

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-77705; File No. SR-Nasdaq-2016-002)

April 26, 2016

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to List and Trade Shares of the First Trust Municipal High Income ETF of First Trust Exchange-Traded Fund III

I. Introduction

On January 6, 2016, The NASDAQ Stock Market LLC (“Nasdaq” or the “Exchange”) 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 list and trade shares (“Shares”) of the First Trust Municipal High Income ETF (“Fund”) under Nasdaq Rule 5735. The proposed rule change was published for comment in the Federal Register on January 27, 2016.<sup>3</sup> On February 16, 2016, the Exchange filed Amendment No. 1.<sup>4</sup> On March 8, 2016, pursuant to Section 19(b)(2) of the Act,<sup>5</sup>

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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. 76944 (Jan. 21, 2016), 81 FR 4712 (“Notice”).

<sup>4</sup> In Amendment No. 1, the Exchange clarified that the Fund’s portfolio will satisfy the following quantitative standards set forth NASDAQ 5705(b)(4)(A) except for those in Nasdaq Rule 5705(b)(4)(A)(ii): (i) The index or portfolio must consist of Fixed Income Securities;(ii) Components that in aggregate account for at least 75% of the weight of the index or portfolio must have a minimum original principal amount outstanding of \$100 million or more;(iii) A component may be a convertible security, however, once the convertible security component converts to an underlying equity security, the component is removed from the index or portfolio;(iv) No component fixed-income security (excluding Treasury Securities) will represent more than 30% of the weight of the index or portfolio, and the five highest weighted component fixed-income securities do not in the aggregate account for more than 65% of the weight of the index or portfolio;(v) An underlying index or portfolio (excluding exempted securities) must include securities from a minimum of 13 non-affiliated issuers; and(vi) Component securities that in aggregate account for at least 90% of the weight of the index or portfolio must be either: (a) from issuers that are required to file reports pursuant to Sections 13 and 15(d) of the

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.<sup>6</sup> The Commission received no comments on the proposed rule change. This order institutes proceedings under Section 19(b)(2)(B) of the Act<sup>7</sup> to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1 thereto.

## II. Description of the Proposal

Nasdaq proposes to list and trade Shares of the Fund under Nasdaq Rule 5735, which governs the listing and trading of Managed Fund Shares on the Exchange. The Shares will be offered by the First Trust Exchange-Traded Fund III (“Trust”), a Massachusetts business trust registered with the Commission as an open-end investment company.<sup>8</sup> First Trust Advisors L.P.

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Act; (b) from issuers that have a worldwide market value of its outstanding common equity held by non-affiliates of \$700 million or more; (c) from issuers that 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 as defined in section 3(a)(12) of the Act; or (e) from issuers that are a government of a foreign country or a political subdivision of a foreign country. Because Amendment No. 1 to the proposed rule change is technical in nature and does not materially alter the substance of the proposed rule change or raise any novel regulatory issues, it is not subject to notice and comment. Amendment No. 1 is available on the Commission’s website at: <http://www.sec.gov/comments/sr-nasdaq-2016-002/nasdaq2016002-1.pdf>.

<sup>5</sup> 15 U.S.C. 78s(b)(2).

<sup>6</sup> See Securities Exchange Act Release No. 34-77320, 81 FR 13429 (Mar. 14, 2016). The Commission designated April 26, 2016 as the date by which the Commission shall either approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change.

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

<sup>8</sup> The Trust is registered with the Commission as an investment company and has filed a registration statement on Form N-1A (“Registration Statement”) with the Commission. See Post-Effective Amendment No. 27 to Registration Statement on Form N-1A for the Trust, dated August 31, 2015 (File Nos. 333-176976 and 811-22245). In addition, the Exchange represents that the Commission has issued an order, upon which the Trust may rely, granting certain exemptive relief under the Investment Company Act of 1940 (“1940 Act”). See Investment Company Act Release No. 30029 (April 10, 2012) (File No. 812-13795).

will be the investment manager to the Fund (“Adviser”),<sup>9</sup> and First Trust Portfolios L.P. will serve as the principal underwriter and distributor for the Fund. Brown Brothers Harriman & Co. will act as the administrator, accounting agent, custodian and transfer agent to the Fund.

The Exchange has made the following representations and statements in describing the Fund and its investment strategy, including other portfolio holdings and investment restrictions.<sup>10</sup>

A. Principal Investments of the Fund

The primary investment objective of the Fund will be to generate current income that is exempt from regular federal income taxes, and its secondary objective will be long-term capital appreciation. Under normal market conditions,<sup>11</sup> the Fund will seek to achieve its investment

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<sup>9</sup> The Exchange represents that the Adviser is not a broker-dealer, but it is affiliated with the Distributor, a broker-dealer, and has implemented a fire wall with respect to its broker-dealer affiliate regarding access to information concerning the composition of or changes to the portfolio. The Exchange further represents that personnel who make decisions on the Fund’s portfolio composition will be subject to procedures designed to prevent the use and dissemination of material non-public information regarding the Fund’s portfolio. In the event (a) the Adviser or any sub-adviser registers as a broker-dealer or becomes newly affiliated with a broker-dealer, or (b) any new adviser or sub-adviser is a registered broker-dealer or becomes affiliated with another broker-dealer, the adviser or sub-adviser will implement a fire wall with respect to its relevant personnel and/or such broker-dealer affiliate, as applicable, regarding access to information concerning the composition of and changes to the portfolio and will be subject to procedures designed to prevent the use and dissemination of material non-public information regarding such portfolio. See Notice, supra note 3, at 4713.

<sup>10</sup> The Commission notes that additional information regarding the Fund, the Trust, and the Shares, including investment strategies, risks, creation and redemption procedures, fees, portfolio holdings disclosure policies, calculation of net asset value (“NAV”), distributions, and taxes, among other things, can be found in the Notice and the Registration Statement, as applicable. See Notice and Registration Statement, supra notes 3 and 5, respectively.

<sup>11</sup> The term “under normal market conditions” as used herein includes, but is not limited to, the absence of adverse market, economic, political or other conditions, including extreme volatility or trading halts in the fixed income markets or the financial markets generally; operational issues causing dissemination of inaccurate market information; or force majeure type events such as systems failure, natural or man-made disaster, act of God,

objectives by investing at least 80% of its net assets (including investment borrowings) in Municipal Securities.<sup>12</sup> Municipal Securities are generally issued by or on behalf of states, territories or possessions of the U.S. and the District of Columbia and their political subdivisions, agencies, authorities and other instrumentalities. The types of Municipal Securities in which the Fund may invest include municipal lease obligations (and certificates of participation in such obligations), municipal general obligation bonds, municipal revenue bonds, municipal notes, municipal cash equivalents, private activity bonds (including without limitation industrial development bonds), and pre-refunded and escrowed to maturity bonds. In addition, Municipal Securities include securities issued by entities whose underlying assets are municipal bonds (i.e., tender option bond (TOB) trusts and custodial receipts trusts). The Fund may invest in Municipal Securities of any maturity.

Under normal market conditions, the Fund will invest at least 65% of its net assets in Municipal Securities that are, at the time of investment, rated below investment grade (i.e., not rated Baa3/BBB- or above) by at least one nationally recognized statistical rating organization (“NRSRO”) rating such securities (or Municipal Securities that are unrated and determined by

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armed conflict, act of terrorism, riot or labor disruption or any similar intervening circumstance. On a temporary basis, including for defensive purposes, during the initial invest-up period and during periods of high cash inflows or outflows, the Fund may depart from its principal investment strategies; for example, it may hold a higher than normal proportion of its assets in cash. During such periods, the Fund may not be able to achieve its investment objectives. The Fund may adopt a defensive strategy when the Adviser believes securities in which the Fund normally invests have elevated risks due to political or economic factors and in other extraordinary circumstances.

<sup>12</sup> According to the Exchange, the Fund may invest up to 100% of its net assets in Municipal Securities that pay interest that generates income subject to the federal alternative minimum tax, assuming compliance with the investment requirements and limitations described herein.

the Adviser to be of comparable quality)<sup>13</sup> (commonly referred to as “high yield” or “junk” bonds);<sup>14</sup> however, the Fund will consider pre-refunded or escrowed to maturity bonds, regardless of rating, to be investment grade securities. The Fund may invest up to 35% of its net assets in Municipal Securities that are, at the time of investment, rated investment grade (i.e., rated Baa3/BBB- or above) by each NRSRO rating such securities (or Municipal Securities that are unrated and determined by the Adviser to be of comparable quality). If, subsequent to purchase by the Fund, a Municipal Security held by the Fund experiences an improvement in credit quality and becomes investment grade, the Fund may continue to hold the Municipal Security and it will not cause the Fund to violate the 35% investment limitation; however, the Municipal Security will be taken into account for purposes of determining whether purchases of additional Municipal Securities will cause the Fund to violate such limitation.

B. Other (Non-Principal) Investments of the Fund

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<sup>13</sup> Comparable quality of unrated Municipal Securities will be determined by the Adviser based on fundamental credit analysis of the unrated security and comparable rated securities. On a best efforts basis, the Adviser will attempt to make a rating determination based on publicly available data. In making a “comparable quality” determination, the Adviser may consider, for example, whether the issuer of the security has issued other rated securities, the nature and provisions of the relevant security, whether the obligations under the relevant security are guaranteed by another entity and the rating of such guarantor (if any), relevant cash flows, macroeconomic analysis, and/or sector or industry analysis.

<sup>14</sup> The Municipal Securities in which the Fund will invest to satisfy this 65% investment requirement may include Municipal Securities that are currently in default and not expected to pay the current coupon (“Distressed Municipal Securities”). The Fund may invest up to 10% of its net assets in Distressed Municipal Securities. If, subsequent to purchase by the Fund, a Municipal Security held by the Fund becomes a Distressed Municipal Security, the Fund may continue to hold the Distressed Municipal Security and it will not cause the Fund to violate the 10% limitation; however, the Distressed Municipal Security will be taken into account for purposes of determining whether purchases of additional Municipal Securities will cause the Fund to violate such limitation.

The Exchange represents that the non-principal investments listed below would consist of investments that are not included in the Fund's 80% Policy. Such assets may be invested in the Fixed Income Instruments and other instruments, as described below.

Under normal market conditions, the Fund will invest substantially all of its assets to meet its investment objectives as described above. In addition, the Fund may invest its assets or hold cash as generally described below.

The Exchange represents that the Fund may invest up to 10% of its net assets in taxable municipal securities. The Fund may also invest up to 10% of its net assets in short-term debt instruments,<sup>15</sup> money market funds, and other cash equivalents, or it may hold cash. The percentage of the Fund invested in such holdings or held in cash will vary and will depend on several factors, including market conditions.

With respect to up to 20% of its net assets, the Fund may (i) invest in the securities of other investment companies registered under the 1940 Act, including money market funds, other ETFs, open-end funds (other than money market funds and other ETFs), and closed-end funds and (ii) acquire short positions in the securities of the foregoing investment companies.

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<sup>15</sup> Short-term debt instruments, which do not include Municipal Securities, are issued by issuers having a long-term debt rating of at least A-/A3 (as applicable) by Standard & Poor's Ratings Services ("S&P Ratings"), Moody's Investors Service, Inc. ("Moody's") or Fitch Ratings ("Fitch") and have a maturity of one year or less. According to the Exchange, the Fund may invest in the following short-term debt instruments: (1) fixed rate and floating rate U.S. government securities, including bills, notes, and bonds differing as to maturity and rates of interest, which are either issued or guaranteed by the U.S. Treasury or by U.S. government agencies or instrumentalities; (2) certificates of deposit issued against funds deposited in a bank or savings and loan association; (3) bankers' acceptances, which are short-term credit instruments used to finance commercial transactions; (4) repurchase agreements, which involve purchases of debt securities; (5) bank time deposits, which are monies kept on deposit with banks or savings and loan associations for a stated period of time at a fixed rate of interest; and (6) commercial paper (rated A-3 or higher by S&P Ratings, Prime-3 or higher by Moody's or F3 or higher by Fitch), which is short-term unsecured promissory notes.

With respect to up to 20% of its net assets, the Fund may (i) invest in exchange-listed options on U.S. Treasury securities, exchange-listed options on U.S. Treasury futures contracts, and exchange-listed U.S. Treasury futures contracts and (ii) acquire short positions in the foregoing derivatives. Transactions in the foregoing derivatives may allow the Fund to obtain net long or short exposures to selected interest rates. These derivatives may also be used to hedge risks, including interest rate risks and credit risks, associated with the Fund's portfolio investments. The Fund's investments in derivative instruments will be consistent with the Fund's investment objectives and the 1940 Act and will not be used to seek to achieve a multiple or inverse multiple of an index.

C. Investment Restrictions

The Exchange represents that the Fund may hold up to an aggregate amount of 15% of its net assets in illiquid assets (calculated at the time of investment), including Rule 144A securities deemed illiquid by the Adviser.<sup>16</sup> The Exchange further represents that the Fund will monitor its portfolio liquidity on an ongoing basis to determine whether, in light of current circumstances, an adequate level of liquidity is being maintained, and will consider taking appropriate steps in order to maintain adequate liquidity if, through a change in values, net assets, or other circumstances, more than 15% of the Fund's net assets are held in illiquid assets.

The Fund may not invest 25% or more of the value of its total assets in securities of issuers in any one industry, although this restriction does not apply to (a) Municipal Securities issued by governments or political subdivisions of governments, (b) obligations issued or

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<sup>16</sup> In reaching liquidity decisions, the Adviser may consider the following factors: the frequency of trades and quotes for the security; the number of dealers wishing to purchase or sell the security and the number of other potential purchasers; dealer undertakings to make a market in the security; and the nature of the security and the nature of the marketplace in which it trades (e.g., the time needed to dispose of the security, the method of soliciting offers and the mechanics of transfer).

guaranteed by the U.S. government, its agencies or instrumentalities, or (c) securities of other investment companies.

D. Nasdaq Rule 5705(b)(4)(A)

The Fund will be actively managed and will not be tied to an index. Under normal market conditions, on a continuous basis determined at the time of purchase, its portfolio of Municipal Securities<sup>17</sup> will generally meet, as applicable, all criteria for non-actively managed, index-based, fixed income ETFs contained in Nasdaq Rule 5705(b)(4)(A) except for those set forth in Nasdaq Rule 5705(b)(4)(A)(ii), which requires that components that in the aggregate account for at least 75% of the weight of the index or portfolio have a minimum original principal amount outstanding of \$100 million or more. However, under normal market conditions, at least 40% (based on dollar amount invested) of the Municipal Securities in which the Fund invests will be issued by issuers with total outstanding debt issuances that, in the aggregate, have a minimum original principal amount outstanding of \$75 million or more, which according to the Exchange, should provide support regarding the anticipated liquidity of the Fund's Municipal Securities portfolio.

III. Proceedings to Determine Whether to Approve or Disapprove SR-Nasdaq-2016-002 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>18</sup> to determine whether the proposed rule change, as modified by Amendment No. 1 thereto, 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

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<sup>17</sup> According to the Exchange, for purposes of this statement and the discussion of the requirements of Nasdaq Rule 5705(b)(4)(A), with respect to Municipal Securities that are issued by entities whose underlying assets are municipal bonds, the underlying municipal bonds, rather than the securities issued by such entities, will be taken into account.

<sup>18</sup> 15 U.S.C. 78s(b)(2)(B).

does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described below, the Commission seeks and encourages interested persons to provide comments on the proposed rule change.

Pursuant to Section 19(b)(2)(B) of the Act,<sup>19</sup> the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of the proposed rule change’s consistency with Section 6(b)(5) of the 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,” and “to protect investors and the public interest.”<sup>20</sup>

#### IV. Procedure: Request for Written 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 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.<sup>21</sup>

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Id.

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15 U.S.C. 78f(b)(5).

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Section 19(b)(2) of the 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).

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<sup>22</sup> and in Amendment No. 1 to the proposed rule change,<sup>23</sup> in addition to any other comments they may wish to submit about the proposed rule change.

The Exchange provides that the Fund may invest in one or more of the following broad categories of Municipal Securities<sup>24</sup>: (a) municipal lease obligations; (b) municipal general obligation bonds; (c) municipal revenue bonds; (d) municipal notes; (e) municipal cash equivalents; (f) private activity bonds; and (g) pre-refunded and escrowed to maturity bonds. Moreover, the Exchange represents that under normal market conditions: (i) no component fixed income security (excluding Treasury securities) will represent more than 30% of the weight of the index or portfolio, and that the five highest weighted component fixed income securities will not in the aggregate account for more than 65% of the weight of the index or portfolio; (ii) component securities that in the aggregate account for at least 90% of the weight of the index or portfolio be either exempted securities or from a specified type of issuer; (iii) at least 40% (based on dollar amount invested) of the Municipal Securities in which the Fund invests will be issued by issuers with total outstanding debt issuances that, in the aggregate, have a minimum

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<sup>22</sup> See supra note 3.

<sup>23</sup> See supra note 4.

<sup>24</sup> In addition, Municipal Securities include securities issued by entities whose underlying assets are municipal bonds (i.e., tender option bond (TOB) trusts and custodial receipts trusts).

original principal amount outstanding of \$75 million or more; and (iv) the underlying index or portfolio (excluding one consisting entirely of exempted securities) will include securities from a minimum of 13 non-affiliated issuers.

Apart from these broad representations, the Exchange provides no other information about the kinds of municipal bonds in which the Fund may invest. Accordingly, the Commission seeks comment on whether the Exchange's representations relating to the Municipal Securities to be held by the Fund are sufficient to limit the susceptibility of the portfolio to manipulation, and are consistent with the requirements of Section 6(b)(5) of the Act, which, among other things, requires that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices.

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
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-Nasdaq-2016-002 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 Numbers SR-Nasdaq-2016-002. 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 these filings also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Nasdaq-2016-002 and should be submitted on or before [insert date 21 days from 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.<sup>25</sup>

Robert W. Errett  
Deputy Secretary

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<sup>25</sup> 17 CFR 200.30-3(a)(57).