beneficial holder minimum likely is to enforce some sort of minimum liquidity, and accordingly suggests alternative liquidity measures such as the quality of secondary markets (e.g., spreads and depth of book), the liquidity of the underlying basket, and the number of potential liquidity providers. In this commenter’s view, increasing the time period to achieve the minimum number of beneficial holders is a positive step, but eliminating the requirement altogether “would be far more purposeful.”¹⁶

Another commenter states that the Beneficial Holders Rule “does not appear to provide any meaningful investor-protection benefits.”¹⁷ Specifically, this commenter expresses the view that the liquidity of shares of an exchange-traded fund (“ETF”) is primarily a function of the

¹³ See id.

¹⁴ See Letter to Secretary, Commission, from S Phil Bak, Founder & CEO, SecLenX (May 13, 2020) (“SecLenX Letter”); and letter to Secretary, Commission, from Timothy W. Cameron, Asset Management Group – Head, and Lindsey Weber Keljo, Asset Management Group – Managing Director and Associate General Counsel, SIFMA AMG (Dec. 18, 2020) (“SIFMA Letter”).

¹⁵ See SecLenX Letter, supra note 14, at 1.

¹⁶ Id. at 2.

¹⁷ SIFMA Letter, supra note 14, at 3.

liquidity of the ETF's underlying securities, that the marketplace taps into this liquidity through the creation and redemption and arbitrage processes, and that this mitigates potential price manipulation concerns.¹⁸ In addition, the commenter believes that the enhanced disclosure requirements of Rule 6c-11 under the Investment Company Act of 1940,¹⁹ including those relating to an ETF's portfolio holdings and when an ETF's premium or discount exceeds 2% for more than seven consecutive days, will help facilitate effective arbitrage. The commenter further states that it is appropriate to increase the period of time for an ETF to comply with the applicable beneficial holders requirement because it may take several years for an ETF to gain significant market acceptance and to gather assets.²⁰ This commenter believes that many investment platforms require a three-year track record before making investment products available to clients, and the proposal would better align the rule with the lifecycle of these ETFs.²¹ This commenter concludes from a survey conducted of its members that ETF sponsors often make decisions about whether to delist and terminate funds with low levels of assets after approximately three years, and that the level of assets, number of shareholders, and average daily trading volume often improved after three years.²²

¹⁸ See id.

¹⁹ See id. at 3-4.

²⁰ See id. at 4.

²¹ See id. The commenter also states that the proposal could put newer and smaller sponsors at an unnecessary disadvantage to larger sponsors having the enterprise-wide scale and distribution reach to gather assets in the months after launch. See id.

²² See id. The commenter also states that data from one large ETF sponsor revealed that liquidity tends to build between 12 and 36 months after launch, and that: (a) the median shareholder count increased over ten-fold between 12 and 36 months after launch; (b) secondary market liquidity saw a similar growth trajectory between 12 and 36 months after launch; and (c) median spreads tightened by 3 basis points between 12 and 36 months after launch. See id., n.10.

III. DISCUSSION AND COMMISSION FINDINGS

The Commission must consider whether BZX’s proposal is consistent with Section 6(b)(5) of the Exchange Act, which requires, in relevant part, that the rules of a national securities exchange be designed “to prevent fraudulent and manipulative acts and practices” and “to protect investors and the public interest.”²³ 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 [‘SRO’] that proposed the rule change.”²⁴

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,²⁵ and any failure of an SRO 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 Exchange Act and the

²³ 15 U.S.C. 78f(b)(5). Pursuant to Section 19(b)(2) of the Exchange Act, 15 U.S.C. 78s(b)(2), the Commission must disapprove a proposed rule change filed by a national securities exchange if it does not find that the proposed rule change is consistent with the applicable requirements of the Exchange Act. Exchange Act Section 6(b)(5) states that an exchange shall not be registered as a national securities exchange unless the Commission determines that “[t]he rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange.” 15 U.S.C. 78(f)(b)(5).

²⁴ Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

²⁵ See id.

applicable rules and regulations.²⁶ Moreover, “unquestioning reliance” on an SRO’s representations in a proposed rule change is not sufficient to justify Commission approval of a proposed rule change.²⁷

The Commission has consistently recognized the importance of the minimum number of holders and other similar requirements, stating that such listing standards help ensure that exchange listed securities have sufficient public float, investor base, and trading interest to provide the depth and liquidity necessary to promote fair and orderly markets.²⁸ As stated by the Exchange, the minimum number of holders requirement also helps to ensure that trading in exchange-listed securities is not susceptible to manipulation.²⁹

As discussed above, the Exchange is proposing to increase the Non-Compliance Period from 12 months to 36 months, thereby extending by two years the length of time during which an ETP listed on the Exchange would have no requirement to have a minimum number of beneficial holders. In support of its proposal, the Exchange emphasizes that some ETPs have had difficulty complying with the Beneficial Holders Rule. The Exchange indicates that non-compliance with the Beneficial Holders Rule is increasing because the ETP market has become so competitive,

²⁶ See id.

²⁷ Susquehanna Int’l Group, LLP v. Securities and Exchange Commission, 866 F.3d 442, 447 (D.C. Cir. 2017).

²⁸ See, e.g., Securities Exchange Act Release No. 57785 (May 6, 2008), 73 FR 27597 (May 13, 2008)(SR-NYSE-2008-17) (stating that the distribution standards, which includes exchange holder requirements “... should help to ensure that the [Special Purpose Acquisition Company’s] securities have sufficient public float, investor base, and liquidity to promote fair and orderly markets”); Securities Exchange Act Release No. 86117 (June 14, 2019), 84 FR 28879 (June 20, 2018) (SR-NYSE-2018-46) (disapproving a proposal to reduce the minimum number of public holders continued listing requirement applicable to Special Purpose Acquisition Companies from 300 to 100).

²⁹ See Notice, supra note 3, 85 FR at 27255.

and there are so many of them, that it can be difficult to acquire the requisite number of beneficial holders within the existing Non-Compliance Period. The Exchange also believes that the existing Beneficial Holders Rule forces the delisting of ETPs that may still be economically viable. The Exchange takes the position that the manipulation risk would not be materially greater if an ETP had 49 beneficial holders as opposed to 50, and that no new manipulation concerns would arise with a longer Non-Compliance Period than a shorter one. The Exchange also asserts that existing surveillances and other listing standards are sufficient to mitigate manipulation concerns.³⁰

The Exchange takes the position that the highly-competitive ETP market has made compliance with the Beneficial Holders Rule difficult and has led to the delisting of ETPs that may be economically viable. However, the Exchange does not sufficiently support its assertion that compliance with the Beneficial Holders Rule is especially difficult for ETPs or that any such compliance difficulties have led to the delisting of economically viable ETPs. For example, while the Exchange states that 22 ETP issues voluntarily delisted within 12 months of commencing trading on the Exchange, the Exchange acknowledges that it cannot attribute any of those voluntary delistings to non-compliance with the Beneficial Holders Rule.³¹

In addition, the Exchange does not sufficiently explain why any such compliance difficulties justify tripling the Non-Compliance Period for this core quantitative listing standard from one year to three years, and permitting ETPs to trade on the Exchange for an additional two years without the protections, described above, that the Beneficial Holders Rule was designed to

³⁰ The commenter suggests eliminating the requirement altogether, but does not address how increasing the time period to achieve the minimum number of beneficial holders is consistent with any provision of the Exchange Act.

³¹ See id. at 27255, n.6.

provide. For example, the Exchange states that no new manipulation concerns would arise with a longer Non-Compliance Period than a shorter one, but does not address why tripling the period during which the same regulatory risks posed by a Non-Compliance Period would be present is consistent with the Exchange Act. As discussed above, the Beneficial Holders Rule and other minimum number of holders requirements are important to ensure that trading in exchange listed securities is fair and orderly and not susceptible to manipulation, and the Exchange does not explain why it is consistent with the Exchange Act to permit ETPs to trade for two additional years without any of the protections of the Beneficial Holders Rule. The Exchange also states that the manipulation risk is not materially greater with 49 beneficial holders than with 50, but there is no minimum number of beneficial holders during the Non-Compliance Period, and the Exchange does not sufficiently address why the manipulation and other regulatory risks to fair and orderly markets, investor protection and the public interest would not be materially greater with a number of beneficial holders that is substantially smaller than 49 (e.g., 10 or 20).

Finally, while the Exchange asserts that existing surveillances and other listing standards are sufficient to mitigate manipulation concerns, it does not offer any explanation of the basis for that view or provide any supporting information or evidence to support its conclusion. Notably, although the Exchange acknowledges that the Beneficial Holders Rule helps to ensure that trading in exchange-listed securities is not susceptible to manipulation, the Exchange does not explain how any of its specific existing surveillances or other listing requirements effectively address, in the absence of the Beneficial Holders Rule, those manipulation concerns and other

regulatory risks to fair and orderly markets, investor protection and the public interest.³²

Accordingly, the Commission is unable to assess whether the Exchange's assertion has merit.

The Commission identified all of these concerns in the OIP, but the Exchange has not responded or provided additional data addressing these concerns.³³ As stated above, 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 ['SRO'] that proposed the rule change."³⁴ 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 an SRO to provide this information may result in the

³² The Exchange states that its surveillances focus on detecting securities trading outside of their normal patterns, followed by surveillance analysis and investigations, where appropriate, to review the behavior of all relevant parties for all relevant trading violations. The Exchange also states that it or the Financial Industry Regulatory Authority, on behalf of the Exchange, or both, communicate as needed regarding ETP trading with other markets and the Intermarket Surveillance Group member entities, and may obtain trading information in ETPs from such markets and other entities.

³³ While one commenter suggests alternative liquidity standards (see SecLenX Letter, *supra* note 14), this commenter does not explain them with any specificity or explain how they would satisfy the requirements of the Exchange Act, and, in any event, the Exchange has not proposed them. The other commenter asserts that the creation and redemption processes, which tap into the liquidity of the underlying holdings, coupled with the enhanced disclosures mandated under Rule 6c-11 under the Investment Company Act of 1940, mitigate manipulation concerns. See SIFMA Letter, *supra* note 14, at 3. However, neither the Exchange nor that commenter explains why arbitrage opportunities would sufficiently mitigate manipulation concerns for the full range of ETPs, including ETPs overlying a portfolio of instruments that are themselves illiquid, or where market interest in the ETP is not sufficient to attract effective arbitrage activity. While this commenter asserts that certain disclosures under Rule 6c-11 under the Investment Company Act of 1940 provide investors with additional insight into the effectiveness of an ETF's arbitrage (see SIFMA Letter, *supra* note 14, at 3-4), neither the Exchange nor the commenter explains how such disclosures might prevent manipulation.

³⁴ Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the applicable rules and regulations.³⁵ The Commission concludes that, because BZX has not demonstrated that its proposal is designed to prevent fraudulent and manipulative acts and practices or to protect investors and the public interest, the Exchange has not met its burden to demonstrate that its proposal is consistent with Section 6(b)(5) of the Exchange Act.³⁶ For this reason, the Commission must disapprove the proposal.

IV. CONCLUSION

For the reasons set forth above, the Commission does not find, pursuant to Section 19(b)(2) of the Exchange Act, that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange, and in particular, with Section 6(b)(5) of the Exchange Act.

³⁵ See id.

³⁶ In disapproving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f). Although one commenter (see SecLenX Letter, supra note 14) asserts that the current Beneficial Holders Rule disproportionately punishes smaller companies and disincentivizes issuers from launching funds that can prove their investment merit over the long term, no data is provided – by the commenter or the Exchange – to support these conclusions. Similarly, although the other commenter (see SIFMA Letter, supra note 14, at 4) asserts that the current Beneficial Holders Rule puts newer and smaller sponsors at an unnecessary disadvantage to larger sponsors having the enterprise-wide scale and distribution reach to gather assets in the months after launch, neither the commenter nor the Exchange has provided data to support this conclusion.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act, that proposed rule change SR-CboeBZX-2020-036 is disapproved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁷

J. Matthew DeLesDernier
Assistant Secretary

³⁷ 17 CFR 200.30-3(a)(12).