

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-81265; File No. SR-NASDAQ-2017-038)

July 31, 2017

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment No. 1, and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendments No. 1 and 2, Relating to the First Trust Municipal High Income ETF

I. Introduction

On May 16, 2017, The NASDAQ Stock Market LLC (“Nasdaq” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change relating to the First Trust Municipal High Income ETF (“Fund”) of First Trust Exchange-Traded Fund III (“Trust”), the shares of which have been approved by the Commission for listing and trading under Nasdaq Rule 5735 (“Managed Fund Shares”). The proposed rule change was published for comment in the Federal Register on June 2, 2017.<sup>3</sup> On July 10, 2017, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>4</sup> On July 11, 2017, 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

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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. 80802 (May 26, 2017), 82 FR 25648 (Jun. 2, 2017) (“Notice”).

<sup>4</sup> In Amendment No. 1, which amended and replaced the proposed rule change in its entirety, the Exchange: (a) modified the requirement that the Fund invest at least 65% of its net assets in Municipal Securities (as defined herein) that are rated below investment grade to at least 50% of its net assets; (b) modified the limitation that the Fund invest up to 35% of its net assets in investment grade Municipal Securities to up to 50% of its net assets; and (c) removed references to the Liquidity Rule. Amendment No. 1 to the proposed rule change is available on the Commission’s website at: <https://www.sec.gov/comments/sr-nasdaq-2017-038/nasdaq2017038-1841718-155073.pdf>.

disapprove the proposed rule change.<sup>5</sup> On July 13, 2017, the Exchange filed Amendment No. 2 to the proposed rule change.<sup>6</sup> The Commission has received no comments on the proposal. The Commission is publishing this notice to solicit comments on Amendment No. 1 from interested persons, and is approving the proposed rule change, as modified by Amendments No. 1 and 2, on an accelerated basis.

II. The Exchange's Description of the Proposed Rule Change, as Modified by Amendments No. 1 and 2

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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<sup>5</sup> See Securities Exchange Act Release No. 81123 (Jul. 11, 2017), 82 FR 32737 (Jul. 17, 2017). The Commission designated August 31, 2017, as the date by which the Commission shall either approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change. See id.

<sup>6</sup> In Amendment No. 2, which partially amended the proposed rule change, as modified by Amendment No. 1, the Exchange provided the rationale with respect to the modifications to the percentages of investment grade and non-investment grade Municipal Securities in which the Fund may invest. Because Amendment No. 2 makes clarifying changes and does not present unique or novel regulatory issues, it is not subject to notice and comment. Amendment No. 2 is available on the Commission's website at: <https://www.sec.gov/comments/sr-nasdaq-2017-038/nasdaq2017038-1851791-155341.pdf>. See infra notes 30-32 (noting where the Exchange provided the rationale with respect to the modifications to the percentages of investment grade and non-investment grade Municipal Securities in Amendment No. 2).

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Commission has approved the listing and trading of Shares under Nasdaq Rule 5735, which governs the listing and trading of Managed Fund Shares on the Exchange.<sup>7</sup> However, no Shares are currently listed and traded on the Exchange. The Exchange believes the proposed rule change reflects no significant issues not previously addressed in the Prior Release.

The Fund is an actively-managed exchange-traded fund (“ETF”). The Shares will be offered by the Trust, which was established as a Massachusetts business trust on January 9, 2008. The Trust, which is registered with the Commission as an investment company under the Investment Company Act of 1940 (the “1940 Act”), has filed a registration statement on Form N-1A (“Registration Statement”) relating to the Fund with the Commission.<sup>8</sup> The Fund is a series of the Trust.

The primary purpose of this proposed rule change is to modify certain representations set forth in the Prior Release. Since the Prior Release, in evaluating its ability to construct a portfolio that would both enable the Fund to pursue its investment objectives effectively and satisfy the

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<sup>7</sup> The Commission approved Nasdaq Rule 5735 in Securities Exchange Act Release No. 57962 (June 13, 2008), 73 FR 35175 (June 20, 2008) (SR-NASDAQ-2008-039). The Commission previously approved the listing and trading of the Shares of the Fund. See Securities Exchange Act Release No. 78913 (September 23, 2016), 81 FR 69109 (October 5, 2016) (SR-NASDAQ-2016-002) (“Prior Release”).

<sup>8</sup> 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). The descriptions of the Fund and the Shares contained herein are based, in part, on information in the Registration Statement. Before Shares are publicly offered, the Trust will file a post-effective amendment to its Registration Statement. The changes in this proposed rule change will not be implemented for the Fund until the post-effective amendment to the Registration Statement becomes effective. First Trust Advisors L.P. (the “Adviser”) represents that the Adviser will not implement the changes described herein until the instant proposed rule change is operative.

representations set forth in the Prior Release, the Adviser determined that, based on certain factors, including regulatory and market developments with portfolio management implications, additional flexibility would be needed to launch and operate the Fund. Additionally, the Adviser took into account that recent increases in interest rates have been accompanied by substantial outflows from mutual funds and ETFs, and that future interest rate swings may spark increased market volatility and trigger potentially dramatic inflows and outflows. To enable the Fund to operate effectively (including, in addition to pursuing its investment objectives, responding to potential market volatility), the Adviser believes that additional portfolio management flexibility is needed and warranted. Additionally, for the reasons discussed in more detail below, the Exchange believes that the proposal is consistent with Section 6(b)(5) of the Act.

As a related matter, the Exchange notes that although the Prior Release included certain representations that were based on the generic listing standards for index-based ETFs, the Exchange's "generic listing standards" for actively-managed ETFs (the "Active ETF Generic Listing Standards")<sup>9</sup> were recently adopted and, with one exception, the Fund's proposed revised representations would meet or exceed similar requirements for portfolios of fixed income securities set forth in Nasdaq Rule 5735(b)(1)(B) under the Active ETF Generic Listing Standards ("Rule 5735(b)(1)(B)"). In addition, this proposed rule change would make certain changes to the description of the Fund's investments. Further, to provide the Adviser with greater flexibility in hedging interest rate risks associated with the Fund's portfolio investments, this proposed rule change would expand the Fund's ability to invest in derivatives by permitting it to invest in over-the-counter ("OTC") forward contracts and OTC swaps, subject to a limitation that

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<sup>9</sup> See Securities Exchange Act Release No. 78918 (September 23, 2016), 81 FR 67033 (September 29, 2016).

would be consistent with the limitation on investments in OTC derivatives set forth in Nasdaq Rule 5735(b)(1)(E) under the Active ETF Generic Listing Standards (“Rule 5735(b)(1)(E”).

#### Changes to Representations

The Prior Release noted that the Fund would be actively managed and not tied to an index, but that under normal market conditions, on a continuous basis determined at the time of purchase, its portfolio of Municipal Securities (as defined in the Prior Release) would generally meet, as applicable, all except for two of the criteria for non-actively managed, index-based, fixed income ETFs contained in Nasdaq Rule 5705(b)(4)(A), as described therein. More specifically, the Prior Release stated that, under normal market conditions, the Fund’s portfolio of Municipal Securities would meet the requirements of: (i) Nasdaq Rule 5705(b)(4)(A)(i) (requiring that the index or portfolio consist of “Fixed Income Securities”); (ii) Nasdaq Rule 5705(b)(4)(A)(iv) (requiring that no component fixed income security (excluding Treasury securities) represent more than 30% of the weight of the index or portfolio, and that 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); and (iii) Nasdaq Rule 5705(b)(4)(A)(v) (requiring that an underlying index or portfolio (excluding one consisting entirely of exempted securities) include securities from a minimum of 13 non-affiliated issuers) (collectively, the “Rule 5705-Related Representations”).

Additionally, the Prior Release noted that Nasdaq Rule 5705(b)(4)(A)(iii) (relating to convertible securities) was inapplicable to the Fund’s portfolio of Municipal Securities. Further, the Prior Release provided that the Fund’s portfolio of Municipal Securities may not satisfy 5705(b)(4)(A)(vi) (requiring that 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) and that it would not generally satisfy Rule 5705(b)(4)(A)(ii) (requiring 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, the Prior Release stated that under normal market conditions, at least 40% (based on dollar amount invested) of the Municipal Securities in which the Fund invested would be issued by issuers with total outstanding debt issuances that, in the aggregate, have a minimum amount of municipal debt outstanding at the time of purchase of \$75 million or more (the “40/75 Representation”).<sup>10</sup>

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<sup>10</sup> As noted in the Prior Release, the Commission has previously issued orders approving proposed rule changes relating to the listing and trading under NYSE Arca Equities Rule 5.2(j)(3), Commentary .02 (which governs the listing and trading of fixed-income index ETFs on NYSE Arca, Inc.) to various ETFs that track indexes comprised of municipal securities (including high-yield municipal index ETFs) that did not meet the analogous requirement included in Commentary .02(a)(2) to NYSE Arca Equities Rule 5.2(j)(3), but demonstrated that the portfolio of municipal securities in which the ETFs would invest would be sufficiently liquid (including Securities Exchange Act Release Nos. 75376 (July 7, 2015), 80 FR 40113 (July 13, 2015) (SR-NYSEArca-2015-18) (order approving listing and trading of Vanguard Tax-Exempt Bond Index Fund); 71232 (January 3, 2014), 79 FR 1662 (January 9, 2014) (SR-NYSEArca-2013-118) (order approving listing and trading of Market Vectors Short High-Yield Municipal Index ETF); and 63881 (February 9, 2011), 76 FR 9065 (February 16, 2011) (SR-NYSEArca-2010-120) (order approving listing and trading of SPDR Nuveen S&P High Yield Municipal Bond ETF)). See also Securities Exchange Act Release Nos. 67985 (October 4, 2012), 77 FR 61804 (October 11, 2012) (SR-NYSEArca-2012-92) (order approving listing and trading of iShares 2018 S&P AMT-Free Municipal Series and iShares 2019 S&P AMT-Free Municipal Series); 72464 (June 25, 2014), 79 FR 37373 (July 1, 2014) (SR-NYSEArca-2014-45) (order approving continued listing and trading of PowerShares Insured California Municipal Bond Portfolio, PowerShares Insured National Municipal Bond Portfolio and PowerShares Insured New York Municipal Bond Portfolio); 72523 (July 2, 2014), 79 FR 39016 (July 9, 2014) (SR-NYSEArca-2014-37) (order approving listing and trading of iShares 2020 S&P AMT-Free Municipal Series); 75468 (July 16, 2015), 80 FR 43500 (July 22, 2015) (SR-NYSEArca-2015-25) (order approving listing and trading of iShares iBonds Dec 2021 AMT-Free Muni Bond ETF and iShares iBonds Dec 2022 AMT-Free Muni Bond ETF); 78329 (July 14, 2016), 81 FR 47217 (July 20, 2016) (SR-BatsBZX-2016-01) (order approving listing and trading of VanEck Vectors AMT-Free 6-8 Year Municipal Index ETF, VanEck Vectors AMT-Free 8-12 Year Municipal Index ETF, and VanEck Vectors AMT-Free 12-17 Year Municipal Index ETF); and 79885 (January 26, 2017), 82 FR 8963 (February 1, 2017) (SR-NYSEArca-2016-100) (order approving listing and trading of Direxion Daily Municipal Bond Taxable Bear 1X Fund).

In addition to the Rule 5705-Related Representations and the 40/75 Representation, the Prior Release provided that under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows,<sup>11</sup> the Fund's investments in Municipal Securities would provide exposure (based on dollar amount invested) to (a) at least 10 different industries (with no more than 25% of the value of the Fund's net assets comprised of Municipal Securities that provide exposure to any single industry) and (b) at least 15 different states (with no more than 30% of the value of the Fund's net assets comprised of Municipal Securities that provide exposure to any single state) (collectively, the "Industry/State Representations").

Additionally, the Prior Release stated that under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows, (a) with respect to 75% of the Fund's net assets, the Fund's exposure to any single borrower (based on dollar amount invested) would not exceed 3% of the value of the Fund's net assets and (b) with respect to 15% of the Fund's net assets, the Fund's exposure to any single borrower (based on dollar amount invested) would not exceed 5% of the value of the Fund's net assets (collectively, the "Borrower Exposure Representations").

The Prior Release also provided that under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows, (a) with respect to the Municipal Securities in which the Fund invested that were rated investment grade by each nationally recognized statistical rating organization ("NRSRO") rating such securities, at the time of purchase, the applicable borrower would be obligated to pay debt service on issues of

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<sup>11</sup> As described in the Prior Release, the term "initial invest-up period" means the six-week period following the commencement of trading of Shares on the Exchange and the term "periods of high cash inflows or outflows" means rolling periods of seven calendar days during which inflows or outflows of cash, in the aggregate, exceed 10% of the Fund's net assets as of the opening of business on the first day of such periods.

municipal obligations that have an aggregate principal amount outstanding of \$100 million or more and (b) with respect to all other Municipal Securities in which the Fund invested (referred to as “Clause B Munis”), at the time of purchase of a Clause B Muni, the borrowers of all Clause B Munis held by the Fund, in the aggregate, would have a weighted average of principal municipal debt outstanding of \$50 million or more (collectively, the “Borrower Debt Representations” and, together with the Borrower Exposure Representations, the Industry/State Representations, the 40/75 Representation and the Rule 5705-Related Representations, the “Prior Representations”).

As indicated above, the Adviser has reconsidered the Prior Representations and concluded that additional flexibility will be needed to launch and operate the Fund. As a result, in this proposed rule change, the Exchange is proposing that, going forward: (a) the Prior Representations, except for the Industry/State Representations, would be deleted and (b) the representations included in the next two paragraphs (referred to as the “New Representations”) would be added. Further, the Exchange notes that the New Representations have been designed to correspond to the requirements of Rule 5735(b)(1)(B), as these are more readily adapted to the Fund (as an actively-managed ETF) than the generic listing standards for index-based ETFs upon which the Rule 5705-Related Representations were based.

Although as described below, certain of the New Representations would meet or exceed similar requirements set forth in Rule 5735(b)(1)(B), it is not anticipated that the Fund would meet the requirement that components that in the aggregate account for at least 75% of the fixed income weight of the portfolio each have a minimum original principal amount outstanding of \$100 million or more (the “Generic 100 Requirement”).<sup>12</sup> In general terms, the Fund would

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<sup>12</sup> See Nasdaq Rule 5735(b)(1)(B)(i).

operate as an actively-managed ETF that normally invests in a portfolio of Municipal Securities (as defined in the Prior Release, with the modification described below). The Adviser notes that debt issuance sizes for municipal obligations are generally smaller than for corporate obligations.<sup>13</sup> Furthermore, as a general matter, municipal borrowers in certain industries in which the Fund currently intends to invest significantly<sup>14</sup> tend to have less outstanding debt than municipal borrowers in other municipal industries. Therefore, under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows,<sup>15</sup> at least 40% (based on dollar amount invested) of the Municipal Securities in which the Fund invests<sup>16</sup> would be issued by issuers with total outstanding debt issuances that, in the aggregate, have a minimum amount of municipal debt outstanding at the time of purchase of \$50 million or more (the “40/50 Representation”). Based on its expertise and understanding of the municipal securities market and the manner in which municipal securities generally trade, the Adviser believes that, notwithstanding both the previous more stringent 40/75 Representation and the Generic 100 Requirement, the 40/50 Representation is appropriate in light of the Fund’s

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<sup>13</sup> As indicated above in note 10, various ETFs seeking to track indexes comprised of municipal securities have previously sought and obtained approval by the Commission of proposed rule changes because they would not meet the requirement under the applicable generic listing standards that is similar to the Generic 100 Requirement.

<sup>14</sup> These industries include charter schools, senior living facilities (*i.e.*, continuing care retirement communities (“CCRCs”)) and special tax districts, among others. As noted in the Prior Release, in the case of a municipal conduit financing (in general terms, the issuance of municipal securities by an issuer to finance a project to be used primarily by a third party (the “conduit borrower”)), the “borrower” is the conduit borrower (*i.e.*, the party on which a bondholder must rely for repayment) and in the case of other municipal financings, the “borrower” is the issuer of the municipal securities.

<sup>15</sup> See note 11 regarding the meaning of the terms “initial invest-up period” and “periods of high cash inflows or outflows.”

<sup>16</sup> For the avoidance of doubt, in the case of Municipal Securities that are issued by entities whose underlying assets are municipal bonds (“Municipal Entities”), the underlying municipal bonds would be taken into account.

investment objectives and the manner in which the Fund intends to pursue them.<sup>17</sup> Given the nature of the municipal securities market and the manner in which municipal securities generally trade, the expected availability of Municipal Securities that would satisfy the Fund's investment parameters, and the debt issuance profiles of the corresponding issuers and borrowers, the 40/50 Representation should both provide the Fund with flexibility to construct its portfolio and, when combined with the Industry/State Representations and the other New Representations included in this filing (including certain representations set forth below pertaining to fixed income securities weightings and number of non-affiliated issuers that are based on, but more stringent than, as applicable, the requirements set forth in Rule 5735(b)(1)(B)), should support the potential for diversity and liquidity, thereby mitigating the Commission's concerns about manipulation.<sup>18</sup>

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<sup>17</sup> The Adviser notes that individual issues of municipal securities represented by CUSIPs (*i.e.*, the specific identifying numbers for securities) may be placed into categories according to common characteristics (such as rating, geographical region, purpose, and maturity). Municipal securities that share similar characteristics generally tend to trade similarly to one another; therefore, within these categories, issues may be considered somewhat fungible from a portfolio management perspective, allowing one CUSIP to be represented by another that shares similar characteristics for purposes of developing an investment strategy. Moreover, when municipal securities are close substitutes for one another, pricing vendors may be able to use executed trade information from similar municipal securities as pricing inputs for an individual security. This can make individual securities more liquid because valuations for a single security are generally better estimators of actual trading prices when they are informed by trades in a large group of closely related securities.

<sup>18</sup> The Exchange notes that, in addition to approving the Fund in the Prior Release, the Commission has also approved for listing and trading shares of other actively-managed ETFs that principally hold municipal securities. *See, e.g.*, Securities Exchange Act Release Nos. 60981 (November 10, 2009), 74 FR 59594 (November 18, 2009) (SR-NYSEArca-2009-79) (order approving listing and trading of PIMCO Short Term Municipal Bond Strategy Fund and PIMCO Intermediate Municipal Bond Strategy Fund); 71617 (February 26, 2014), 79 FR 12257 (March 4, 2014) (SR-NYSEArca-2013-135) (order approving listing and trading of db-X Managed Municipal Bond Fund); 71913 (April 9, 2014), 79 FR 21333 (April 15, 2014) (SR-NASDAQ-2014-019) (order approving listing and trading of First Trust Managed Municipal ETF); and 79293 (November 10, 2016), 81 FR 81189 (November 17, 2016) (SR-NYSEArca-2016-107) (order approving listing and trading of Cumberland Municipal Bond ETF).

Under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows,<sup>19</sup> no component fixed income security (excluding the U.S. government securities described under the heading “Other Investments” in the Prior Release) would represent more than 15% of the Fund’s net assets, and the five most heavily weighted component fixed income securities in the Fund’s portfolio (excluding U.S. government securities) would not, in the aggregate, account for more than 25% of the Fund’s net assets.<sup>20</sup> Further, under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows,<sup>21</sup> the Fund’s portfolio of Municipal Securities would include securities from a minimum of 30 non-affiliated issuers.<sup>22</sup> Moreover, under normal market

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<sup>19</sup> See note 11 regarding the meaning of the terms “initial invest-up period” and “periods of high cash inflows or outflows.”

<sup>20</sup> See the Active ETF Generic Listing Standards requirement set forth in Nasdaq Rule 5735(b)(1)(B)(ii), which provides that no component fixed income security (excluding U.S. Treasury securities and government-sponsored entity (“GSE”) securities) may represent more than 30% of the fixed income weight of the portfolio, and that the five most heavily weighted component fixed income securities in the portfolio (excluding U.S. Treasury securities and GSE securities) may not in the aggregate account for more than 65% of the fixed income weight of the portfolio. For the avoidance of doubt, in the case of Municipal Securities that are issued by Municipal Entities, the underlying municipal bonds would be taken into account.

<sup>21</sup> See note 11 regarding the meaning of the terms “initial invest-up period” and “periods of high cash inflows or outflows.”

<sup>22</sup> For the avoidance of doubt, in the case of Municipal Securities that are issued by Municipal Entities, the underlying municipal bonds would be taken into account. Additionally, for purposes of this restriction, each state and each separate political subdivision, agency, authority, or instrumentality of such state, each multi-state agency or authority, and each guarantor, if any, would be treated as separate, non-affiliated issuers of Municipal Securities. The Active ETF Generic Listing Standards requirement set forth in Nasdaq Rule 5735(b)(1)(B)(iii) provides that generally, an underlying portfolio (excluding exempted securities) that includes fixed income securities must include a minimum of 13 non-affiliated issuers. Although not required, if the Fund’s portfolio of Municipal Securities is comprised entirely of securities that meet the definition of “municipal securities” set forth in Section 3(a)(29) of the Act, then such portfolio would also be comprised entirely of “exempted securities” as defined in Section 3(a)(12) of the

conditions, except for the initial invest-up period and periods of high cash inflows or outflows,<sup>23</sup> component securities that in the aggregate account for at least 90% of the weight of the Fund’s portfolio of Municipal Securities would be exempted securities as defined in Section 3(a)(12) of the Act (the “Exempted Securities Representation”).<sup>24</sup> Additionally, to the extent the Fund invests in Municipal Securities that are mortgage-backed or asset-backed securities, such investments would not account, in the aggregate, for more than 20% of the weight of the fixed income portion of the Fund’s portfolio.<sup>25</sup>

The New Representations differ from the Prior Representations and do not, in certain respects, comply with Rule 5735(b)(1)(B) (particularly with respect to the Generic 100 Requirement). However, taking into account the nature of the municipal securities market and the manner in which municipal securities generally trade, in light of the requirements that the New Representations and the Industry/State Representations would impose (e.g., concerning municipal debt outstanding, fixed income securities weightings, issuer diversification, the nature of the securities in which the Fund would invest (including representations relating to exempted securities and mortgage-backed and asset-backed securities), and exposure to industries and states), they should provide support regarding the anticipated diversity and liquidity of the

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Act and, therefore, the requirements of Rule 5735(b)(1)(B)(iii) would not pertain to such portfolio; see the Exempted Securities Representation below (which refers to 90% of the weight of the Fund’s portfolio of Municipal Securities).

<sup>23</sup> See note 11 regarding the meaning of the terms “initial invest-up period” and “periods of high cash inflows or outflows.”

<sup>24</sup> See the Active ETF Generic Listing Standards requirement set forth in Nasdaq Rule 5735(b)(1)(B)(iv)(d). For the avoidance of doubt, in the case of Municipal Securities that are issued by Municipal Entities, the underlying municipal bonds would be taken into account.

<sup>25</sup> See the Active ETF Generic Listing Standards requirement set forth in Nasdaq Rule 5735(b)(1)(B)(v).

Fund's Municipal Securities portfolio and should mitigate the risks associated with manipulation, while also providing the Adviser with the necessary flexibility to operate the Fund as intended.

#### Changes to Description of Certain Fund Investments

The Prior Release stated that under normal market conditions, the Fund would seek to achieve its investment objectives by investing at least 80% of its net assets (including investment borrowings) in municipal debt securities that pay interest that is exempt from regular federal income taxes which are “exempted securities” under Section 3(a)(12) of the Act (collectively, “Municipal Securities”). In light of the Exempted Securities Representation, going forward, the Exchange proposes to revise the foregoing by deleting the phrase “which are ‘exempted securities’ under Section 3(a)(12) of the Act.” In addition, the Prior Release stated that the Fund “may invest up to 20% of its net assets in short-term debt instruments . . . , taxable municipal securities or tax-exempt municipal securities that are not exempted securities under Section 3(a)(12) under the Act, or it may hold cash.” Going forward, the Exchange proposes to revise the foregoing by replacing the phrase “taxable municipal securities or tax-exempt municipal securities that are not exempted securities under Section 3(a)(12) under the Act,” with the phrase “and taxable municipal securities and other municipal securities that are not Municipal Securities.”

Additionally, the Prior Release stated that under normal market conditions, the Fund would 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 NRSRO rating such securities (or Municipal Securities that are unrated and determined by the Adviser to be of comparable quality) (the “Below Investment Grade Requirement”). The Prior Release also provided that the Fund could invest up to 35% of its net assets in “investment grade” Municipal Securities (meaning 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)) (the “Investment Grade Limitation”). Going forward, the Exchange proposes to modify the Below Investment Grade Requirement by replacing the phrase “Under normal market conditions, the Fund will invest at least 65% of its net assets” with the following: “Under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows, the Fund will invest at least 50% of its net assets”.<sup>26</sup> Further, the Exchange proposes to modify the Investment Grade Limitation by replacing the phrase “The Fund may invest up to 35% of its net assets” with the following: “Under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows, the Fund may not invest more than 50% of its net assets”.<sup>27</sup>

#### Changes to Expand Permitted Derivatives Investments

As described in the Prior Release, the Fund may (i) invest in exchange-listed options on U.S. Treasury securities, exchange-listed options on U.S. Treasury futures contracts, and

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<sup>26</sup> See note 11 regarding the meaning of the terms “initial invest-up period” and “periods of high cash inflows or outflows.” In addition, to conform to the change to the Below Investment Grade Requirement, the Exchange proposes that, going forward, the phrase “65% investment requirement” be replaced with “50% investment requirement” in the following statement included in the Prior Release: “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”).”

<sup>27</sup> See note 11 regarding the meaning of the terms “initial invest-up period” and “periods of high cash inflows or outflows.” In addition, to conform to the change to the Investment Grade Limitation, the Exchange proposes that, going forward, the phrase “35% investment limitation” be replaced with “50% investment limitation” in the following statement included in the Prior Release: “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.”

exchange-listed U.S. Treasury futures contracts (collectively, the “Listed Derivatives”) and (ii) acquire short positions in the Listed Derivatives. No changes are being proposed with respect to the Fund’s investments in the Listed Derivatives. Going forward, however, the Exchange proposes that the Fund’s ability to invest in derivatives would be expanded to permit it to also invest in OTC forward contracts and OTC swaps (collectively, the “OTC Derivatives”) to hedge interest rate risks associated with the Fund’s portfolio investments.

On both an initial and continuing basis, no more than 20% of the assets in the Fund’s portfolio would be invested in the OTC Derivatives and, for purposes of calculating this limitation, the Fund’s investment in the OTC Derivatives would be calculated as the aggregate gross notional value of the OTC Derivatives.<sup>28</sup> The Fund would only enter into transactions in the OTC Derivatives with counterparties that the Adviser reasonably believes are capable of performing under the applicable contract or agreement.<sup>29</sup> The Fund’s investments in both Listed Derivatives and OTC Derivatives would be consistent with the Fund’s investment objectives and the 1940 Act and would not be used to seek to achieve a multiple or inverse multiple of an index.

The OTC Derivatives would typically be valued using information provided by a Pricing Service (as defined in the Prior Release). Pricing information for the OTC Derivatives would be available from major broker-dealer firms and/or major market data vendors and/or Pricing Services (as defined in the Prior Release).

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<sup>28</sup> This limitation is consistent with the limitation set forth in Rule 5735(b)(1)(E).

<sup>29</sup> The Fund would seek, where possible, to use counterparties, as applicable, whose financial status is such that the risk of default is reduced; however, the risk of losses resulting from default is still possible. The Adviser would evaluate the creditworthiness of counterparties on an ongoing basis. In addition to information provided by credit agencies, the Adviser’s analysis would evaluate each approved counterparty using various methods of analysis and may consider the Adviser’s past experience with the counterparty, its known disciplinary history and its share of market participation.

The Adviser represents that there would be no change to the Fund's investment objectives. Except as provided herein, all other facts presented and representations made in the Prior Release would remain unchanged. The Fund and the Shares would comply with all initial and continued listing requirements under Nasdaq Rule 5735.

2. Statutory Basis

Nasdaq believes that the proposal is consistent with Section 6(b) of the Act in general and Section 6(b)(5) of the Act, in particular, in that it is 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 facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest. Except as provided herein, all other facts presented and representations made in the Prior Release would remain unchanged. The Fund would comply with all the initial and continued listing requirements under Nasdaq Rule 5735.

The Exchange believes that the proposed rule change is designed to prevent fraudulent and manipulative acts and practices in that the Shares would be listed and traded on the Exchange pursuant to the initial and continued listing criteria in Nasdaq Rule 5735 and, except as provided herein, all other facts presented and representations made in the Prior Release would remain unchanged. The Exchange notes that Shares have not yet been listed on the Exchange. Consistent with the Prior Release, the Exchange represents that trading in the Shares would be subject to the existing trading surveillances, administered by both Nasdaq and also the Financial Industry Regulatory Authority ("FINRA"), on behalf of the Exchange, which are designed to detect violations of Exchange rules and applicable federal securities laws.

The proposed rule change is designed to promote just and equitable principles of trade and to protect investors and the public interest in that the Adviser represents that taking into

account the nature of the municipal securities market and the manner in which municipal securities generally trade, in light of the requirements that the New Representations, the Industry/State Representations, the modified Below Investment Grade Requirement and the modified Investment Grade Limitation would impose (e.g., concerning municipal debt outstanding, fixed income securities weightings, issuer diversification, the nature of the securities in which the Fund would invest (including representations relating to exempted securities and mortgage-backed and asset-backed securities), exposure to industries and states, and investments in below investment grade Municipal Securities), they should provide support regarding the anticipated diversity and liquidity of the Fund's Municipal Securities portfolio and should mitigate the risks associated with manipulation, while also providing the Adviser with the necessary flexibility to operate the Fund as intended.<sup>30</sup>

With one exception, the New Representations would meet or exceed similar requirements for portfolios of fixed income securities set forth in Rule 5735(b)(1)(B). In this regard, it is not anticipated that the Fund would meet the Generic 100 Requirement. Based on its expertise and understanding of the municipal securities market and the manner in which municipal securities generally trade, the Adviser believes that, notwithstanding both the previous more stringent 40/75 Representation and the Generic 100 Requirement, the 40/50 Representation is appropriate in light of the Fund's investment objectives and the manner in which the Fund intends to pursue them. Further, given the nature of the municipal securities market and the manner in which municipal securities generally trade, the expected availability of Municipal Securities that would satisfy the Fund's investment parameters, and the debt issuance profiles of the corresponding issuers and borrowers, the 40/50 Representation should both provide the Fund with flexibility to

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<sup>30</sup> See Amendment No. 2, supra note 6.

construct its portfolio and, when combined with the Industry/State Representations, the other New Representations, the modified Below Investment Grade Requirement and the modified Investment Grade Limitation, should support the potential for diversity and liquidity, thereby mitigating the Commission's concerns about manipulation.<sup>31</sup>

In connection with the proposal to modify the Below Investment Grade Requirement and the Investment Grade Limitation, the Exchange notes that the Fund's ability to invest in investment grade Municipal Securities would be expanded. Accordingly, Nasdaq believes that this is consistent with the Act because the liquidity profile of the Fund's potential pool of Municipal Securities is expected to increase, which should lessen manipulation concerns.<sup>32</sup>

Further, in connection with the proposal to permit the Fund to invest in the OTC Derivatives, the Exchange notes that the ability to invest in the OTC Derivatives would provide the Adviser with additional flexibility in hedging interest rate risks associated with the Fund's portfolio investments and would be subject to a limitation that is consistent with the limitation set forth in Rule 5735(b)(1)(E). Additionally, the Fund would only enter into transactions in the OTC Derivatives with counterparties that the Adviser reasonably believes are capable of performing under the applicable contract or agreement.

In addition, a large amount of information would be publicly available regarding the Fund and the Shares, thereby promoting market transparency. Moreover, the Intraday Indicative Value (as described in the Prior Release), available on the NASDAQ OMX Information LLC proprietary index data service, would be widely disseminated by one or more major market data vendors and broadly displayed at least every 15 seconds during the Regular Market Session. On each business day, before commencement of trading in Shares in the Regular Market Session on

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<sup>31</sup> See id.

<sup>32</sup> See id.

the Exchange, the Fund would disclose on its website the Disclosed Portfolio that will form the basis for the Fund's calculation of NAV at the end of the business day.

The proposed rule change is designed to perfect the mechanism of a free and open market and, in general, to protect investors and the public interest. The Exchange notes that the Fund does not yet have publicly offered Shares and does not yet have Shares listed and traded on the Exchange. Before Shares are publicly offered, the Trust will file a post-effective amendment to its Registration Statement. The Shares will not be publicly offered until the post-effective amendment to the Registration Statement becomes effective.

For the above reasons, Nasdaq believes the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The Exchange believes that the proposed rule change would provide the Adviser with the flexibility needed to proceed with launching the Fund, accommodating the listing and trading of Managed Fund Shares for an additional actively-managed exchange-traded product, thereby enhancing competition among market participants, to the benefit of investors and the marketplace.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

III. Discussion and Commission Findings

After careful review, the Commission finds that the Exchange's proposal is consistent with the requirements of Section 6 of the Act<sup>33</sup> and the rules and regulations thereunder

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<sup>33</sup> 15 U.S.C. 78f.

applicable to a national securities exchange.<sup>34</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>35</sup> which requires, among other things, that the Exchange's rules 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.

As described above, the Exchange proposes to: (a) delete all of the Prior Representations (including the 40/75 Representation), except for the Industry/State Representations; and (b) apply the New Representations. According to the Exchange, the Fund's proposed New Representations would meet the requirements of Nasdaq Rule 5735(b)(1)(B), with the exception of the Generic 100 Requirement. In lieu of the Generic 100 Requirement, the Exchange proposes to apply New Representations, which include the 40/50 Representation. Specifically, the 40/50 Representation requires that, under normal market conditions and except for the initial invest-up period and periods of high cash inflows or outflows, at least 40% (based on dollar amount invested) of the Municipal Securities in which the Fund invests would be issued by issuers with total outstanding debt issuances that, in the aggregate, have a minimum amount of municipal debt outstanding at the time of purchase of \$50 million or more.

The Commission believes that, because this Fund is a series of Managed Fund Shares under Nasdaq Rule 5735, it is reasonable and appropriate for the Exchange to use the Active ETF Generic Listing Standards of Nasdaq Rule 5735 as a point of comparison, rather than to apply the 5705-Related Representations from the Prior Release, which were based on standards

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<sup>34</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>35</sup> 15 U.S.C. 78f(b)(5).

applicable to the listing and trading of Index Fund Shares.<sup>36</sup> The Exchange acknowledges that the 40/50 Representation is less stringent than the 40/75 Representation provided in the Prior Release. The Commission notes, however, that the Exchange’s proposed 40/50 Representation is consistent with similar requirements applicable to other series of Managed Fund Shares that invest in municipal securities.<sup>37</sup> The Commission also notes that, according to the Exchange, the “Industry/State Representations” from the Prior Release would remain in effect with respect to this Fund.

The Commission further notes that, as part of the proposed New Representations, the Exchange has made the following additional representations with respect to the Fund and the requirements applicable to its Municipal Securities investments:

- (1) No component fixed income security (excluding the U.S. government securities described under the heading “Other Investments” in the Prior Release) would represent more than 15% of the Fund’s net assets, and the five most heavily weighted component fixed income securities in the Fund’s portfolio (excluding U.S. government securities) would not, in the aggregate, account for more than 25% of the Fund’s net assets.<sup>38</sup>

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<sup>36</sup> See supra note 9 (order approving the adoption of generic listing standards for Managed Fund Shares).

<sup>37</sup> See, e.g., Securities Exchange Act Release No. 80745 (May 23, 2017), 82 FR 24755 (May 30, 2016) (SR-NASDAQ-2017-033) (order approving the listing and trading of shares of the First Trust California Municipal High Income ETF) (“CA Municipal ETF”).

<sup>38</sup> See Nasdaq Rule 5735(b)(1)(B)(ii) (requiring that no component fixed income security (excluding U.S. Treasury securities and government-sponsored entity (“GSE”) securities) may represent more than 30% of the fixed income weight of the portfolio, and that the five most heavily weighted component fixed income securities in the portfolio (excluding U.S. Treasury securities and GSE securities) may not in the aggregate account for more than 65% of the fixed income weight of the portfolio).

- (2) Under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows, the Fund’s portfolio of Municipal Securities would include securities from a minimum of 30 non-affiliated issuers.<sup>39</sup>
- (3) Under normal market conditions, except for the initial invest-up period and periods of high cash inflows or outflows, component securities that in the aggregate account for at least 90% of the weight of the Fund’s portfolio of Municipal Securities would be exempted securities as defined in Section 3(a)(12) of the Act.<sup>40</sup>
- (4) To the extent the Fund invests in Municipal Securities that are mortgage-backed or asset-backed securities, such investments would not account, in the aggregate, for more than 20% of the weight of the fixed income portion of the Fund’s portfolio.<sup>41</sup>

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<sup>39</sup> The Exchange has clarified that, for purposes of this restriction, each state and each separate political subdivision, agency, authority, or instrumentality of such state, each multi-state agency or authority, and each guarantor, if any, would be treated as separate, non-affiliated issuers of Municipal Securities. See Nasdaq Rule 5735(b)(1)(B)(iii) (requiring that an underlying portfolio that includes fixed income securities, excluding exempted securities, must include a minimum of 13 non-affiliated issuers). The Exchange further clarifies that if the Fund’s portfolio of Municipal Securities is composed entirely of securities that meet the definition of “municipal securities” set forth in Section 3(a)(29) of the Act, then the portfolio would also be composed entirely of “exempted securities” as defined in Section 3(a)(12) of the Act and, therefore, the requirements of Rule 5735(b)(1)(B)(iii) would not pertain to the portfolio.

<sup>40</sup> See Nasdaq Rule 5735(b)(1)(B)(iv)(d). See also id. (describing Nasdaq Rule 5735(b)(1)(B)(iii) and applicability of this requirement if the Fund’s portfolio of Municipal Securities is comprised entirely of securities that meet the definition of “exempted securities” under the Act).

<sup>41</sup> See Nasdaq Rule 5735(b)(1)(B)(v) (requiring that non-agency, non-GSE and privately-issued mortgage-related and other asset-backed securities components of a portfolio must not account, in the aggregate, for more than 20% of the weight of the fixed income portion of the portfolio).

- (5) No more than 20% of the Fund's assets will be invested in OTC Derivatives, and, for purposes of calculating this limitation, the Fund's investment in the OTC Derivatives would be calculated as the aggregate gross notional value of the OTC Derivatives.

The Exchange also proposes to change the description of certain fund investments to remove references to "exempted securities" as a redundancy because Section 3(a)(12) of the Act exempts certain Municipal Securities. The Commission believes that this clarifying change is reasonable, in light of the representations provided by the Exchange with respect to the Fund's Municipal Securities investment restrictions.

The Commission notes that the Exchange has represented that, other than the proposed changes, the Fund and the Shares will comply with all other initial and continued listing requirements under Nasdaq Rule 5735. The Commission notes that, according to the Exchange, there is no change to the Fund's investment objectives and that, except as provided herein, all other facts presented and representations made in the Prior Release would remain unchanged. Specifically, the Commission notes that in the Prior Release, the Exchange represented that all statements and representations made in the proposed rule change regarding (a) the description of the portfolio, (b) limitations on portfolio holdings or reference assets, or (c) the applicability of Exchange rules and surveillance procedures constitute continued listing requirements for listing the Shares on the Exchange. In addition, the issuer has represented to the Exchange that it will advise the Exchange of any failure by the Fund to comply with the continued listing requirements, and, pursuant to its obligations under Section 19(g)(1) of the Act, the Exchange will monitor for compliance with the continued listing requirements. If the Fund is not in

compliance with the applicable listing requirements, the Exchange will commence delisting procedures under the Nasdaq 5800 Series.<sup>42</sup>

This approval order is based on all of the Exchange's representations, including those set forth above, in the Notice, and in the Prior Release, as applicable, and the Exchange's description of the Fund. The Commission notes that the Fund and the Shares must comply with the requirements of Nasdaq Rule 5735 to be listed and traded on the Exchange.

For the foregoing reasons, the Commission finds that the proposed rule change, as modified by Amendments No. 1 and 2, is consistent with Section 6(b)(5) of the Act<sup>43</sup> and the rules and regulations thereunder applicable to a national securities exchange.

#### IV. Solicitation of Comments on Amendment No. 1 to the Proposed Rule Change

Interested persons are invited to submit written data, views, and arguments concerning whether Amendment No. 1 is consistent with the Act. 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-2017-038 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.

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<sup>42</sup> See *supra* note 7.

<sup>43</sup> 15 U.S.C. 78f(b)(5).

All submissions should refer to File Number SR-NASDAQ-2017-038. 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; 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-2017-038, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Accelerated Approval of Proposed Rule Change, as Modified by Amendments No. 1 and 2

The Commission finds good cause to approve the proposed rule change, as modified by Amendments No. 1 and 2, prior to the thirtieth day after the date of publication of notice of the filing of Amendment No. 1 in the Federal Register. In Amendment No. 1, the Exchange:

- (a) modified the requirement that the Fund invest at least 65% of its net assets in Municipal Securities that are rated below investment grade to at least 50% of its net assets; (b) modified the

limitation that the Fund invest up to 35% of its net assets in investment grade Municipal Securities to up to 50% of its net assets; and (c) removed references to the Liquidity Rule.

The Commission notes that Amendment No. 1 supplements the proposed rule change by providing additional information regarding the scope of the Fund's permitted investments in investment grade and below investment grade Municipal Securities. The Commission believes that the proposed change to the Fund's investment parameters does not change the Commission's determination in the Prior Release that the listing and trading of the Shares on the Exchange is consistent with the requirements of the Act. In addition, the Commission believes that Amendment No. 1 clarifies the proposed rule change by deleting references to the Liquidity Rule under the 1940 Act. The Commission believes that Amendment No. 1 does not raise any novel or unique regulatory issues under the Act. The changes and additional information in Amendment No. 1 helped the Commission to evaluate whether the listing and trading of the Shares would be consistent with the protection of investors and the public interest. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>44</sup> to approve the proposed rule change, as modified by Amendments No. 1 and 2, on an accelerated basis.

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<sup>44</sup> 15 U.S.C. 78s(b)(2).

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,<sup>45</sup> that the proposed rule change (SR-NASDAQ-2017-038), as modified by Amendments No. 1 and 2 be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>46</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>45</sup> Id.

<sup>46</sup> 17 CFR 200.30-3(a)(12).