

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-91446; File No. SR-NASDAQ-2020-017)

March 31, 2021

Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Order Disapproving a Proposed Rule Change to Amend Nasdaq Rule 5704

I. INTRODUCTION

On July 23, 2020, 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 (“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 On November 5, 2020, the Commission instituted proceedings under Section 19(b)(2)(B) of the Exchange Act⁶ to determine whether to approve or disapprove the

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).

⁶ 15 U.S.C. 78s(b)(2)(B).

proposed rule change.⁷ On January 26, 2021, the Commission designated a longer period for Commission action on the proposed rule change.⁸ The Commission has received comment letters on the proposed rule change.⁹

This order disapproves the proposed rule change because, as discussed below, Nasdaq has not met its burden under the Exchange Act and the Commission’s Rules of Practice to demonstrate that its proposal is consistent with the requirements of Exchange Act Section 6(b)(5), and, in particular, the requirement that the rules of a national securities exchange be designed “to prevent fraudulent and manipulative acts and practices” and “to protect investors and the public interest.”¹⁰

II. DESCRIPTION OF THE PROPOSAL

As described in detail in the Notice and OIP, 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 (“Beneficial Holders Rule”); and (2) replace its existing minimum number of shares requirement (“Minimum Shares Outstanding Rule”) 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.¹¹

⁷ See Securities Exchange Act Release No. 90355, 85 FR 71977 (November 12, 2020) (“OIP”).

⁸ See Securities Exchange Act Release No. 90994, 86 FR 7750 (February 1, 2021).

⁹ Comments on the proposed rule change can be found on the Commission’s website at: <https://www.sec.gov/comments/sr-nasdaq-2020-017/srnasdaq2020017.htm>.

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ 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.

The Exchange asserts that the Beneficial Holders Rule is no longer necessary. The Exchange argues 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 Beneficial Holders Rule was intended to address.¹² The Exchange further asserts that requiring a sufficient number of shares to be outstanding at all times to facilitate the formation of at least one creation unit, together with the daily portfolio transparency and other enhanced disclosure requirements of Rule 6c-11 under the 1940 Act,¹³ will facilitate an effective 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 per-share value of a fund’s portfolio.

Specifically with respect to arbitrage, the Exchange states that the arbitrage mechanism relies on the fact that shares of a fund can be created and redeemed and that shares of a 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

¹² In contrast, Nasdaq believes that the shareholder requirement applicable 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 Notice, supra note 3 at 48012, n.6.

¹³ As an example, the Exchange notes that Rule 6c-11(c)(1)(vi) under the 1940 Act requires additional disclosure if the premium or discount is in excess of 2% for more than seven consecutive days and argues that this disclosure would provide additional 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.

to facilitate creations and redemptions with the fund and support the liquidity of the fund. As a result, the Exchange states 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 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 Beneficial Holders Rule as duplicative and unnecessary.

The Exchange further asserts that, in order for fund redemptions to be executed in support of the arbitrage mechanism, it is appropriate that, in lieu of the Beneficial Holders Rule, 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.

The Commission received two comment letters on the proposal, one comment in support of the proposal and one comment unrelated to the proposal.¹⁴ The commenter in favor of the proposal states that the Beneficial Holders Rule “does not appear to provide any meaningful investor-protection benefits.”¹⁵ Specifically, the commenter expresses the view that the liquidity of shares of an exchange-traded fund (“ETF”) is primarily a function of the liquidity of the ETF’s underlying securities, that the marketplace taps into this liquidity through the creation and redemption and arbitrage processes, and that this mitigates potential price manipulation concerns.¹⁶ In addition, the commenter believes that the enhanced disclosure requirements of

¹⁴ See Letter from Timothy W. Cameron, Asset Management Group – Head, and Lindsey Weber Keljo, Asset Management Group – Managing Director and Associate General Counsel, SIFMA AMG (December 18, 2020) (“SIFMA Letter”). The second comment letter received was made in connection with a different Nasdaq rule proposal, therefore, this second comment letter is not addressed here. See Letter from Rungsun Pakyo Gunkoom (August 4, 2020) (referencing the file number to this proposed rule change but commenting on a different Nasdaq proposal).

¹⁵ SIFMA Letter, supra note 14, at 3.

¹⁶ See id.

Rule 6c-11 under the 1940 Act,¹⁷ including those relating to an ETF’s portfolio holdings and when an ETF’s premium or discount exceeds 2% for more than seven consecutive days, will help facilitate effective arbitrage. The commenter conducted a survey of its members that sought information on level of assets, number of beneficial holders, and various trading measures of newly-listed ETFs over different periods following initial listing, and concluded that the number of shareholders in an ETF does not appear to be a significant consideration in an ETF’s sponsor’s decision to delist and terminate an ETF and that this requirement does not appear to offer investor protection benefits.¹⁸

III. DISCUSSION AND COMMISSION FINDINGS

The Commission must consider whether Nasdaq’s proposal is consistent with Section 6(b)(5) of the Exchange Act, which requires, in relevant part, that the rules of a national securities exchange be designed “to prevent fraudulent and manipulative acts and practices” and “to protect investors and the public interest.”¹⁹ Under the Commission’s Rules of Practice, the

¹⁷ See id. at 3-4. The commenter also states that the Beneficial Holders Rule puts newer and smaller sponsors at an unnecessary disadvantage to larger sponsors having the enterprise-wide scale and distribution reach to gather assets in the months after launch. See id.

¹⁸ See id.

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

“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.”²⁰

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,²¹ 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.²² Moreover, “unquestioning reliance” on an SRO’s representations in a proposed rule change is not sufficient to justify Commission approval of a proposed rule change.²³

The Commission has consistently recognized the importance of the minimum number of holders and other similar requirements, stating that such listing standards help ensure that exchange listed securities have sufficient public float, investor base, and trading interest to provide the depth and liquidity necessary to promote fair and orderly markets.²⁴ As stated by a

dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange.” 15 U.S.C. 78(f)(b)(5).

²⁰ Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

²¹ See id.

²² See id.

²³ Susquehanna Int’l Group, LLP v. Securities and Exchange Commission, 866 F.3d 442, 447 (D.C. Cir. 2017).

²⁴ The Commission considers distribution standards, including minimum number of holders and number of shares outstanding requirements, to be important means of promoting fair and orderly markets. 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 include exchange holder and number of shares outstanding requirements

commenter, the minimum number of holders requirement also helps to mitigate the risks of manipulation.²⁵

As discussed above, the Exchange is proposing to (1) remove the Beneficial Holders Rule applicable to Exchange Traded Fund Shares listed on Nasdaq, and (2) replace its existing Minimum Shares Outstanding Rule 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.²⁶ In support of its proposal, the Exchange asserts that the Beneficial Holders Rule 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 Rule was intended to address. However, the Exchange does not sufficiently support its assertions under the Exchange Act, particularly where 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, SPY and QQQ, and explains the role of APs in the creation and redemption process, it does not sufficiently address how the arbitrage mechanism will ensure

“... 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).

²⁵ See SIFMA Letter, supra note 14, at 3 (stating that the Beneficial Holders Rule was intended to address “potential price manipulation,” among other things).

²⁶ The Commission identified its concern in the OIP that, while 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, 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. See OIP, supra note 7, 85 FR at 71978, n.14. As discussed below, the Exchange has not responded to the concerns raised in the OIP.

Exchange Traded Fund Shares with very few beneficial holders would be sufficiently liquid to support fair and orderly markets. The Exchange also does not discuss in sufficient detail the 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. In addition, the Exchange does not sufficiently explain how an efficient and effective arbitrage mechanism and sufficient liquidity could result for a series of Exchange Traded Fund Shares held only by a very few number of buy-and-hold investors and thereby mitigate manipulation risks. Further, the Exchange does not sufficiently address the impact of creation unit size on the efficiency of the arbitrage mechanism. For example, with respect to a series of illiquid Exchange Traded Fund Shares with very few beneficial holders, the Exchange does not describe how the proposal is designed to mitigate the risks of manipulation if the creation unit size for the Exchange Traded Fund Shares is large in comparison to the total number of Exchange Traded Fund Shares outstanding. 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 ETFs, and the number and size of the creation units for existing Exchange Traded Fund Shares. In fact, although the Exchange discusses risks relating to lack of liquidity, the Exchange fails to provide any analysis regarding susceptibility to manipulation under the Exchange Act in the proposed rule change. As discussed above, the Beneficial Holders Rule and other minimum number of holders requirements are important to ensure that trading in exchange listed securities is fair and orderly and not susceptible to manipulation, and the Exchange does not sufficiently explain why its proposed modification of these requirements is consistent with the Exchange Act.

While the Exchange also proposes to replace the existing Minimum Shares Outstanding Rule 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 sufficiently 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, and 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. The Exchange concludes that the existence of the creation and redemption process, daily portfolio transparency, and a sufficient number of shares outstanding to allow for the formation of at least one creation unit would ensure that market participants are able to redeem shares and thereby support the proper functioning of the arbitrage mechanism. The Exchange, however, fails to explain in sufficient detail how an efficient and effective arbitrage mechanism could result for an illiquid series of Exchange Traded Fund Shares held by very few beneficial holders and with only one creation unit of Exchange Traded Fund Shares outstanding. The Exchange presents evidence that, of the over 350 funds whose shares are currently listed on Nasdaq that would be eligible to be listed under Nasdaq Rule 5704, only two had a single creation unit outstanding, and that the remaining funds have, on average, shares outstanding equal to approximately 300 creation units. However, this data does not establish that arbitrage opportunities would sufficiently mitigate manipulation concerns for all series of Exchange Traded Fund Shares, including those with only a single creation unit outstanding and those overlying a portfolio of instruments that are illiquid.

Finally, while the Exchange asserts that its surveillance procedures and trading halt authority would provide for additional investor protections by mitigating any abnormal trading that would affect Exchange Traded Fund Shares prices, it does not offer any explanation of the basis for that view or provide any supporting information or evidence to support its conclusion. Notably, the Exchange does not explain how any of its specific existing surveillance procedures or administration of its trading halt authority effectively address, in the absence of the Beneficial Holders Rule²⁷ and under the proposed replacement of the Minimum Shares Outstanding Rule, manipulation concerns and other regulatory risks to fair and orderly markets, investor protection, and the public interest. Accordingly, the Commission is unable to assess whether the Exchange's assertion has merit.

The Commission identified all of these concerns in the OIP, but the Exchange has not responded or provided additional data addressing these concerns.²⁸ As stated above, under the

²⁷ See supra note 25 and accompanying text.

²⁸ See OIP, supra note 7. The commenter asserts that the creation and redemption processes, which tap into the liquidity of the underlying holdings, coupled with the enhanced disclosures mandated under Rule 6c-11 under the 1940 Act, mitigate manipulation concerns. See SIFMA Letter, supra note 14, at 3. However, neither the Exchange nor the commenter explains why arbitrage opportunities would sufficiently mitigate manipulation concerns for the full range of ETFs, including ETFs overlying a portfolio of instruments that are themselves illiquid, or where market interest in the ETF is not sufficient to attract effective arbitrage activity. While the Exchange and the commenter assert that certain disclosures under Rule 6c-11 under the 1940 Act provide investors with transparency into the holdings of the underlying portfolio and additional insight into the effectiveness of an ETF's arbitrage (see Notice, supra note 3, 85 FR at 48012, 48015; SIFMA Letter, supra note 14, at 3-4; supra note 13 and accompanying text), neither the Exchange nor the commenter sufficiently explains how such disclosures might prevent manipulation. In addition, while the commenter states that its survey data showed that an ETF's number of shareholders, level of assets, and liquidity tended to improve after three years of operation as compared to one year, the commenter does not assert that the survey addressed the concerns about potential manipulation that the proposal raises, as described above.

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."²⁹ 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.³⁰ The Commission concludes that, because Nasdaq has not demonstrated that its proposal is designed to prevent fraudulent and manipulative acts and practices or to protect investors and the public interest, the Exchange has not met its burden to demonstrate that its proposal is consistent with Section 6(b)(5) of the Exchange Act.³¹ For this reason, the Commission must disapprove the proposal.

IV. CONCLUSION

For the reasons set forth above, the Commission does not find, pursuant to Section 19(b)(2) of the Exchange Act,³² that the proposed rule change is consistent with the requirements

²⁹ Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

³⁰ See id.

³¹ In disapproving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f). Although the commenter (see SIFMA Letter, supra note 14, at 4) asserts that the current Beneficial Holders Rule puts newer and smaller sponsors at an unnecessary disadvantage to larger sponsors having the enterprise-wide scale and distribution reach to gather assets in the months after launch, neither the commenter nor the Exchange has provided data to support this conclusion.

³² 15 U.S.C. 78s(b)(2).

of the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange, and in particular, with Section 6(b)(5) of the Exchange Act.³³

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act, that proposed rule change SR-NASDAQ-2020-017 is disapproved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁴

J. Matthew DeLesDernier
Assistant Secretary

³³ 15 U.S.C. 78f(b)(5).

³⁴ 17 CFR 200.30-3(a)(12).