



8011-01p
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67485; File No. SR-NYSEArca-2012-50)

July 23, 2012

Self-Regulatory Organizations; NYSE Arca, Inc.; Order Granting Approval of Proposed Rule Change Relating to Listing and Trading of the First Trust CBOE VIX Tail Hedge Index Fund under NYSE Arca Equities Rule 5.2(j)(3)

I. Introduction

On May 25, 2012, NYSE Arca, Inc. (“Exchange” or “NYSE Arca”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to list and trade shares (“Shares”) of the First Trust CBOE VIX Tail Hedge Index Fund (“Fund”) under NYSE Arca Equities Rule 5.2(j)(3). The proposed rule change was published in the Federal Register on June 8, 2012.³ The Commission received no comments on the proposal. This order grants approval of the proposed rule change.

II. Description of the Proposal

The Exchange proposes to list and trade the Shares of the Fund under NYSE Arca Equities Rule 5.2(j)(3), the Exchange’s listing standards for Investment Company Units (“Units”). The Shares will be offered by First Trust Exchange-Traded Fund (“Trust”), which is organized as a Massachusetts business trust and is registered with the Commission as an open-end management investment company.⁴ The investment adviser to the Fund will be First Trust

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 67107 (June 4, 2012), 77 FR 34102 (“Notice”).

⁴ The Trust is registered under the Investment Company Act of 1940 (“1940 Act”). On October 17, 2011, the Trust filed with the Commission an amendment to the Trust’s registration statement on Form N-1A under the Securities Act of 1933 and under the 1940

Advisors L.P. (“Adviser”). First Trust Portfolios L.P. will be the principal underwriter and distributor of the Fund’s Shares. The Bank of New York Mellon Corporation will serve as administrator, custodian, and transfer agent for the Fund.

Description of the Fund

The Fund will seek investment results that correspond generally to the price and yield, before the Fund’s fees and expenses, of an equity index called the CBOE S&P VIX Tail Hedge Index (“Index”). The Fund will normally invest at least 90% of its net assets (plus the amount of any borrowings for investment purposes) in common stocks included in the Index. In addition, the Fund will normally invest 0.0% to 1.0% of its net assets in VIX call options, as described below.

The Exchange submitted this proposed rule change because the Index for the Fund does not meet all of the “generic” listing requirements of Commentary .01(a)(A) to NYSE Arca Equities Rule 5.2(j)(3) applicable to the listing of Units based upon an index of US Component Stocks.⁵ Specifically, Commentary .01(a)(A) to NYSE Arca Equities Rule 5.2(j)(3)⁶ sets forth the requirements to be met by components of an index or portfolio of US Component Stocks. As described further below, the Index consists of an S&P 500 Index stock portfolio and a position in

Act relating to the Fund (File Nos. 333-125751 and 811-21774) (“Registration Statement”). In addition, the Commission has issued an order granting exemptive relief to the Trust under the 1940 Act. See Investment Company Act Release No. 27068 (September 20, 2005) (File No. 812-13000) (“Exemptive Order”).

⁵ NYSE Arca Equities Rule 5.2(j)(3) provides that the term “US Component Stock” shall mean an equity security that is registered under Sections 12(b) or 12(g) of the Exchange Act or an American Depositary Receipt, the underlying equity security of which is registered under Sections 12(b) or 12(g) of the Exchange Act.

⁶ Commentary .01(a)(A) to NYSE Arca Equities Rule 5.2(j)(3) states, in relevant part, that the components of an index of US Component Stocks, upon the initial listing of a series of Units pursuant to Rule 19b-4(e) under the Exchange Act, shall be NMS Stocks as defined in Rule 600 of Regulation NMS under the Exchange Act. See 17 CFR 242.600(b)(47) (defining “NMS Stock” as any NMS Security other than an option).

specified VIX Index (“VIX”) call options.⁷ The Index meets all requirements of NYSE Arca Equities Rule 5.2(j)(3) and Commentary .01(a)(A) thereto, except that the Index includes VIX call options, which are not NMS Stocks as defined in Rule 600 of Regulation NMS. As described below, the Index is predominately S&P 500 companies and includes an exposure to VIX call options ranging from 0.00% to 1.00% of the weight of the Index. All securities in the S&P 500 Index are listed and traded on a national securities exchange. Options on the VIX are traded on the Chicago Board Options Exchange (“CBOE”). Notwithstanding that the Index does not meet all of the generic listing requirements of Commentary .01(a)(A) to NYSE Arca Equities Rule 5.2(j)(3), the Exchange believes that the Index is sufficiently broad-based to deter potential manipulation in that the S&P 500 Index stocks are among the most actively traded, highly capitalized stocks traded in the U.S. In addition, the Exchange states that VIX call options are highly liquid, with trading volume on the CBOE during the first quarter of 2012 of 257,220 contracts per day. VIX call options would represent, at most, only 1% of the total weight of the Index. All Index components are traded on exchanges that are members of the Intermarket Surveillance Group (“ISG”), and the Exchange, therefore, would be able to share surveillance information with such exchanges with respect to trading in all Index components.

The CBOE S&P VIX Tail Hedge Index

The Index is rules-based and is owned and was developed by Standard & Poor’s Financial Services LLC (“Index Provider”).⁸ The Index Provider will calculate and maintain the Index. The Index is designed to provide a benchmark for investors interested in hedging tail risk

⁷ The VIX Index is a measure of estimated near-term future volatility based upon the weighted average of the implied volatilities of near-term put and call options on the S&P 500.

⁸ The Index Provider is not a broker-dealer and has implemented procedures designed to prevent the use and dissemination of material, non-public information regarding the Index.

in an S&P 500 portfolio.⁹ Index components are reviewed quarterly for eligibility, and the weights are re-set according to that distribution. As of the Index rebalance on March 21, 2012, the Index was comprised of 99.0% S&P 500 stocks and 1.00% VIX call options. The Index consists of an S&P 500 stock portfolio (with dividends reinvested), and an amount of one-month, 30-delta VIX call options that is determined by the level of forward volatility. On the day of the monthly expiration of VIX call options, previously purchased VIX call options are cash-settled, and new VIX call options are purchased at the 10:00 a.m., Central Time asking price. The percent of money allocated to VIX call options depends on the level of forward volatility at the next call expiration as measured by the opening price of VIX futures with the same expiration as the VIX call options as follows:

- VIX futures price less than or equal to 15,¹⁰ no VIX call options are purchased;

⁹ Tail hedging, in the context used by the Index Provider, is the practice of trying to hedge the portfolio from extreme market moves that are the result of random, unexpected, and unpredictable events. Unexpected events of this nature often result in rapid increases in market volatility, both realized and implied volatility. The Fund will utilize a tail hedging strategy which attempts to profit from the sudden rise in implied volatility due to any unexpected event. The gains from the “tail hedge” would then hopefully offset some of the losses incurred in the common stock portfolio due to the unexpected events.

¹⁰ VIX futures represent the level of expected future 30-day volatility as measured in standard deviation units, expressed in percent terms (expected volatility multiplied by 100). For example, assume that on September 21, 2011, the September VIX call options expired and new call options expiring on October 19, 2011 were included within the Index. The amount or weighting assigned to the October VIX call options within the Index would have been determined by the opening price on September 21 of the October 2011 VIX futures contract. CBOE data indicate that the opening price was 31.15. Because the opening price of the October VIX futures contract was greater than 30.00 but less than or equal to 50.00, the allocation to VIX call options within the Index would have been equal to 0.50%, and the S&P 500 weighting would have been 99.50%. If the opening futures price had been equal to or below 15.0 or greater than 50.0, the allocation to the call options would have been 0% and the Index’s composition would have been equal to the S&P 500’s weightings. If the opening futures price had been greater than 15.0 but less than or equal to 30.0, the allocation to VIX call options within the Index would have been equal to 1.0%, and the S&P 500 weighting would have been equal to 99.0%.

- VIX futures price greater than 15 and less than or equal to 30, 1% Index weight in VIX call options;
- VIX futures price greater than 30 and less than or equal to 50, 0.50% Index weight in VIX call options; and
- VIX futures price above 50, no VIX call options are purchased.

This dynamic allocation to VIX call options is designed to reduce hedging costs by limiting the number of VIX call options that are purchased during periods of expected low volatility, and also has the effect of taking VIX call option profits when extreme volatility levels are reached. The Index is reconstituted and rebalanced monthly.

The Index Provider will, in most cases, use the quantitative ranking and screening system described herein. However, subjective screening based on fundamental analysis or other factors may be used, if, in the opinion of the Index Provider, certain components should be included or excluded from the Index.

The Fund intends to qualify annually and to elect to be treated as a Regulated Investment Company under Subchapter M of the Internal Revenue Code.

Additional information regarding the Trust, the Fund, and the Shares, including investment strategies, risks, creation and redemption procedures, fees, portfolio holdings disclosure policies, distributions, and taxes, among other things, is included in the Notice and Registration Statement, as applicable.¹¹

III. Discussion and Commission's Findings

The Commission has carefully reviewed the proposed rule change and finds that it is

¹¹ See Notice and Registration Statement, supra notes 3 and 4, respectively.

consistent with the requirements of Section 6 of the Act¹² and the rules and regulations thereunder applicable to a national securities exchange.¹³ In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹⁴ which requires, among other things, that the Exchange's rules be designed 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. The Commission notes that the Fund and the Shares must comply with the requirements of NYSE Arca Equities Rules 5.2(j)(3) and 5.5(g)(2) to be listed and traded on the Exchange.

The Commission finds that the proposal to list and trade the Shares on the Exchange is consistent with Section 11A(a)(1)(C)(iii) of the Act,¹⁵ which sets forth Congress' finding that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure the availability to brokers, dealers, and investors of information with respect to quotations for, and transactions in, securities. Quotation and last-sale information for the Shares will be available via the Consolidated Tape Association ("CTA") high-speed line and, for the securities, including VIX call options, held by the Fund, will be available from the exchange on which they are listed.¹⁶ The Index value will be widely disseminated at least every 15 seconds during the Core Trading Session by one or more major market data vendors, such as

¹² 15 U.S.C. 78f.

¹³ In approving 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).

¹⁴ 17 U.S.C. 78f(b)(5).

¹⁵ 15 U.S.C. 78k-1(a)(1)(C)(iii).

¹⁶ The intra-day, closing, and settlement prices of the portfolio securities will also be readily available from the securities exchanges trading such securities, automated quotation systems, published or other public sources, or on-line information services, such as Bloomberg or Reuters.

Bloomberg, and additional information regarding the Index and the underlying components (S&P 500 stock portfolio and the allocation of VIX call options) will be available at CBOE's website. In addition, an Intraday Indicative Value ("IIV") for the Shares and the Index value will be widely disseminated at least every 15 seconds during the Core Trading Session (9:30 a.m. to 4:00 p.m., Eastern Time) by one or more major market data vendors.¹⁷ On each business day, before commencement of trading in Shares in the Core Trading Session on the Exchange, the Fund will disclose on its website the portfolio of securities and financial instruments that will form the basis for the Fund's calculation of NAV at the end of the business day.¹⁸ The Fund's NAV will be determined as of the close of trading (normally 4:00 p.m., Eastern Time) on each day the New York Stock Exchange is open for business. A basket composition file, which includes the security names and share quantities required to be delivered in exchange for the Fund's Shares, together with estimates and actual cash components, will be publicly disseminated daily prior to the opening of the New York Stock Exchange via the National Securities Clearing Corporation. Information regarding market price and trading volume of the Shares will be continually available on a real-time basis throughout the day on brokers' computer screens and other electronic services, and information regarding the previous day's closing price and trading volume information for the Shares will be published daily in the financial section of newspapers. The Fund's website will also include a form of the prospectus for the Fund, information relating to NAV (updated daily), and other quantitative and trading information.

¹⁷ See NYSE Arca Equities Rule 5.2(j)(3), Commentaries .01(b)(2) and .01(c). According to the Exchange, several major market data vendors widely disseminate IIVs taken from the CTA or other data feeds. See Notice, *supra* note 3, at 34104.

¹⁸ On a daily basis, the Adviser will disclose for each portfolio security and other financial instrument of the Fund the following information on the Fund's website: ticker symbol (if applicable), name of security and financial instrument, number of shares or dollar value of financial instruments held in the portfolio, and percentage weighting of the security and financial instrument in the portfolio.

The Commission further believes that the proposal to list and trade the Shares is reasonably designed to promote fair disclosure of information that may be necessary to price the Shares appropriately and to prevent trading when a reasonable degree of transparency cannot be assured. The Commission notes that the Exchange will obtain a representation from the issuer of the Shares that the NAV per Share will be calculated daily and will be made available to all market participants at the same time.¹⁹ If the IIV or the Index value is not being disseminated as required, the Exchange may halt trading during the day in which the interruption to the dissemination of the applicable IIV or Index value occurs. If the interruption to the dissemination of the applicable IIV or Index value persists past the trading day in which it occurred, the Exchange will halt trading.²⁰ In addition, if the Exchange becomes aware that the NAV is not being disseminated to all market participants at the same time, it will halt trading in the Shares on the Exchange until such time as the NAV is available to all market participants. The Exchange states that it has a general policy prohibiting the distribution of material, non-public information by its employees. The Exchange further states that the Index Provider is not a broker-dealer and has implemented procedures designed to prevent the use and dissemination of material, non-public information regarding the Index.²¹ The Commission notes that the

¹⁹ See NYSE Arca Equities Rule 5.2(j)(3)(A)(v).

²⁰ With respect to trading halts, the Exchange may consider all relevant factors in exercising its discretion to halt or suspend trading in the Shares of the Fund. Trading in Shares of the Fund will be halted if the circuit breaker parameters in NYSE Arca Equities Rule 7.12 have been reached. Trading also may be halted because of market conditions or for reasons that, in the view of the Exchange, make trading in the Shares inadvisable. These may include: (1) the extent to which trading is not occurring in the securities and/or the financial instruments comprising the Fund's portfolio; or (2) whether other unusual conditions or circumstances detrimental to the maintenance of a fair and orderly market are present.

²¹ The Commission also notes that an investment adviser to an open-end fund is required to be registered under the Investment Advisers Act of 1940 ("Advisers Act"). As a result, the Adviser and its personnel are subject to the provisions of Rule 204A-1 under the

Exchange would be able to obtain information with respect to the equity securities and VIX call options comprising the Index and which will be held by the Fund because such equity securities and VIX call options will trade in markets that are ISG members or are parties to comprehensive surveillance sharing agreements with the Exchange.

The Exchange represents that the Shares are deemed to be equity securities, thus rendering trading in the Shares subject to the Exchange's existing rules governing the trading of equity securities. In support of this proposal, the Exchange has made representations, including:

- (1) The continued listing standards under NYSE Arca Equities Rules 5.2(j)(3) and 5.5(g)(2) applicable to Units shall apply to the Shares.
- (2) In addition, the Fund and the Shares will comply with all other requirements applicable to Units including, but not limited to, requirements relating to the dissemination of key information such as the value of the Index, IIV, and NAV, rules governing the trading of equity securities, trading hours, trading halts, surveillance, information barriers, and Information Bulletin to Equity Trading Permit ("ETP") Holders (each as described in more detail herein and in the Notice and Registration Statement, as applicable), as set forth in Exchange rules

Advisers Act relating to codes of ethics. This Rule requires investment advisers to adopt a code of ethics that reflects the fiduciary nature of the relationship to clients as well as compliance with other applicable securities laws. Accordingly, procedures designed to prevent the communication and misuse of non-public information by an investment adviser must be consistent with Rule 204A-1 under the Advisers Act. In addition, Rule 206(4)-7 under the Advisers Act makes it unlawful for an investment adviser to provide investment advice to clients unless such investment adviser has (i) adopted and implemented written policies and procedures reasonably designed to prevent violation, by the investment adviser and its supervised persons, of the Advisers Act and the Commission rules adopted thereunder; (ii) implemented, at a minimum, an annual review regarding the adequacy of the policies and procedures established pursuant to subparagraph (i) above and the effectiveness of their implementation; and (iii) designated an individual (who is a supervised person) responsible for administering the policies and procedures adopted under subparagraph (i) above.

applicable to Units and prior Commission orders approving the generic listing rules applicable to the listing and trading of Units.

- (3) The Exchange has appropriate rules to facilitate transactions in the Shares during all trading sessions.
- (4) The Exchange's surveillance procedures applicable to derivative products, which include Units, are adequate to properly monitor Exchange trading of the Shares in all trading sessions and to deter and detect violations of Exchange rules and applicable federal securities laws. All Index components are traded on exchanges that are members of ISG.
- (5) Prior to the commencement of trading, the Exchange will inform its ETP Holders in an Information Bulletin of the special characteristics and risks associated with trading the Shares. Specifically, the Information Bulletin will discuss the following: (a) the procedures for purchases and redemptions of Shares in Creation Unit Aggregations (as defined in the Notice) and that Shares are not individually redeemable; (b) NYSE Arca Equities Rule 9.2(a), which imposes a duty of due diligence on its ETP Holders to learn the essential facts relating to every customer prior to trading the Shares; (c) the risks involved in trading the Shares during the Opening and Late Trading Sessions when an updated IIV will not be calculated or publicly disseminated; (d) how information regarding the IIV is disseminated; (e) the requirement that ETP Holders deliver a prospectus to investors purchasing newly issued Shares prior to or concurrently with the confirmation of a transaction; and (f) trading and other information.
- (6) For initial and/or continued listing, the Fund will be in compliance with Rule 10A-3

under the Act,²² as provided by NYSE Arca Equities Rule 5.3.

- (7) The Fund will normally invest at least 90% of its net assets (plus the amount of any borrowings for investment purposes) in S&P 500 common stocks, which are listed and traded on a national securities exchange, and 0.0% to 1.0% of its net assets in VIX call options, which are traded on CBOE.
- (8) VIX call options would represent, at most, 1.0% of the total weight of the Index, and the VIX options components of the Index, if any, must remain listed and traded on a national securities exchange.
- (9) A minimum of 100,000 Shares of the Fund will be outstanding at the commencement of trading on the Exchange.

This approval order is based on all of the Exchange's representations, including those set forth above and in the Notice, and the Exchange's description of the Fund.

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act²³ and the rules and regulations thereunder applicable to a national securities exchange.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁴ that the

²² See 17 CFR 240.10A-3.

²³ 15 U.S.C. 78f(b)(5).

²⁴ 15 U.S.C. 78s(b)(2).

proposed rule change (SR-NYSEArca-2012-50) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁵

Kevin M. O'Neill
Deputy Secretary

[FR Doc. 2012-18311 Filed 07/26/2012 at 8:45 am; Publication Date: 07/27/2012]

²⁵ 17 CFR 200.30-3(a)(12).