



8011-01p

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-88003; File No. SR-NYSE-2019-54]

Self-Regulatory Organizations; New York Stock Exchange LLC; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Permit the Exchange to List and Trade Exchange Traded Products

January 17, 2020

On October 3, 2019, New York Stock Exchange LLC (“Exchange” or “NYSE”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b–4 thereunder,² a proposed rule change to list and trade Exchange Traded Products that have a component NMS Stock listed on the Exchange or that are based on, or represent an interest in, an underlying index or reference asset that includes an NMS Stock listed on the Exchange. The proposed rule change was published for comment in the Federal Register on October 23, 2019.³ On December 5, 2019, pursuant to Section 19(b)(2) of the Act,⁴ the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.⁵ The Commission has

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 87329 (Oct. 17, 2019), 84 FR 56864 (“Notice”).

⁴ 15 U.S.C. 78s(b)(2).

⁵ See Securities Exchange Act Release No. 87671 (Dec. 5, 2019), 84 FR 67763 (Dec. 11, 2019). The Commission designated January 21, 2020, as the date by which it should approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change.

received no comment letters on the proposal. This order institutes proceedings under Section 19(b)(2)(B) of the Act⁶ to determine whether to approve or disapprove the proposed rule change.

I. Summary Description of the Proposal

The Exchange proposes to expand the Exchange Traded Products (“ETPs”) that would be eligible to list and trade on the Exchange to include ETPs that have a component NMS Stock⁷ or that are based on, or represent an interest in, an underlying index or reference asset that includes an NMS Stock listed on the Exchange. To effectuate this change, the Exchange proposes to delete the preambles to NYSE Rules 5P and 8P currently providing that the Exchange will not list such ETPs.

The proposal would permit the Exchange to list and trade on the NYSE Trading Floor⁸ both ETPs and one or more component NMS Stocks forming part of the underlying ETP index or portfolio (“side-by-side trading”⁹). Because listed securities are assigned to a Designated Market

⁶ 15 U.S.C. 78s(b)(2)(B).

⁷ NMS Stock is defined in Rule 600 of Regulation NMS, 17 CFR 242.600(b)(48) as “any NMS security other than an option.” “NMS Security” means any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.” See 17 CFR 242.600(b)(47). “NMS Security” refers to “exchange-listed equity securities and standardized options, but does not include exchange-listed debt securities, securities futures, or open-end mutual funds, which are not currently reported pursuant to an effective transaction reporting plan.” See Question 1.1 in the “Responses to Frequently Asked Questions Concerning Large Trader Reporting,” available at: <https://www.sec.gov/divisions/marketreg/large-trader-faqs.htm>.

⁸ The term “Trading Floor” is defined in NYSE Rule 6A to mean the restricted-access physical areas designated by the Exchange for the trading of securities, commonly known as the “Main Room” and the “Buttonwood Room.”

⁹ “Side-by-side trading” refers to the trading of an equity security and its related derivative product at the same physical location, though “not necessarily by the same specialist or specialist firm.” Securities Exchange Act Release No. 46213 (July 16, 2002), 67 FR 48232, 48233 (July 23, 2002) (SR-Amex-2002-21) (“Release No. 46213”) (order approving side-by-side trading and integrated market making of broad index-based ETFs

Maker (“DMM”), the proposed elimination of the current restriction could result in DMMs being assigned ETPs that may have one or more component NMS Stocks forming part of the underlying ETP index or portfolio that are also assigned to the DMM (“integrated market making”).¹⁰ The Commission has approved integrated market making and side-by-side trading for “broad-based” ETPs and related options.¹¹ According to the Exchange, the test for whether a product is “broad-based”, and therefore is not readily susceptible to manipulation, is whether the individual components of the ETP are sufficiently liquid and well-capitalized and the product is not over-concentrated.¹² When an ETP meets both criteria, and therefore can be considered

and related options); see also Securities Exchange Act Release No. 45454 (February 15, 2002), 67 FR 8567, 8568 n.7 (February 25, 2002) (SR-NYSE-2001-43) (“Release No. 45454”) (order approving approved person of a specialist to act as a specialist or primary market maker with respect to an option on a stock in which the NYSE specialist is registered on the Exchange).

¹⁰ “Integrated market making” refers to the practice of the same person or firm making markets in an equity security and its related option. See Release No. 45454, 67 FR at 8568 n.7.

¹¹ See Release No. 46213, 67 FR at 48232 (approving side-by-side trading and integrated market making for certain Exchange Traded Funds (“ETF”) and Trust Issued Receipts (“TIR”) and related options); see also Securities Exchange Act Release No. 62479 (July 9, 2010), 75 FR 41264 (July 15, 2010) (SR-Amex-2010-31) (“Release No. 62479”) (order approving side-by-side trading and integrated market making in the QQQ ETF and certain of its component securities where the QQQs met the composition and concentration measures to be classified as a broad-based ETF).

¹² See Release No. 62479, id., 75 FR at 41272. The Commission has expressed its belief “that, when the securities underlying an ETF consist of a number of liquid and well-capitalized stocks, the likelihood that a market participant will be able to manipulate the price of the ETF is reduced.” See id. See generally Securities Exchange Act Release Nos. 56633 (October 9, 2007), 72 FR 58696 (October 16, 2007) (SR-ISE-2007-60) (order approving generic listing standards for ETFs based on both U.S. and international indices, noting they are “sufficiently broad-based in scope to minimize potential manipulation.”); 55621 (April 12, 2007), 72 FR 19571 (April 18, 2007) (SR-NYSEArca-2006-86); 54739 (November 9, 2006), 71 FR 66993 (November 17, 2006) (SR-Amex-2006-78); 57365 (February 21, 2008), 73 FR 10839 (February 28, 2008) (SR-CBOE-2007-109) (order approving generic listing standards for ETFs based on international indices, noting they are “sufficiently broad-based in scope to minimize potential

“broad-based,” the Commission has explicitly permitted integrated market making and side-by-side trading in both the ETP and related options, with no requirement for information barriers or physical or organizational separation.¹³

In making a determination of whether an ETP is broad-based, the Commission has relied on an exchange’s listing standards. According to the Exchange, in permitting integrated market making and side-by-side trading for two types of ETPs and their related options, the Commission looked to the American Stock Exchange LLC’s listing standards that are very similar to the Exchange’s current listing standards.

The Exchange notes that the relationship between an ETP and its underlying listed NMS Stock component or components is fundamentally different than that between an ETP and its related option. In the latter case, a small move in the price of the listed security can trigger a large move in the price of the related option, increasing the incentive for a market maker or specialist to manipulate the security or coordinate trading with the options market maker or specialist. Here, the Exchange asserts that there is no similar outsized correlation between a move in the price of a listed ETP and one or more of its underlying NMS Stock components. The potential for manipulation or coordinated trading is significantly attenuated for listed ETPs and their underlying NMS Stock components because the Exchange’s generic listed standards are designed to ensure that the Exchange will only list ETPs that are “broad-based” -- that is, the ETP’s underlying component securities must be sufficiently liquid and well-capitalized, and the ETP must not be unduly concentrated.

manipulation.”); 56049 (July 11, 2007), 72 FR 39121 (July 17, 2007) (SR-Phlx-2007-20); 55113 (January 17, 2007), 72 FR 3179 (January 24, 2007) (SR-NYSE-2006-101); and 55269 (February 9, 2007), 72 FR 7490 (February 15, 2007) (SR-NASDAQ-2006-50).

¹³ See note 11, *supra*.

According to the Exchange, the listing standards for Units based on an index of both US Component Stocks and Non-US Component Stocks;¹⁴ Equity-Index Linked securities (commonly referred to as Exchange Traded Notes or “ETNs”);¹⁵ Portfolio Depositary Receipts under NYSE Rule 8.100 with underlying component stocks consisting of an index or portfolio of US Component Stocks;¹⁶ and actively managed funds under NYSE Rule 8.600¹⁷ are all broadly similar. The Exchange could not list an ETP that does not meet these generic listing requirements without a proposed rule change being filed with the Commission.

The Exchange believes that listed ETPs meeting these composition and concentration measures would be sufficiently broad-based to allow integrated market making and side-by-side trading in both the ETP and the component NMS securities with no requirement for information barriers or physical or organizational separation.

As noted by the Exchange, equity-based ETPs that do not meet the applicable generic listing standards would require a rule filing with the Commission prior to commencement of Exchange listing or trading. The rule filing would set forth the initial and continued listing requirements in order for such a product to be listed and traded on the Exchange. In order for a rule proposal to be consistent with the Act, it must, among other things, further the objectives of Section 6(b)(5) of the Act¹⁸ in that it is designed to prevent fraudulent and manipulative acts and practices. The Exchange believes that equity-based ETPs whose underlying component

¹⁴ See NYSE Rule 5.2(j)(3), Supp. Material .01(a)(B)(1)-(5). The index or portfolio must include a minimum of 20 component stocks.

¹⁵ See NYSE Rule 5.2(j)(6)(B)(I).

¹⁶ See NYSE Rule 8.100.

¹⁷ See NYSE Rule 8.600.

¹⁸ 15 U.S.C. 78f(b)(5).

composition varies greatly from the generic listing standards, i.e., an ETP whose components are insufficiently liquid or well-capitalized or unduly concentrated, would be unlikely to meet this requirement. Accordingly, the Exchange believes that ETPs listed and traded via the rule filing process would also be sufficiently broad-based in order to minimize potential manipulation, thus justifying integrated market making and side-by-side trading in both the ETP and the component NMS securities.

While the “broad-based” nature of listed ETPs under either the generic listing standards or via a rule filing makes manipulation less likely, the Exchange also believes that the potential for manipulation of listed ETPs is minimal because ETP pricing is based on an “arbitrage function” performed by market participants that affects the supply of and demand for ETP shares and, thus, ETP prices. This “arbitrage function” is effectuated by creating new ETP shares and redeeming existing ETP shares based on investor demand; thus, ETP supply is open-ended. As the Commission has acknowledged, the arbitrage function helps to keep an ETP’s price in line with the value of its underlying portfolio, i.e., it minimizes deviation from NAV. Generally, the higher the liquidity and trading volume of an ETP, the more likely the ETP’s price will not deviate from the value of its underlying portfolio. Market makers registered in ETPs play a key role in this arbitrage function and DMMs, along with other market participants, would perform this role for ETPs listed on the Exchange. In short, the Exchange believes that the arbitrage mechanism is an effective and efficient means of ensuring that intraday pricing in ETPs closely tracks the value of the underlying portfolio or reference assets.

The Exchange believes that the price regulating function played by the arbitrage mechanism renders attempts to influence or manipulate the price of an ETP more difficult and more susceptible to immediate detection and correction. The fact that an ETP and one or more of

its underlying components are traded in the same physical space on the Exchange or by the same DMM on the Exchange does not alter this dynamic in the slightest, nor does it make price manipulation more likely. Rather, the Exchange believes the arbitrage mechanism would make price manipulation more difficult and, thus, less likely. Attempts by Floor-based market participants to influence the price of an ETP by, for instance, manipulating one or more component securities would be reflected in the deviation of the price from the NAV just as similar attempts today by upstairs traders would be reflected in the deviation of the price from the NAV. Moreover, the Exchange asserts that a broad-based ETP would, as shown above, be even less susceptible to price manipulation. The Exchange thus believes that the type of broad-based equity ETPs eligible for listing under the generic listing standards, coupled with the arbitrage mechanism, sufficiently minimize the potential for manipulation of ETPs listed and traded on the Trading Floor.

With respect to integrated market making, the Commission has approved changes to NYSE Rule 98 that permit a DMM unit to engage in integrated market making with off-Floor market making units in related products.¹⁹ NYSE Rule 98(c)(6) prohibits DMM units from operating as a specialist or market maker on the Exchange in related products, unless specifically permitted in Exchange rules. NYSE Rule 98(b)(7) defines “related products” as “any derivative instrument that is related to a DMM security.”²⁰ Accordingly, consistent with the proposal, the

¹⁹ See Securities Exchange Act Release No. 58328 (August 7, 2008), 73 FR 48260 (August 18, 2008) (SR-NYSE-2008-45) (order approving amendments to NYSE Rule 98 that permit specialist firms to integrate with off-Floor trading desks that trade in “related products,” as that term is defined in NYSE Rule 98).

²⁰ Under NYSE Rule 98(b)(7), derivative instruments include options, warrants, hybrid securities, single-stock futures, security-based swap agreement, a forward contract, or “any other instrument that is exercisable into or whose price is based upon or derived from a security traded at the Exchange.”

Exchange proposes to amend NYSE Rule 98(b)(7) to specifically exclude ETPs from the definition of “related products.” The Exchange believes that ETPs are different from other types of related products such as single-stock options or futures and that, given the broad-based nature of listed ETPs, integrated market making and side-by-side trading in both the ETP and underlying NMS stock components is appropriate with no requirement for information barriers or physical or organizational separation.

According to the Exchange, trading on the Exchange is subject to a comprehensive regulatory program that includes a suite of surveillances and routine examinations that review trading by DMMs and other market participants on the Exchange’s trading Floor. Market participants on the trading Floor, including DMMs, are also required to implement policies and procedures reasonably designed to detect and to deter inappropriate conduct and prevent the misuse of material, non-public information or disclosure of Floor-based non-public order information.²¹

II. Proceedings to Determine Whether to Approve or Disapprove SR-NYSE-2019-54 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act²² to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described below,

²¹ See, e.g., NYSE Rule 98(c)(3) (setting forth restrictions on trading for member organizations operating a DMM unit).

²² 15 U.S.C. 78s(b)(2)(B).

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,²³ 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.”²⁴

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,²⁵ in addition to any other comments they may wish to submit about the proposed rule change. In particular, the Commission seeks comment on the following questions and asks commenters to submit data where appropriate to support their views.

1. What are commenters’ views generally on whether the Exchange’s proposal to implement side-by-side trading and integrated market making for ETPs to be listed and traded on the Exchange is consistent with Section 6(b)(5) of the Act, which requires that the Exchange’s rules be designed to, among other things, prevent fraudulent and manipulative acts and practices?

2. With respect to ETPs that meet their respective generic listing requirements, is the “broad-based” test as outlined by the Exchange the appropriate standard that should be equally applied to all ETPs, including ETFs, TIRs, and ETNs? Specifically, are the ETPs included in the

²³ Id.

²⁴ 15 U.S.C. 78f(b)(5).

²⁵ See Notice, supra note 3.

proposal “broadly similar” as the Exchange asserts and therefore subject to the same analysis? If so, why? If not, what factors, if any, should the Commission consider in its review of side-by-side trading and integrated market making related to each category of ETPs, such as ETFs, TIRs, and ETNs?

3. What are commenters’ views about whether, as a result of the proposal to implement side-by-side trading and integrated market making, certain Exchange members may acquire an informational advantage over other market participants with respect to trading in the ETP and the underlying securities? What are commenters’ views on whether such informational advantage, if any, presents concerns regarding the potential for misuse of material, non-public information?

4. What are commenters’ views on the Exchange’s assertion that ETPs listed and traded via the rule filing process “would also be sufficiently broad-based” in order to minimize potential manipulation, thus justifying integrated market making and side-by-side trading in both the ETP and the component NMS securities? Specifically, what are commenters’ views on whether the Exchange’s application of the “broad-based” test to equity-based ETPs that do not comply with their respective generic listing requirements is appropriate? If not, why not? What are other factors, if any, that ought to be considered with respect to these types of equity-based ETPs, specifically? What are other factors, if any, that ought to be considered for all ETPs, including ETPs that are not primarily based on equity securities, but nevertheless include NMS stocks in their indexes or portfolios, that do not satisfy their respective generic listing requirements in some form or manner?

5. What are commenter’s views on the Exchange’s assertions that the potential for manipulation of listed ETPs would be minimal because ETP pricing is based on an “arbitrage

function” performed by market participants that affects the supply of, and demand for, ETP shares and, thus, ETP prices?

III. 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.²⁶

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, in addition to any other comments they may wish to submit about the proposed rule change.

Comments may be submitted by any of the following methods:

²⁶ 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).

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. Please include File Number SR-NYSE-2019-54 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-NYSE-2019-54. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All

submissions should refer to File Number SR-NYSE-2019-54 and should be submitted by **[INSERT DATE 21 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Rebuttal comments should be submitted by **[INSERT DATE 35 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁷

J. Matthew DeLesDernier,

Assistant Secretary.

²⁷ 17 CFR 200.30-3(a)(57).

[FR Doc. 2020-01097 Filed: 1/22/2020 8:45 am; Publication Date: 1/23/2020]