

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-90355; File No. SR-NASDAQ-2020-017)

November 5, 2020

Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Amend Nasdaq Rule 5704

On July 23, 2020, The Nasdaq Stock Market LLC (“Exchange” or “Nasdaq”) 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 certain listing requirements relating to maintaining a minimum number of beneficial holders and minimum number of shares outstanding. The proposed rule change was published for comment in the Federal Register on August 7, 2020.³

On September 10, 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 The Commission has received no comments on the proposed rule change. The Commission is issuing this order to institute proceedings pursuant to Section

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 89464 (August 4, 2020), 85 FR 48012 (“Notice”).

⁴ 15 U.S.C. 78s(b)(2).

⁵ See Securities Exchange Act Release No. 89823, 85 FR 57895 (September 16, 2020). The Commission designated November 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.

19(b)(2)(B) of the Exchange Act⁶ to determine whether to approve or disapprove the proposed rule change.

I. Description of the Proposal

The Exchange proposes to amend Nasdaq Rule 5704 to: (1) remove the requirement that, twelve months after the commencement of trading on the Exchange, a series of Exchange Traded Fund Shares must have 50 or more beneficial holders; and (2) replace its existing minimum number of shares requirement with a requirement that each series of Exchange Traded Fund Shares have a sufficient number of shares outstanding at the commencement of trading to facilitate the formation of at least one creation unit.⁷

The Exchange believes that the requirement that a series of Exchange Traded Fund Shares listed on the Exchange must have at least 50 beneficial shareholders is no longer necessary. The Exchange believes that the requirements of Rule 6c-11 under the Investment Company Act of 1940 (“1940 Act”), coupled with the existing creation and redemption process, mitigate the potential lack of liquidity that, according to the Exchange, the shareholder requirement was intended to address.⁸ The Exchange further believes that requiring at least one creation unit to be outstanding at the commencement of trading, together with the daily portfolio transparency and other enhanced disclosure requirements of Rule 6c-11 under the 1940 Act,⁹ will facilitate an effective

⁶ 15 U.S.C. 78s(b)(2)(B).

⁷ Currently, Nasdaq Rule 5704(b)(1)(A) provides that the Exchange will establish a minimum number of Exchange Traded Fund Shares required to be outstanding at the time of commencement of trading on the Exchange.

⁸ In contrast, Nasdaq believes that the shareholder requirement as it relates to common stock is a measure of liquidity designed to help assure that there will be sufficient investor interest and trading to support price discovery once a security is listed. See id. at 48012, n.6.

⁹ As an example, the Exchange notes that Rule 6c-11(c)(1)(vi) requires additional disclosure if the premium or discount is in excess of 2% for more than seven consecutive

arbitrage mechanism and provide market participants and investors with sufficient transparency into the holdings of the underlying portfolio, and ensure that the trading price in the secondary market remains in line with the value per share of a fund's portfolio.

Specifically with respect to arbitrage, the Exchange states that the arbitrage mechanism relies on the fact that shares of the Fund can be created and redeemed and that shares of the Fund are able to flow into or out of the market when the price of the Fund is not aligned with the net asset value per share of the portfolio. The resulting buying and selling of the shares of the Fund, as well as the underlying portfolio components, generally causes the market price and the net asset value per share to converge. In addition, the Exchange states that the proper functioning of the arbitrage mechanism is reliant on the presence of authorized participants ("APs") that are eligible to facilitate creations and redemptions with the fund and support the liquidity of the fund. As a result, the Exchange believes that the AP is able to buy and sell Exchange Traded Fund Shares from both the fund and investors. Because Exchange Traded Fund Shares can be created and redeemed "in-kind" and do not have an upper limit of the number of shares that can be outstanding, an AP can fulfill customer orders or take advantage of arbitrage opportunities regardless of the number of shares currently outstanding. Thus, the Exchange believes that, unlike common stock, the liquidity of Exchange Traded Fund Shares is not dependent on the number of shares currently outstanding or the number of shareholders, but on the availability of APs to transact in the Exchange Traded Fund Shares primary market.

To support these contentions, the Exchange provides information, during a two-month observation period, regarding how closely two funds – the SPY and QQQ – tracked their

days, so that there would be transparency to investors in the event that the trading value and the underlying portfolio deviate for an extended period of time, which could indicate an inefficient arbitrage mechanism.

respective underlying indexes, as well as data regarding creation and redemption activity in those two funds during the same observation period. The Exchange asserts that a symbiotic relationship exists between the disclosure requirements of Rule 6c-11 under the 1940 Act, the ability of the AP to create and redeem shares of a fund, and the functioning of the arbitrage mechanism that helps to ensure that the trading price in the secondary market is at fair value. According to the Exchange, this renders the need for a shareholder requirement as duplicative and unnecessary.

The Exchange further believes that, in order for fund redemptions to be executed in support of the arbitrage mechanism, it is appropriate that, in lieu of the minimum number of shareholders requirement, the fund have a sufficient number of shares outstanding in order to facilitate the formation of at least one creation unit on an initial and continued listing basis. The Exchange claims that the existence of the creation and redemption process, daily portfolio transparency, as well as a sufficient number of shares outstanding to allow for the formation of at least one creation unit, ensures that market participants are able to redeem shares and thereby support the proper functioning of the arbitrage mechanism. According to the Exchange, of the more than 350 funds currently listed on Nasdaq that would be eligible to be listed under Nasdaq Rule 5704, only two had a single creation unit outstanding. The remaining funds have, on average, shares outstanding equal to approximately 300 creation units.

In addition, the Exchange states that its surveillance program for, and its ability to halt trading in, Exchange Traded Fund Shares provide for additional investor protections by further mitigating any abnormal trading that would affect the prices of Exchange Traded Fund Shares.

II. Proceedings to Determine Whether to Approve or Disapprove SR-NASDAQ-2020-017 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act¹⁰ to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved.

Pursuant to Section 19(b)(2)(B) of the Exchange Act,¹¹ the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of and input concerning the proposed rule change's consistency with the Exchange Act and, in particular, Section 6(b)(5) of the Exchange Act, which requires, among other things, that the rules of a national securities exchange be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, 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."¹²

The Commission has consistently recognized the importance of the minimum number of holders and other similar requirements in exchange listing standards. Among other things, such listing standards help ensure that exchange listed securities have sufficient public float, investor

¹⁰ 15 U.S.C. 78s(b)(2)(B).

¹¹ Id.

¹² 15 U.S.C. 78f(b)(5).

base, and trading interest to provide the depth and liquidity necessary to promote fair and orderly markets.¹³

As discussed above, the Exchange is proposing to: (1) remove the listing requirement that, following the initial twelve-month period after commencement of trading of a series of Exchange Traded Fund Shares on the Exchange, such series have at least 50 beneficial holders, and (2) replace its existing minimum number of shares requirement with a requirement that each series of Exchange Traded Fund Shares have a sufficient number of shares outstanding at the commencement of trading to facilitate the formation of at least one creation unit.¹⁴ In support of its proposal, the Exchange asserts that the minimum number of beneficial holders requirement is no longer necessary because the requirements of Rule 6c-11 under the 1940 Act, coupled with the existing creation and redemption process, mitigate the potential lack of liquidity that Nasdaq believes the beneficial holders requirement was intended to address. The Exchange, however, does not explain in any detail the basis for this view, particularly if a series of Exchange Traded Fund Shares is permitted to have a very small number of beneficial holders. For example, while the Exchange provides data with respect to two widely-held and highly liquid funds, it does not address how the arbitrage mechanism will assure Exchange Traded Fund Shares with very few

¹³ 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).

¹⁴ In support of its proposal, Nasdaq states that it would require that a sufficient number of shares to be outstanding at “all times” to facilitate the formation of at least one creation unit. See Notice, *supra* note 3, 85 FR at 48012. However, proposed Nasdaq Rule 5704(b)(1)(A) establishes that requirement “at the time of commencement of trading on Nasdaq,” making it an initial and not a continued listing standard.

holders or very few active APs will effectively support fair and orderly markets. The Exchange also does not discuss potential inefficiencies in the arbitrage mechanism that might occur with illiquid Exchange Traded Fund Shares that have very few holders, and the impact that would have on the ability of the arbitrage mechanism to effectively mitigate the risks of manipulation. Further, the Exchange does not address the impact of creation unit size on the efficiency of the arbitrage mechanism across the spectrum of Exchange Traded Fund Shares (e.g., illiquid Exchange Traded Fund Shares with very few holders and a large creation unit size). The Exchange provides no data or analysis to support its position, other than with respect to the SPY and QQQ, two highly liquid and widely held Exchange Traded Fund Shares, and the number and size of the creation units for existing Exchange Traded Fund Shares.

The Exchange provides no specific arguments to support the proposed elimination of its existing minimum number of shares requirement. While the Exchange proposes to replace that requirement with a requirement that each series of Exchange Traded Fund Shares have a sufficient number of shares outstanding at the commencement of trading to facilitate the formation of at least one creation unit, the Exchange does not explain why this is an appropriate substitute for its existing standards. Creation unit sizes could be highly variable, since they are determined at the discretion of the issuer of Exchange Traded Fund Shares. The Exchange has not articulated how this new standard would effectively support fair and orderly markets, address the risks of manipulation, and otherwise be consistent with Section 6(b)(5) and other relevant provisions of the Exchange Act for Exchange Traded Fund Shares with only a single and relatively small creation unit outstanding. The Exchange also has proposed to limit this requirement to a single determination at the commencement of trading, and has not explained the impact of fewer shares potentially being outstanding thereafter. Further, the Exchange has

proposed to require that there be a sufficient number of shares outstanding to “facilitate the formation of” at least one creation unit, and has not explained how this standard differs from a requirement that the number of shares outstanding at least equals one creation unit.

Finally, the Exchange takes the position that its surveillance procedures and trading halt authority would mitigate any abnormal trading that would affect Exchange Traded Fund Shares prices in the secondary market. The Exchange, however, does not explain in any detail the basis for this view, or how specifically its existing procedures would effectively mitigate the risks addressed by the minimum number of beneficial holders and minimum number of shares requirements the Exchange is proposing to eliminate.

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.”¹⁵ 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 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.¹⁶

For these reasons, the Commission believes it is appropriate to institute proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act to determine whether the proposal should be approved or disapproved.

¹⁵ Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

¹⁶ See id.

IV. Commission's Solicitation of Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any other concerns they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposal is consistent with Section 6(b)(5) or any other provision of the Exchange Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.¹⁷

Interested persons are invited to submit written data, views, and arguments regarding whether the proposal should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register]. The Commission asks that commenters address the sufficiency of the Exchange's statements in support of the proposal, which are set forth in the Notice,¹⁸ in addition to any other comments they may wish to submit about the proposed rule change.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

¹⁷ Section 19(b)(2) of the Exchange Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

¹⁸ See supra note 3.

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASDAQ-2020-017 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2020-017. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All

submissions should refer to File Number SR-NASDAQ-2020-017 and should be submitted by [insert date 21 days from date of publication in the Federal Register]. Rebuttal comments should be submitted by [insert date 35 days from date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

J. Matthew DeLesDernier
Assistant Secretary

¹⁹ 17 CFR 200.30-3(a)(57).