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March 18, 2014

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rule Change to Adopt NYSE Arca Equities Rule 8.900, Which Permits the Listing and Trading of Managed Portfolio Shares, and to List and Trade Shares of the ActiveShares℠ Large-Cap Fund, ActiveShares℠ Mid-Cap Fund, and ActiveShares℠ Multi-Cap Fund Pursuant to that Rule (Release No. 34-71588; File No. SR-NYSEArca-2014-10)

Dear Ms. Murphy:

Thank you for the opportunity to comment on the above-referenced filing (Filing) by NYSE Arca, Inc. (the Exchange) to permit the listing and trading of Managed Portfolio Shares (Shares).[1] The Filing relates to the request[2] by the Precidian ETF Trust (Trust) and other parties for exemptive relief from various provisions of the Investment Company Act of 1940, as amended (Exemptive Application), and the registration statement[3] filed by the Trust on Form N-1A under the Securities Act of 1933, as amended (Registration Statement). In my comments, I treat the Filing, the Exemptive Application and the Registration Statement as elements of a single proposal (Proposal) and refer to the various filing parties as the "Applicants." For a complete description of the Proposal, please refer to the Filing, the Exemptive Application and the Registration Statement. Unless otherwise noted, the capitalized terms I

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[1] As background, I am the author of The Exchange-Traded Funds Manual (Second Edition, Wiley, 2010) and numerous articles on exchange-traded funds. Since 2003, I have been the principal of a consulting business now operating as ETF Consultants.com, Inc. I was previously Managing Director for ETF Product Development at Nuveen Investments and Senior Vice President for New Product Development at the American Stock Exchange. In 2005, Managed ETFs™ LLC (Managed ETFs), of which I am a principal, filed an application for exemptive relief to permit the offering of certain actively managed ETFs (File No. 812-13228 (May 29, 2005); no longer active). The intellectual property developed by Managed ETFs was subsequently sold to an affiliate of Eaton Vance Corp. (Eaton Vance) and forms much of the basis for Eaton Vance's ongoing efforts to introduce "Exchange-Traded Managed Funds" (ETMFs). Eaton Vance has filed an application for exemptive relief to permit the offering of ETMFs (File No. 812-14139 (January 23, 2014)) and The NASDAQ Stock Market LLC (Nasdaq) has filed a proposed rule change to permit the listing and trading of ETMFs (Release No. 34-71572; File No. SR-NASDAQ-2014-020 (March 6, 2014)). Because ETMFs may be competitive with the Shares and because I have a retained economic interest, my views on the Filing may be considered subject to a conflict of interest. The comments expressed herein are my own and do not necessarily represent the opinions of Eaton Vance, Nasdaq or any other party. My comments are made in the public interest and, to the best of my ability, are not influenced by any conflict.

[2] *See* File No. 812-14116 (July 18, 2013).

[3] *See* File Nos. 333-171987 and 811-22524 (January 22, 2014).

use have the same meanings as in those documents. Where the various documents use different terminology, I follow the Filing.

Summary of the Proposal

Managed Portfolio Shares are shares of proposed actively managed funds (Funds) that would invest primarily in U.S. equities. The Shares would list and trade on the Exchange and also trade on other national securities exchanges. Compared to actively managed ETFs as approved to date, the Funds' distinguishing features are: (a) disclosure of portfolio holdings quarterly with a lag, rather than on a current daily basis; (b) issuance of Shares for cash in any Share quantity, rather than only in large aggregations; (c) cash redemptions of Shares held by Retail Investors in any Share quantity less than a Redemption Unit; (d) redemptions of Redemption Units of Shares through a blind trust; (e) Order Cut-off Times for purchases and redemptions of Shares that are prior to the Funds' Valuation Time; and (f) reliance on Portfolio Indicative Values (PIVs) disseminated intraday, rather than daily holdings disclosures, as the primary basis for seeking to ensure the Shares' secondary market trading efficiency.

The Applicants assert that the Funds will have cost and tax advantages versus actively managed mutual funds and, unlike fully transparent ETFs, will not be subject to potential front running of the Fund's portfolio trades by other investors. In the secondary market trading of Shares, the Adviser "does not believe that large discounts or premiums to NAV will exist for extended periods of time."[4] Should market prices vary from NAV, "investors may choose to purchase Shares directly from a Fund if they want to assure that they will not purchase Shares at a premium"[5] and "Retail Investors may decide to redeem their Shares for cash if they want to make sure they receive the NAV and do not want to risk selling their Shares in the secondary market at a discount."[6]

Assessment of the Proposal

My analysis concludes that the Proposal has serious flaws that *strongly recommend against its approval*. I believe approval would not be in the public interest or consistent with the protection of investors. I see a host of structural deficiencies that undermine the Funds' asserted benefits, inflict potential harm on investors and violate principles of equal market access and fair treatment. In the following sections I address my concerns in detail and provide commentary on other considerations that I believe should weigh importantly in the SEC's evaluation of the Proposal.

Tax Treatment of In-kind Redemptions[7]

The Applicants represent that they expect the Funds to be "substantially more tax-efficient than existing mutual funds that pursue similar investment strategies."[8] The Funds' purported tax advantages derive from the proposed use of distributions of portfolio securities to meet redemptions. None of the

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[4] *See* Registration Statement at page 16.

[5] *See* Filing at page 9.

[6] *ibid* at page 30.

[7] I am not an attorney or tax expert, but have consulted extensively with a tax attorney who I believe is widely recognized as one of the foremost specialists on investment company tax matters. The attorney has reviewed a draft of this section and concurs with the tax analysis and conclusions presented here.

[8] *See* Exemptive Application at page 20.

descriptions of the Funds' investment strategies suggest that the Funds will employ other means to minimize or defer shareholder taxes.

As background on the Funds' proposed use of in-kind redemptions to enhance tax efficiency, Section 852(b)(6) of the Internal Revenue Code (IRC) provides that a distribution of appreciated property from a regulated investment company (RIC) to a shareholder does not result in recognition of gain for the distributing RIC "if such distribution is in redemption of its stock upon the demand of the shareholder." Applying IRC Section 852(b)(6), ETFs that redeem their shares by distributing portfolio securities have generally avoided recognizing gains in connection with shareholder redemptions. The Applicants assert that "the Fund[s] can use in-kind redemptions to reduce the unrealized capital gains that may, at times, exist in a Fund by distributing low cost lots of each security that a Fund needs to dispose of to maintain its desired portfolio exposures. Shareholders of a Fund would benefit from the in-kind redemptions through the reduction of the unrealized capital gains in a Fund that would otherwise have to be realized and, eventually, distributed to shareholders."[9]

As described in the Proposal, the Funds' in-kind redemptions would differ from how existing ETFs redeem shares in kind in three significant respects. First, unlike ETFs that distribute broad baskets of securities, the Funds would have the ability to concentrate their distributions in targeted individual securities "to effectively implement changes to the Fund's portfolio composition [and] take advantage of tax strategies."[10] Because the Funds' distributions of securities to redeeming Authorized Participants would be through a blind trust, the Funds could reduce their holdings of individual securities without revealing the identity of those securities to the marketplace. By distributing, rather than selling, securities, a Fund could reduce or eliminate unwanted holdings without realizing taxable gains in a manner generally not available to funds that distribute broad baskets of securities.

Second, the Fund and its principal agents, the Adviser and the Custodian, would participate significantly in the operation of the blind trust that receives and sells the redemption proceeds. "Each Authorized Participant will be required to appoint the Custodian as trustee of its blind trust"[11] and "the trustee will be paid by the Authorized Participant a fee negotiated by the Adviser on behalf of Authorized Participants."[12] Further, "the Trust, on behalf of a Fund, will maintain a security interest in the assets of [the] blind trust and, under applicable documentation, will be entitled to such assets in the event an Authorized Participant fails to make timely delivery of redeemed Shares."[13]

Third, as a practical matter, it appears that a redeeming Authorized Participant will have little or no ability to control the disposition of the distributed securities, whose identity is never disclosed to the Authorized Participant. "Although an Authorized Participant could, in its sole discretion, provide different standing instructions, it is expected that, in order to realize proceeds from a redemption at a value as close as possible to the redemption's NAV, all Authorized Participants will likely instruct the

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[9] *See* Filing at page 27 and Exemptive Application at page 10.

[10] *See* Filing at page 29 and Exemptive Application at page 11.

[11] *See* Filing at pages 26-27 and Exemptive Application at page 10.

[12] *See* Filing footnote 23 at page 27 and Exemptive Application footnote 11 at page 10.

[13] *See* Filing at page 29.

trustee of the blind trust to sell all securities received in kind as redemption proceeds at the close of the market on the date of redemption."[14]

Tax Analysis. Applying the substance-over-form doctrine, the federal courts have a long history of re-characterizing in-kind distributions of appreciated property by a corporation[15] to a shareholder followed by an immediate sale of the property. In *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), the Supreme Court held that a corporation's distribution of assets in liquidation followed by a shareholder's pre-planned sale of the assets designed to avoid taxation to the corporation should be viewed as a sale occurring at the corporate level, basing its decision in part on the corporation's role in negotiating the sale. Other cases have similarly also focused on the corporation's involvement in negotiating and planning the sale of distributed assets, as well as the existence of a tax avoidance motive, lack of a business purpose and the expectation of immediate sale by the shareholder.

In *Anderson v. Commissioner*, 92 T.C. 138 (1989), the Tax Court required some evidence of involvement by the distributing corporation in the sale of publicly traded stock distributed to a shareholder to re-characterize the transaction. The Tax Court in *Anderson* held that, if the assets distributed were not inventory or similar to inventory, to re-characterize the transaction as a sale by the corporation it was essential that that there be a finding that the corporation had "participation in a significant manner" in the shareholder's sale of the distributed assets by negotiation, prior agreement, post-distribution activities or otherwise. In such a case, tax avoidance motives, lack of business purpose, existence of a ready market and expectation of immediate sale, although relevant factors, were not enough without some participation by the distributing corporation.

A number of factors present in the Proposal weigh in favor of the IRS re-characterizing the Funds' in-kind distributions as constructive sales. Not only is an immediate sale of the distributed securities expected, it is arguably a foregone conclusion due to the blind nature of the trust and the redeeming Authorized Participant's ignorance regarding what securities are distributed. While in form redeeming Authorized Participants would control disposition of the distributed securities, in substance they may exercise little real, meaningful choice, and are more similar to a conduit. The Proposal makes clear that a Fund will likely specify Order Cut-off Times for Redemption Unit redemptions in advance of the market close, with the expectation that the distributed securities will be sold at or near the market close. As stated in the Exemptive Application, "redemptions (while effected in-kind to preserve the tax-efficiency of ETFs) will be capable of being liquidated for cash at values that are extremely close to NAV."[16]

In addition, there is a clear tax benefit to a Fund of using in-kind redemptions through the blind trust to discretely remove unwanted holdings from the Fund's portfolio, which benefit the Proposal promotes. Further, to the extent *Anderson*'s requirement of at least some involvement in the sale by the distributing corporation were to apply, factors supporting a Fund's "participation in a significant manner" in the sale of the distributed securities by a redeeming Authorized Participant would include

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[14] *ibid* footnote 25 at page 28.

[15] For federal income tax purposes, RICs are corporations subject to special requirements and special tax treatment. Until enactment of the Tax Reform Act of 1986, all corporate taxpayers were generally permitted to make tax-free distributions of appreciated property to their shareholders. Only RICs and certain other categories of corporate taxpayers may do so today.

[16] *See* Exemptive Application at page 21.

the Custodian's role as trustee of the blind trust, the Adviser's role in negotiating trustee fees and the Fund's retained security interest in the assets of the blind trust. The entire blind trust arrangement is constructed by the Fund's agents, and redeeming Authorized Participants have no choice other than to redeem through the specified arrangement.

Conclusion and Recommendations. In my view, there is a significant risk that the Funds' in-kind distributions of securities will be re-characterized for federal income tax purposes as a sale of the securities by the Fund followed by a distribution of cash, thereby negating the normal tax advantages to a RIC of redeeming in kind.

Given the centrality of tax efficiency to the Proposal's overall investor benefits and the strong possibility that the Fund's asserted tax benefits will be denied, I believe this risk cannot be adequately addressed through disclosure. The IRS has in place a process through which a taxpayer taking a tax position can request a ruling (Private Letter Ruling) that the position would not be subject to challenge. Although, to my knowledge, no ETF has previously requested a Private Letter Ruling addressing the appropriate tax treatment of in-kind redemptions, I believe it should be a condition for approval of the Proposal that the Applicants receive, prior to the launch of any Fund, a Private Letter Ruling from the IRS affirming the proposed tax treatment of the Funds' in-kind distributions.

I understand that the IRS has in the past issued favorable Private Letter Rulings on proposed distributions of appreciated property by a RIC,[17] but with conditions and under circumstances quite different from the Proposal. Based on past precedent, I doubt that the IRS would be willing to grant a Private Letter Ruling assenting to the proposed tax treatment of the Funds' in-kind distributions. If the IRS will not grant a favorable Private Letter Ruling, I believe the Proposal should not be permitted to move forward.

Secondary Market Trading Efficiency

Beginning with the introduction of the first index ETF in 1993, a key requirement for approval of new ETF structures has been that applicants demonstrate to the SEC's satisfaction that there will exist a reliable mechanism to ensure that fund investors have an ongoing ability to sell their shares at prices that closely approximate NAV. This requirement relates to the fact that ETFs are generally regulated as open-end investment companies and, accordingly, that their shares are "redeemable securities" as defined in the 1940 Act.

Consideration of actively managed ETFs has similarly demonstrated an overriding concern for the efficiency of secondary market trading. As one commenter responding to the SEC's 2001 Concept Release on Actively Managed Exchange-Traded Funds[18] (2001 Concept Release) expressed, "whatever level of transparency and frequency of disclosure requirements are . . . adopted by the [SEC], they must be designed to result in arbitrage opportunities that will eliminate material deviations between the NAV and market prices of the shares."[19]

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[17] *See, e.g.*, Private Letter Ruling 200023021 (June 12, 2000) and Private Letter Ruling 199924061 (June 21, 1999).

[18] *See* Release No. IC-25258; File No. S7-20-01 (November 8, 2001).

[19] *See* Comments of Leo C. O'Neill, President, Standard & Poor's, January 11, 2002 under File No. S7-20-01 (File name: s72001-5.pdf)

Different from actively managed ETFs as approved to date, the Proposal does not include a requirement or the expectation that the Funds would disclose their full current portfolio holdings[20] each Business Day. Instead, the Funds propose to disclose their holdings on a quarterly basis with a lag of not more than 60 days, consistent with mutual fund disclosure requirements.

As most observers of ETF trading understand, the daily disclosure of current portfolio holdings is the central foundation supporting effective arbitrage and efficient secondary market trading of existing ETFs. Knowing an ETF's current portfolio holdings provides market makers with two pieces of information vital to effective arbitrage: first, the current value of the ETF's holdings, which tells the market maker whether potential arbitrage profits are available, either in buying shares below current value or selling shares above this value; and second, what market exposures the market maker should assume to offset the market risk it takes on when it goes long or short the ETF's shares.

Market makers that enter into arbitrage positions in ETF shares and offsetting market exposures can unwind their ETF positions at NAV (plus or minus a transaction fee) by transacting with the ETF through an Authorized Participant to purchase or redeem creation units of shares. If a market maker has hedged its ETF share inventory by buying or selling the securities that constitute the ETF's current creation/redemption basket, the market maker can unwind its hedge, and lock in arbitrage profits, as it closes its ETF position by (a) depositing the basket securities to the ETF (to close a long position in such securities) in a purchase of fund shares or (b) receiving basket securities from the ETF (to close a short position in such securities) in a redemption of fund shares.

ETF market makers commonly employ transactions in a representative hedge portfolio, rather than trading creation/redemption basket securities, to add or subtract offsetting market exposure as they build short or long inventory positions in ETF shares through intraday trading. Transacting in a hedge portfolio may be easier to implement or more cost effective for a market maker than buying or selling the basket securities. Moreover, for ETFs holding foreign securities that do not trade during U.S. market hours, it may not be possible for a market maker to hedge its ETF positions by simultaneously trading in the basket securities. For a market maker that uses trading in a hedge portfolio to offset changes in its ETF positions, the arbitrage profits it earns will fluctuate to the extent that the hedge portfolio deviates in performance from that of the ETF over their respective holding periods. A loose correspondence between the hedge portfolio and the ETF's holdings means that arbitrage profits may be highly variable. The more uncertain the potential to earn arbitrage profits, the more market makers will seek to be compensated by trading the ETF with wide bid-ask spreads and variable premiums/discounts to the ETF's underlying NAV.

Distinctive Arbitrage Mechanism. Because the Funds will not disclose their holdings on a daily basis, the Applicants propose a different mechanism to seek to ensure that secondary market trading prices of Shares are aligned with NAV. As described in the Proposal documents, Fund market makers would: (a) use the PIVs disseminated at 15 second intervals throughout the Exchange's Regular Trading Session to identify potential opportunities to earn arbitrage profits by either selling Shares above the

[20] All existing actively managed ETFs are required to include on their sponsor's public website, updated each Business Day prior to the opening of market trading, a complete listing of the holdings that will be used to determine the ETF's NAV on such day. Index ETFs are required to make available to market members through NSCC daily creation and redemption composition files that either replicate, or closely approximate, the fund's holdings. Many index ETFs also disclose their full holdings on the sponsor's website on a daily basis.

underlying value of the Fund's net assets or buying Shares below this value; and (b) construct hedges to offset the market risk exposures of the Share positions they assume, based principally on information about the Fund's current portfolio positions they derive from time-series analysis of changes in PIVs. "The real-time dissemination of a Fund's PIV, together with the ability of Authorized Participants to create and redeem each day at the NAV, will be crucial for market participants to value and trade Shares in a manner that will not lead to significant deviations between the Shares' Bid/Ask Price and NAV."[21]

In support of the proposed arbitrage mechanism, the Applicants note that "the Exchange, after consulting with various Lead Market Makers that trade ETFs on the Exchange, believes that market makers will be able to make efficient and liquid markets priced near the PIV as long as an accurate PIV is disseminated every 15 seconds and market makers have knowledge of a [F]und's means of achieving its investment objective, even without daily disclosure of a [F]und's underlying portfolio."[22] The Applicants represent that "market makers will initially use the knowledge of a [F]und's means of achieving its investment objective . . . to construct a hedging proxy . . . to manage [their] quoting risk in connection with trading [F]und shares. Market makers will then conduct statistical arbitrage between their hedging proxy (for example, the Russell 1000 Index) and shares of a [F]und, buying and selling one against the other over the course of the trading day. Eventually, at the end of each day, they will evaluate how their proxy performed in comparison to the price of a [F]und's shares, and use that analysis as well as knowledge of risk metrics, such as volatility and turnover, to enhance their proxy calculation to make it a more efficient hedge."[23]

Analogy to Existing Foreign ETFs. In support of the Proposal, the Applicants observe that "certain existing ETFs with portfolios of foreign securities have shown their ability to trade efficiently in the secondary market at approximately their NAV even though they do not provide opportunities for riskless arbitrage transactions during much of the trading day. Such ETFs have been shown to have pricing characteristics very similar to ETFs that can be arbitraged in this manner. For example, index-based ETFs containing securities that trade during different trading hours than the ETF, such as ETFs that hold Asian stocks, have demonstrated efficient pricing characteristics notwithstanding the inability of market professionals to engage in "riskless arbitrage" with respect to the underlying portfolio for most, or even all, of the U.S. trading day when Asian markets are closed. Pricing for shares of such ETFs is efficient because market professionals are still able to hedge their positions with offsetting, correlated positions in derivative instruments during the entire trading day."[24]

Deferring my analysis of the trading efficiency of existing foreign ETFs to the next section, I note that the challenges faced by the Funds' market makers will be quite different, and more formidable in significant respects, than those faced by market makers in existing foreign ETFs. Today's foreign equity ETFs are almost exclusively index-based and are generally broadly representative of stocks trading in the target country or region. In many cases, there are futures contracts, other derivatives, other ETFs and/or individual stocks from that country or region that trade actively in U.S. markets that can be used by market makers to hedge their positions in foreign ETFs as they trade fund shares intraday. In all cases, market makers in existing foreign ETFs have full knowledge of current fund holdings and full

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[21] *See* Filing at page 44.

[22] *ibid* at pages 10-11 and 41.

[23] *ibid* at page 42.

[24] *ibid* at pages 43-44.

control over the disposition of the securities distributed to meet their redemptions. By contrast, the Funds' market makers will have only indirect, and likely imperfect, information about Fund holdings and will have no ability to manage the sales of the securities they receive from redemptions due to the blind trust structure. I suspect most market makers will learn that effectively arbitraging the Funds is significantly more difficult than doing the same for most existing foreign ETFs.

Trading Efficiency of Existing ETFs. The assertion that existing ETFs whose holdings do not support low-risk arbitrage (*e.g.*, due to differences in trading hours) generally trade at acceptably tight bid-ask spreads and stable premiums/discounts is a key underpinning to the Applicants' argument that the Funds should be expected to trade acceptably well, despite not disclosing their current holdings. The Applicants offer no data to support this key assertion. I suspect this is, at least in part, because the trading experience of different types of ETFs has not been the subject of extensive research.[25] Fortunately, a new academic study examining ETF trading patterns has recently become available: "Inefficiencies in the Pricing of Exchange-Traded Funds," by Antti Petajisto (draft working paper dated September 20, 2013) (Petajisto Study).[26] Data included in the Petajisto Study permits the Applicant's thesis to be tested.

The Petajisto Study is a comprehensive analysis of the pricing efficiency of essentially all U.S.-traded ETFs over the January 2007 through December 2010 study period. For a universe of over 1,000 ETFs, the study evaluated intraday bid-ask spreads and the stability of end-of-day fund premiums/discounts, calculated using closing bid-ask midpoints and NAVs. To control for stale pricing of non-U.S. fund assets, the study computed a second measure of premium/discount stability, using the cross-sectional average closing price of a group of similar ETFs (Peer Group) as a proxy for a fund's true ending portfolio value on a particular day.

For the entire fund universe over the 2007-2010 period examined in the Petajisto Study, the average intraday bid-ask spread of the studied funds was 36 basis points (bps) (0.36%) on an equal-weighted (EW) basis and 7 bps (0.07%) value-weighted (VW). Closing premiums/discounts based on NAV averaged 14 bps, with a standard deviation of 66 bps EW and 57 bps VW. The standard deviation of premiums/discounts based on Peer Group was 56 bps EW and 24 bps VW.[27] Not surprisingly, the Petajisto Study found that market trading efficiency varied significantly by type and size of ETF. Funds with high share trading volumes, liquid underlying holdings and efficient arbitrage mechanisms traded with relatively tight bid-ask spreads and more stable premiums/discounts; funds lacking these characteristics generally traded with wider spreads and more variable premiums/discounts.

To test the Applicants' assertion that "index-based ETFs containing securities that trade during different trading hours than the ETF, such as ETFs that hold Asian stocks, have demonstrated efficient pricing characteristics,"[28] I evaluated the results of the Petajisto Study for "Pacific/Asia ex-Japan Stocks"

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[25] I believe the most up-to-date and comprehensive academic study of ETF trading prior to the Petajisto Study was "Premiums-Discounts and Exchange Traded Funds," Robert Engle and Debojyoti Sarkar, The Journal of Derivatives (Summer 2006), which evaluated trading patterns in a sample of only 37 ETFs tracked through 2000.

[26] Available at http://www.petajisto.net/. I reviewed an earlier draft of the paper for the author.

[27] *See* Petajisto Study Tables III, VI and VII at pages 30, 34 and 36.

[28] *See* Filing at page 43.

(Asia Pacific) ETFs, the largest category of Asian stock ETFs,[29] and compared this to the universe of diversified U.S. equity (Diversified U.S.) ETFs.

	Average Bid-Ask Spread			Average Premium/Discount Based on NAV		Volatility of Premium/Discount Based on NAV			Volatility of Premium/Discount Based on Peer Group	
	EW	VW		EW		EW	VW		EW	VW
Asia Pacific ETFs	24	13		23		110	155		61	60
Diversified U.S. ETFs	16	4		0		26	13		26	11

Source: "Inefficiencies in the Pricing of Exchange-Trade Funds," Anti Petajisto (2013). All data in basis points (1 basis point =0.01%).

Taking the (generous) view that the "true" volatility of the premiums/discounts of Asia Pacific ETFs is the Peer Group VW measure, a typical investor in an Asia Pacific ETF would have had about a 5% chance[30] of incurring a 240 bps or greater swing (plus or minus two standard deviations) in the ETF's premium/discount from purchase to sale. Adding the 13 bps average bid-ask spread increases that range to 253 bps, assuming (very generously) that fluctuations in bid-ask spreads are insignificant or uncorrelated with changes in premiums/discounts, and not positively correlated with other investors' decisions to buy or sell. If "Roundtrip Fund Trading Costs" is defined as the sum of a fund's bid-ask spread and changes in its premium/discount over an investor's holding period, in the Petajisto Study about one in twenty Asia Pacific ETF investors experienced approximately 250 basis points or more of Roundtrip Fund Trading Costs. Calculated in the same manner, the one-in-twenty Roundtrip Fund Trading Costs bound for investors in Diversified US ETFs was approximately 50 basis points.

I conclude from the above that investors in Asia Pacific ETFs have experienced *significantly higher* Roundtrip Fund Trading Costs than investors in Diversified U.S. ETFs. Relating to the Proposal, I see little support for the Applicants' assertion that ETFs, such as Asia Pacific ETFs, that lack an efficient arbitrage mechanism, due to trading hour differences or other factors, have demonstrated a history of trading at generally tight bid-ask spreads and stable premiums/discounts.

Reliance on PIVs. As previously described, dissemination of PIVs reflecting the approximate current values of each Fund's underlying holdings at least every 15 seconds during the Exchange's Core Trading Session is the foundation of the Funds' proposed approach to seeking to ensure that secondary market trading prices and underlying portfolio values stay in alignment. The Applicants note that "the ability of market participants to buy and sell Shares at prices near the PIV is dependent upon their assessment that the PIV is a *reliable, indicative real-time value* (emphasis added) for a Fund's underlying holdings."[31]

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[29] Excluding Japanese stocks is also appropriate because Japanese equity index derivatives trade actively in the United States during the Core Trading Session.

[30] Like in the Petajisto Study, I assume that the data is normally distributed and estimate the incidence of tail outcomes based on this assumption. In a normal distribution, approximately 68% of observations are within one standard deviation of the mean and approximately 95% of observations are within two standard deviations of the mean.

[31] *See* Filing at page 45-46.

To evaluate whether the disseminated PIVs are likely to provide a sufficient basis for ensuring that a Fund's market prices and underlying values will remain aligned, it is necessary to understand how PIVs will be calculated, what PIVs will represent and how that compares to NAV, and, perhaps most importantly, what party, if any, will take responsibility for ensuring the accuracy and timeliness of the disseminated values. I address each of these in the following paragraphs.

PIV Calculation Mechanics. Each Fund will enter into a contractual agreement with an independent third-party PIV calculator, to which the Fund will provide portfolio holdings information in a "secure, confidential and electronic manner."[32] The PIVs will be calculated based on "a Fund's actual portfolio holdings (rather than a proxy portfolio)"[33] and market pricing information for each of the component securities will be provided by an exchange or pricing vendor. The calculation agent will value all equity securities "at the most recently received consolidated last sale price"[34] and calculate a Fund's PIVs "by dividing the "Estimated Fund Value" . . . as of the time of the calculation by the total number of outstanding Shares."[35]

The Applicants warn that the disseminated PIVs "should not be viewed as a "real-time" update of the NAV . . . because the PIV may not be calculated in the same manner as the NAV, which will be computed once a day, generally at the end of the business day. Unlike the PIV, which will be based on consolidated last sale information, the NAV per share will be based on the closing price on the primary market for each portfolio security. If there is no closing price for a particular portfolio security, such as when it [is] the subject of a trading halt, a [F]und will use fair value pricing. That fair value pricing will be carried over to the next day's PIV until the first trade in that stock is reported."[36]

Particularly during periods of rapid market movement, the use of last sale prices in calculating PIVs and disseminating PIVs only every 15 seconds will mean that the disseminated values are, at best, a lagging indicator of actual portfolio values. In addition, the PIVs may reflect clearly erroneous values for securities that have not yet opened for trading on a particular Business Day or that are subject to an intraday interruption in trading. An exchange may institute a trading halt in a stock to address a significant order imbalance or in connection with release of important company news. Intraday trading in a stock may also be interrupted by malfunctions at the stock's listing exchange or other trading venues.

Basis for PIV Calculations. The Adviser "will use *commercially reasonable efforts* (emphasis added) to assure that the calculation agent has an accurate listing of all securities in each Fund's portfolio as of the beginning of trading on each day the Fund is traded"[37] and the contract with the calculation agent will require that it "use *commercially reasonable efforts* (emphasis added) to calculate the [PIV] correctly, and update the calculation in a timely manner."[38]

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[32] *See* Exemptive Application at page 15.

[33] *See* Filing at page 46.

[34] *See* Exemptive Application at page 15.

[35] *See* Filing at page 35.

[36] *See* Filing at page 10.

[37] *See* Exemptive Application at page 15.

[38] *ibid.*

What constitutes "commercially reasonable efforts" in the calculation of PIVs must, by necessity of time, be a substantially lower standard of care than applies to how NAVs are calculated for ETFs and mutual funds. From the close of market trading to when fund NAVs are required to be disseminated, *hours* are available (if necessary) to check for and correct errors, and to make other calculation adjustments as needed. In contrast, PIVs must be disseminated in real time, within *milliseconds* of when calculations are made. Getting it right the first time is the only option for PIV calculations; there is no time or scope for any checking.

The timeliness and accuracy of disseminated intraday values may not matter much for existing ETFs.[39] In contrast, the Applicants' Funds cannot trade with acceptable bid-ask spreads and premium/discount volatilities unless PIVs are deemed useful and reliable by market participants. The Proposal documents make clear, however, that no responsible party will stand behind the PIVs to ensure timeliness and accuracy. The Funds "make no warranty as to the accuracy of the [PIVs]"[40] and the calculation agent "will not guarantee the accuracy of the [PIVs]."[41] Neither the Exchange nor the calculation agent "shall have any liability for damages, claims, losses or expenses caused by any errors, omissions, or delays in calculating or disseminating any current portfolio value . . . resulting from any negligent act or omission by [them] or any act, condition, or cause beyond [their] reasonable control."[42]

Given the various steps and number of parties involved in each PIV calculation, the impracticality of applying rigorous checks prior to PIV dissemination and the need to do this successfully *1,560 times each Business Day*, I would be shocked if any organization would ever voluntarily assume legal liability for PIV errors.

Due to the limitations on what PIVs represent, how the values are calculated and what party (none) stands behind them, I see little support for the Applicants' stated expectation that market participants will "accept the PIV as a reliable, indicative real-time value"[43] or their belief that "the dissemination of the [PIV] calculation will discourage significant deviations between the market price of Shares and a Fund's intraday value."[44] Without reliable PIVs, the Funds cannot and will not trade acceptably in the secondary market.

The Applicants may argue that disseminated intraday values based on substantially the same calculation methodology and substantially the same reliability standards as proposed here have been used by existing ETFs for more than two decades. What this argument overlooks is the dramatic difference in the role of the disseminated intraday values: for the Funds, dissemination of reliable PIVs is the foundation supporting market trading efficiency; for existing (transparent) ETFs, the disseminated portfolio values have essentially zero relevance to Fund trading efficiency and limited overall utility to

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[39] It is widely understood that market makers in existing ETFs place little or no reliance on the "official" intraday fund values disseminated every 15 seconds based on last sale prices. Instead, they use their own calculations of fund value (or valuations provided by third-party pricing services) based on the disclosed portfolio holdings and bid, offer and execution prices of the portfolio securities and other relevant pricing indicators updated continuously.

[40] *See* Registration Statement at page 23.

[41] *See* Exemptive Application at page 15.

[42] *See* Filing at pages 6-7.

[43] *See* Filing at page 45-46.

[44] *See* Exemptive Application at page 21.

investors. Responding to the SEC's 2008 Proposed Exchange-Traded Funds Rule,[45] the Exchange commented that it was "not convinced that the Intraday Value is a meaningful pricing tool for investors [in existing ETFs] in light of the availability of other pricing information" and "a public investor should not use the Intraday Value to determine the price at which the investor will buy or sell a particular ETF."[46]

Blind Trust Arrangement. In the Funds' proposed method of operation, the proceeds of all redemptions of Redemption Units of Shares will be distributed to a blind trust for the benefit of the redeeming Authorized Participant. The distributed securities will be sold or otherwise managed by the trustee of the blind trust (which will be the Custodian) based on standing instructions from the Authorized Participant. "It is contemplated that Authorized Participants will instruct the trustee of the blind trust to liquidate redemption securities in market on close orders on the date of redemption."[47] Because "the Adviser would be free to select redemption securities that do not represent an exact slice of a Fund's portfolio,"[48] the distributed securities may be concentrated in a small number of individual securities, and perhaps only one security.

Compared to the usual redemption arrangements of ETFs, the proposed structure introduces additional costs and uncertainties for Authorized Participants. Elements of the proposed arrangement that contribute to this include: (a) the Custodian has a monopoly position as the sole eligible provider of trustee services for the blind trust; (b) the Adviser, rather than the Authorized Participant, negotiates the fees paid to the trustee; (c) in contrast to existing ETFs, no Authorized Participant would have the potential ability to use its market knowledge and market position to enhance arbitrage profits (or offset arbitrage costs) by managing sales of the distributed securities to minimize market impact or realize prices above the market close; and (d) the Custodian that stands in for the Authorized Participant in the sale of distributed securities would have no apparent incentive to sell distributed securities with low market impact or at prices above the close, as well as little or no downside from doing the opposite. Given the likelihood that the Funds' distributed securities will be significantly more concentrated than is typical for existing ETFs, the potential costs and risks to redeeming Authorized Participants of not being able to control disposition of the securities they receive are considerably magnified. Unavoidably, the extra costs and risks borne by Authorized Participants in connection with the blind trust arrangement will be passed through to shareholders transacting in the secondary market, reflected as wider bid-ask spreads and/or more volatile premiums/discounts for the Shares.

Conclusion and Recommendations. Based on the analysis presented above, I do not believe there is a reasonable basis for concluding that the Shares will trade nearly as well as most existing ETFs. Due to limitations in the proposed PIV-based arbitrage mechanism and the added costs and risks to Authorized Participants of the blind trust, I believe the Shares are likely to trade at significantly wider bid-ask spreads and/or more volatile premiums/discounts than most existing ETFs, including ETFs (such as Asia Pacific ETFs) holding securities that trade during different market hours.

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[45] *See* Release Nos. 33-8901 and IC-28193; File No. S7-07-08 (March 11, 2008).

[46] *See* Comments of Mary Yeager, Corporate Secretary, NYSE Arca, Inc., May 29, 2008 under File No. S7-07-08 (available at http://www.sec.gov/comments/s7-07-08/s70708-16.pdf).

[47] *See* Filing at page 25.

[48] *ibid* at page 28.

Supporters of the Proposal may assert that investors' ability to purchase Shares in direct transactions with the Funds and the right of Retail Investors to redeem Shares through the Retail Redemption Facility should argue for a more lenient standard of secondary market trading efficiency for the Funds to be treated as open-end investment companies and the Shares as redeemable securities for SEC purposes. Due to the limitations and deficiencies in the Funds' direct Share purchase and redemption programs discussed below, as well as the Applicants' expressed belief that "the vast majority"[49] of Share transactions will take place in the secondary market, I reject this notion and believe the Funds and the Shares should be held to the same standards of expected secondary market trading liquidity as the SEC has applied to existing ETFs. I believe the Proposal falls well short of meeting an appropriate secondary market liquidity standard, and should not be approved for this and other reasons stated in this letter.

Erroneous Share Trades

I believe it is inevitable that PIV errors will occur with some frequency, given the various challenges to the accurate calculation and timely dissemination of PIVs throughout each Business Day. Due to the pivotal role of PIVs in determining market prices of Shares, material errors in PIVs will, in turn, invariably cause erroneous Share trades to be executed.

The Proposal does not address the treatment of erroneous Share trades resulting from faulty PIVs. Would all such trades be cancelled? Would the Exchange apply a materiality standard in determining when to cancel trades due to faulty PIVs? Most importantly, as a first step, how would PIV errors and associated erroneous Share trades be detected?

The Filing describes, in general terms, the steps the Exchange will take to monitor trading in Shares, which will "generally focus on detecting securities trading outside their normal patterns, which could be indicative of manipulative or other violative activity."[50] The Exchange does not express an intention to monitor the accuracy and timeliness of disseminated PIVs, or describe how Share trades executed in reliance on faulty PIVs would be treated.

As a condition for approval, I believe the Exchange should be required to institute a comprehensive program to monitor the timeliness and accuracy of disseminated PIVs and to adopt appropriate procedures for the treatment of Share trades executed during periods when erroneous PIVs are determined to have been disseminated. Based on my expectation that PIV errors will occur frequently, I believe appropriate monitoring and remediation efforts will result in significant numbers of executed Share trades being subject to cancellation, which is inconsistent with the maintenance of orderly markets.

Indirect Selective Disclosure

As described in the previous two sections, the potential *unreliability* of a Fund's PIVs raises concerns about the efficiency of the Fund's secondary market trading that argue against approval of the Proposal. In this and the following section, I address separate concerns raised by the potential *reliability* of a Fund's PIVs.

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[49] *See* Registration Statement at page 22 and Exemptive Application at page 20.

[50] *See* Filing at page 37.

Citing from Section 1(b)(3) of the 1940 Act, the SEC observed in the 2001 Concept Release that "the public interest and the interest of investors are adversely affected when investment companies issue securities containing inequitable or discriminatory provisions."[51] Responding to the 2001 Concept Release, Vanguard commented that "sponsors of actively managed ETFs should not be permitted to provide more information about portfolio holdings to the exchange specialist and market makers than they provide to other investors. Vanguard believes, as a matter of fundamental fairness, that all investors in a fund must be treated equally. Providing information only to a favored few is inconsistent with the foundation of our capital markets—full and fair disclosure to all investors."[52]

On this same topic, the Investment Company Institute (ICI) commented that "an actively managed ETF might seek to selectively disclose its portfolio, *i.e.*, to the creation unit holders but not to retail investors. The Institute believes that any such disparate treatment of investors would be contrary to the public interest. Selectively disclosing information to one group of investors—*and allowing them to trade on the basis of this information*—while keeping other investors in the dark would be fundamentally at odds with the core principles of the federal securities laws. For these reasons, the Institute urges the Commission *not* to grant exemptive relief to any actively managed ETF that would disclose information about its portfolio holdings on a disparate basis to different groups of shareholders."[53] It is pretty hard to take issue with these positions.

The SEC's 1940 Act citation and the Vanguard and ICI comment letters collectively implicate one of the Proposal's central features—the asserted ability of market makers and other professional traders to glean information about a Fund's holdings through sophisticated data analysis of changes in PIVs. Assuming that all investors are provided with equal access to PIVs, market makers and other professional traders will not have a *direct* information advantage over other investors. But it is the very intent of the Proposal for market makers to use data analysis to gain knowledge about a Fund's holdings that will provide them with a significant *indirect* information advantage over other investors.

In my own comment letter in response to the 2001 Concept Release, I anticipated the developments of fund ideas like the Proposal and commented that "the ability of some market makers to make superior estimates of portfolio contents from intra-day value calculations suggests that some increase in explicit portfolio disclosure is necessary to level the playing field."[54]

Some observers might argue that concerns about fairness and disparate treatment should not apply to the Funds' PIV disseminations and their use by market makers, due to the role of market makers in determining the trading efficiency of Shares. I don't see it this way: investors should be entitled to at least as much protection against exploitation by market makers as by anyone else seeking to take advantage of an unfair information advantage. In my opinion, the merits of the Proposal are not

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[51] *See* 2001 Concept Release at page 15.

[52] *See* Comments of Heidi Stam, Principal, Securities Regulation, Vanguard Group, Inc., February 14, 2002 under File No. S7-20-01 (File name: s72001-14.pdf).

[53] *See* Comments of Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, January 14, 2002 under File No. S7-20-01 (File name: s72001-6.pdf).

[54] *See* Comments of Gary L. Gastineau, Managing Director, Nuveen Investments, January 14, 2002 under File No. S7-20-01 at page 19 (File name: gastineau1.htm).

sufficient to tolerate the advantage bestowed upon market makers and other professional traders by the Fund's proposed method of indirectly disclosing portfolio information through PIV disseminations.

Reverse Engineering of Portfolio Holdings

A particularly harmful form of information advantage could develop for a Fund if its PIV disclosures are so precise and so accurate as to enable the Fund's holdings and trading activity to be uncovered through data analysis. If this were to occur, the Fund's claims of non-transparency would be invalidated and the Fund would become susceptible to the dilutive effects of front running by investors that gain the ability to anticipate the Fund's trades.

In 2011, the outsourced research provider Amba Holdings Inc. (Amba) performed a private study, the results of which I have reviewed, demonstrating the ability to identify the holdings, and daily changes in holdings, of two sample U.S. equity funds using only intraday fund valuations reported at 15 second intervals during the trading day. The Amba reverse engineering analysis used a pricing matrix of eligible securities and applied multivariate linear regression and stepwise selection statistical techniques to correctly identify the funds' holdings.

The principal factors determining a fund's susceptibility to reverse engineering using intraday valuations disseminated at 15 second intervals were identified in the Amba study as: (a) correspondence in the securities prices used in determining fund valuations and as reported for the fund's eligible investments; (b) the precision (*i.e.*, the number of decimal places) with which per share fund valuations are reported; (c) number of fund holdings; and (d) number of potential fund investments. Other significant factors could include the intraday price volatility of the fund's portfolio as a whole and its eligible investments, and the degree to which price movements of the fund and the eligible investments are correlated.

Given the attention the issue of reverse engineering has received over the years in relation to various non-transparent ETF concepts,[55] I find it surprising that none of the Proposal documents address reverse engineering risk or describe steps the Funds will take to mitigate this risk. As I suspect the Applicants understand, there is a clear conflict between, on the one hand, providing market makers with PIVs and other Fund information to support efficient market making and, on the other hand, protecting the Fund against reverse engineering risk. For example, in determining the frequency of PIV dissemination and the number of decimal points of precision with which disseminated PIVs are disclosed,[56] efficient market making argues for more frequency and more precision, while protection against reverse engineering argues for less.

Prior to approval, the Proposal documents should be amended to include: (a) discussion of the steps to be taken by the Applicants to minimize reverse engineering risk; (b) discussion of how the Funds propose to resolve the conflict between providing market makers with adequate information to support

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[55] A number of U.S. patents have been issued describing methods for addressing reverse engineering risk for non-transparent ETFs, including one held by the principals and counsel of the Adviser.

[56] Applicants specify that the Funds' published NAVs will be rounded to the nearest cent; however, for purposes of determining the price of Shares in creations and redemption, the NAV will be calculated to five decimal places. (*See* Filing at page 25.) No similar specifications for disseminated PIVs are identified in the documents. Applicants should be required to represent that PIVs will be disclosed to all investors with the same number of decimal places of precision.

efficient Share trading and protecting against reverse engineering; and (c) representations that the Funds will adequately disclose reverse engineering risk and the conflicts the Funds face in seeking to provide for efficient market trading and protection against reverse engineering.

Early Order Cut-off Times for Redemptions

A central element of the Proposal is maintaining Order Cut-Off Times for Fund redemptions that facilitate the timely sale of distributed securities by the blind trusts that receive the proceeds of Authorized Participant redemptions and the efficient processing of redemptions by Retail Investors through the Retail Redemption Facility. The Applicants anticipate that "all Funds will adopt Order Cut-Off Times for [Authorized Participant] redemptions prior to their Valuation Time"[57] and represent that an "earlier Order Cut-Off Time is likely necessary in order to facilitate the timely submission of [Retail Redemption Facility redemption] orders."[58]

On its face, the imposition of early Order Cut-off Times for redemptions of Shares violates the prohibition set forth in Section 22(e) of the 1940 Act against a registered investment company suspending the right of redemption of any redeemable security and the requirement of Rule 22c-1 under the 1940 Act that shareholders in open-end funds receive the NAV next computed after their redemption request. Applicants have requested relief from Section 22(e) and Rule 22c-1 on the basis that an "early Order-Cutoff Time may be necessary because of the redemption process for the Funds"[59] and that, using the language of Section 6(c) of the 1940 Act, "the relief requested is appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the [1940] Act."[60]

To my knowledge, the SEC has not previously granted similar relief to any other ETF or mutual fund seeking to suspend redemption rights in its shares for a portion of each Business Day. For many years, ETF sponsors have succeeded in operating a wide range of ETFs without imposing an explicit mandatory early order cutoff time. In my opinion, the merits of the Proposal are not sufficient to warrant granting this novel relief and establishing a new precedent that the SEC may be called upon to repeat.

Direct Share Purchases and Retail Redemption Facility

The Proposal documents include multiple statements to the effect that "investors will be able to purchase shares for cash directly from a [F]und in any amount on any day a [F]und determines its NAV . . . if they want to assure that they will not purchase shares at a premium"[61] and that "the Retail Redemption Facility will permit retail shareholders holding amounts smaller than a Redemption Unit to redeem at NAV on any day the Exchange is open in the event there is any negative variance between the NAV of a Fund's Shares and the secondary market price of Shares at the Valuation Time."[62]

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[57] *See* Filing at page 26.

[58] *See* Exemptive Application at page 25.

[59] *ibid.*

[60] *ibid* at page 26.

[61] *See* Filing at page 9.

[62] *ibid* at pages 44 and 47.

Although these statements exaggerate the benefits of the Funds' direct purchase and redemption features,[63] I nonetheless believe that investors in Shares would frequently find it attractive to purchase and/or redeem Shares directly with the Fund for cash, provided that those options are freely available and fairly presented. Given a fair and balanced presentation of the merits of transacting directly with a Fund at or near NAV versus buying or selling in the secondary market, I cannot see why a large percentage of eligible investors would not elect to transact directly with the Fund, at least occasionally, and probably regularly.

The Applicants assert that "most investors will buy and sell Shares of the Funds in Secondary Market transactions through broker-dealers"[64] and state their expectation that "the vast majority of redemptions will be in [Redemption] Units and that few, if any, redemptions will be submitted through the Retail Redemption Facility."[65] Understanding the potential attractiveness of direct cash purchases and redemptions under at least some circumstances, I find these statements both surprising and suspicious: if the Applicants don't expect the direct cash purchase and Retail Redemption Facility options to be used, how real are they? Are the statements intended to dissuade investors from considering direct purchases and redemptions of Shares?

Although not expressly stated in the Proposal documents, I surmise that a principal purpose of including direct Share purchases and the Retail Redemption Facility in the Proposal is to help the SEC and market participants gain comfort that investors will be able to transact with the Fund at or near NAV whenever secondary market trading prices of Shares vary significantly from NAV. I believe that, as proposed, these provisions are grossly inadequate for this purpose, and do not justify applying a less rigorous standard of expected performance for the Shares' secondary market trading in determining whether the Proposal should be approved.

Among the reasons why the presence of the direct Share purchase and Retail Redemption Facility provisions should not, in my judgment, justify applying a lower standard of secondary market trading performance to the Proposal are: (a) the Retail Redemption Facility will be available only to a limited set of shareholders and restricted to redemptions of less than a Redemption Unit of Shares; (b) the expected early Cut-off Time for direct Share purchases and the Retail Redemption Facility means that an investor's ability to directly purchase or redeem Shares for cash will exist for only a portion of each Business Day; (c) investors who directly purchase and redeem Shares will be subject to Transaction Fees imposed by the Fund of up to 2% and may also be subject to broker-dealer processing fees; (d) skepticism that self-directed investors will have adequate information about the available liquidity options to make intelligent choices about how best to buy and sell Shares; (e) skepticism that broker-dealers will have adequate information to ensure that their customers consistently receive best execution on transactions in Shares, given the two distinct liquidity pathways; and (f) skepticism that broker-dealers now have, or will make the investments to develop, the systems capabilities necessary to

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[63] Due to the Transaction Fees that apply, cash purchases and redemptions of Shares would not take place at NAV, but rather at premiums and discounts, respectively, to NAV equal to the applicable fee. Due to the expected early Order Cut-off Time, a shareholder who identifies a negative variance between NAV and the secondary market trading price of Shares at the Valuation Time would not be able to redeem until the next Business Day.

[64] *See* Registration Statement at page 18.

[65] *See* Exemptive Application at page 20.

support customer transactions in Funds offering both secondary market trading in Shares and direct Share purchases and redemptions. In the below paragraphs I address each of these considerations.

Retail Redemption Facility Eligibility. Although I can see no valid reason why different categories of shareholders should have different redemption rights, participation in the Retail Redemption Facility will be limited to (a) natural persons, (b) trusts exclusively for the benefit of a natural person or group of related family members and (c) tax-deferred retirement plans where investments are selected by a natural person purchasing for its own account.[66] Among the types of investors that may own relatively small holdings of Shares but would not be eligible to participate in the Retail Redemption Facility are (a) spouses, family members and other joint holders of Shares not through a trust,[67] (b) individual retirement plan assets under the supervision of an outside advisor and (c) investment accounts of small endowments and foundations, group retirement plans, for-profit and not-for-profit corporations, partnerships and limited liability companies of various descriptions.

For eligible shareholders, the number of Shares that may be redeemed pursuant to the Retail Redemption Facility on any given day will be restricted to amounts less than a Redemption Unit. A Redemption Unit will initially consist of 50,000 Shares,[68] and the Shares are expected to have an initial NAV of approximately $10.00.[69] The number of Shares in a Redemption Unit[70] and the range of prices of individual Shares[71] are both subject to change.

The significant restrictions on which shareholders may participate in the Retail Redemption Facility and the potential for daily redemption limits to be reduced from the initial expected range ($500,000) mean that a large, and potentially increasing, percentage of shareholders and Share holdings may not be eligible for cash redemptions under the Retail Redemption Facility. Whatever protections or assurances the Retail Redemption Facility offers do not apply to those shareholders and the Share amounts not eligible to participate.

Early Order Cut-off Times. The Order Cut-off Time for direct purchases of Shares will be 3:00 p.m. Eastern time.[72] Applicants represent that an "earlier Order Cut-Off Time is also likely necessary in order to facilitate the timely submission of [Retail Redemption Facility] orders."[73] In my view, the fact that an early Order Cut-off Time will apply to direct Share purchases and will likely also apply to Retail Redemption Facility redemptions further diminishes the utility of the Fund's direct purchase and redemption options as a "safety valve" protecting shareholders against adverse secondary market trading experiences. At precisely the time of day when these options would likely be most valuable to investors, they get taken away.

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[66] *See* Filing at Page 4.

[67] The most egregious element of this absurd categorization is that a husband and wife with separate accounts are eligible for this redemption program; but if they have a joint account they can't use it.

[68] *See* Filing at page 24 and Registration Statement at page 5.

[69] *See* Exemptive Application footnote 8 at page 6.

[70] *See* Filing at page 24 and Registration Statement at page 5.

[71] *See* Exemptive Application footnote 8 at page 6.

[72] *See* Statement of Additional Information at page 18 (contained in Registration Statement).

[73] *See* Exemptive Application at page 25.

Fund Transaction Fees and Broker-Dealer Processing Fees. As described in more detail under "Cost Considerations" below, investors purchasing and redeeming Shares in transactions with a Fund are subject to Fund Transaction Fees of up to 2% and may also be required to pay processing fees to their broker-dealer. Given the likelihood that such fees will include at least some fixed-dollar payment amounts, their impact on an investor's net transaction prices will likely be greatest for transactions in small dollar amounts. As a result, direct purchases and redemptions of Shares may not be a practical alternative for a Fund's smallest investors.

In addition, I worry that the Funds may seek to discourage use of their direct purchase and redemption features by maintaining Transaction Fees at higher levels (*e.g.*, the maximum 2%) than can be justified by actual Fund expenses to accommodate direct Share transactions. Among the reasons a Fund might want to minimize direct Share purchases and redemptions are to reduce the drain on secondary market liquidity that widespread direct purchases and redemptions would cause and to mitigate the challenges faced by broker-dealers seeking to accommodate the Shares' dual-liquidity features. To address this concern, I recommend that Transaction Fees be required to be limited to amounts determined by the Adviser to be appropriate to offset the expenses incurred by a Fund in connection with issuing or redeeming Shares, taking into account the size of a specific purchase or redemption.[74] Because the costs to a Fund of accommodating sub-Redemption Unit purchases and redemptions are largely fixed in nature, I believe it would be completely inappropriate for a Fund to charge the same *percentage* fee (*i.e.*, 2%) on relatively large Share transactions as it does on smaller transactions.

Adequacy of Investor Information. As discussed below under "Adequacy of Investor Information and Potentially Misleading Statements," I believe that, as a condition for approval, the Funds' disclosure documents should be required to include a fair and balanced presentation of shareholders' liquidity options and a discussion of the factors that an investor should consider in determining whether to buy or sell Shares in the secondary market or in direct transactions with the Fund. I also recommend that, to assist investors in deciding whether to transact in Shares directly with the Fund or in the secondary market, the Funds be required to make available on a free public website (a) real-time dissemination of continuously updated PIVs (made available to the public as soon as available *to any party*) and (b) statistics showing historical PIVs, PIV/NAV ratios, price/PIV ratios, bid-ask spreads and the Transaction Fees applicable to direct purchases and redemptions of Shares. Without this information, I do not believe investors will have an adequate basis for determining how best to buy and sell Shares.

Assurance of Best Execution. Broker-dealers executing transactions on behalf of their customers assume responsibility for ensuring best execution. The Funds' direct purchase and redemption options significantly complicate the determination of how to achieve best execution. To avoid potential liability in connection with buying and selling Shares for customers, broker-dealers will need to carefully

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[74] Certain actively managed ETF exemptive applications that I have examined include representations that the transaction fees charged will be limited to amounts determined "to be appropriate in order to defray" the transaction expenses that will be incurred by a fund when an investor purchases or redeems shares. (*See, e.g., T. Rowe Price Associates, Inc. et al.* (File No. 812-13726 (December 14, 2012) at page 12)). The Funds' Exemptive Application (at page 7) includes the more ambiguous statement that "Transaction Fees will be limited to amounts that will have been determined by the Adviser *to be appropriate and will take into account* (emphasis added) transaction and operational processing costs associated with recent purchases and sales of equity securities held." I believe an explicit representation by the Applicants that the Transaction Fees charged a purchasing or redeeming investor will be limited to the estimated Fund expenses incurred to accommodate that investor's purchase or redemption is necessary and appropriate to protect investors directly purchasing and redeeming Shares against unreasonable Transaction Fees.

consider all the various Share information relevant to deciding whether to trade on the secondary market or in a direct transaction with the Fund. Among the information a broker-dealer would need to consider are *at least* the following: (a) the investor's eligibility to participate in the Retail Redemption Facility (if the trade is a sale); (b) the Transaction Fee the Fund would apply to a direct purchase or redemption; (c) time of day (*i.e.*, before or after the Order Cut-off Time for direct purchases and redemptions (assuming there is an early Order Cut-off Time)); (d) current secondary market bid-ask spread; (e) current secondary market premium/discount based on PIV and bid-ask midpoint; (f) size of trade and potential secondary market (or NAV) impact; (g) urgency of trade; (h) any differences in applicable commissions/processing fees between secondary market trades and direct purchases and redemptions of Shares; and (i) the broker-dealer's assessment of the reliability of the PIVs as indicators of Share value. That's quite a list! Broker-dealers who ignore one or more of these factors in their trading decisions risk achieving sub-optimal execution for their customers and potential liability as a result.

Adequacy of Broker-Dealer Systems. I believe the Funds' unique dual-liquidity features will introduce major challenges to the trade management and order processing systems used by broker-dealers to manage, clear and process customer trades. I suspect few broker-dealers have given much thought to how trading in Shares would work in their systems. Among the issues that a broker-dealer will need to address before commencing trading in Shares for customers are: (a) how to track which customers, and what Share amounts, are eligible for cash redemptions through a Fund's Retail Redemption Facility; (b) how to track a Fund's current Order Cut-off Times and the Transaction Fees that would apply to direct purchases and redemptions of various sizes; (c) how to display two different sets of available Fund prices (secondary market and direct) simultaneously on their pricing systems; (d) how to factor into trade management protocols designed to ensure best execution that executed orders to directly purchase and redeem Shares could be cancelled until the applicable Order Cut-off Time, whereas purchases and sales executed in the secondary market would not be cancellable; (e) how to address potential market-on-close buy orders executed above NAV plus the applicable Transaction Fee and market-on-close sell orders executed below NAV minus the applicable fee, the prices of which would not be consistent with best execution; and (f) how to clear and process direct purchases and redemptions in Shares, understanding that large volumes of direct transactions may be possible.

Conclusion and Recommendations. My understanding is that the purpose of the Funds' direct purchase and the Retail Redemption Facility provisions is to provide assurance to regulators and the marketplace that investors will be able to buy and sell Shares at prices approximating NAV even when secondary market trading prices are significantly above or below NAV. As stated previously, I believe that the provisions are grossly inadequate for this purpose and that, for this and other reasons stated elsewhere, the Proposal should not be approved.

If, contrary to my recommendation, the Proposal does move forward, I believe the Funds should be required to extend eligibility for the Retail Redemption Facility to all shareholders and the Order Cut-off Times for direct purchases of Shares and redemptions under the Retail Redemption Facility should be established as the close of the Exchange's Regular Trading Session. Further, I believe the Exchange should be required to limit trading in Shares to broker-dealers that have represented to the Exchange that they have systems in place (a) to accommodate direct purchases and redemptions of Shares on terms no less favorable than their secondary market trading in Shares and (b) to ensure best execution of transactions in Shares, considering both secondary market trading and direct purchase and redemption options. Broker-dealers trading Shares on the Exchange should not be permitted to charge their customers processing fees on direct purchases and redemptions of Shares that exceed what they charge the same customers for secondary market trades. The Funds should not be permitted to charge

Transaction Fees on direct purchases and redemptions of Shares that exceed the associated Fund expenses incurred, taking into account the size of a specific transaction.

Cost Considerations

Cost considerations relevant to the Proposal include: (a) Fund operating expenses as reflected in their total expense ratios; (b) Fund trading costs and possible cash drag on returns incurred in connection with direct purchases and redemptions of Shares; (c) Transaction Fees imposed by the Fund on direct purchases and redemptions of Shares; and (d) processing fees paid by shareholders to their broker-dealers on direct purchases and redemptions of Shares.

Fund Operating Expenses. The Applicants represent that the Funds "will have average annual total operating expenses that are expected to be lower than actively-managed mutual funds with similar investment objectives and policies that are not ETFs."[75] This statement apparently relates to the Applicants belief that "because Shares are all held at DTC, the Funds should not have the same degree of shareholder recordkeeping and service expenses as mutual funds."[76]

These assertions imply that the Applicants do not fully understand the operational complexities of the dual-liquidity mechanism they propose, or the true source of the operational efficiencies and administrative cost savings that ETFs routinely achieve versus mutual funds. I believe the Funds will achieve few, if any, operating economies relative to mutual funds due to the costs of maintaining a Share processing system that accommodates both Share transactions in the secondary market and direct purchases and redemptions of Shares. As described below, I also believe it is unlikely that Transaction Fees limited to 2% will adequately compensate the Fund for the costs it incurs to accommodate small direct purchases and redemptions of Shares.

Fund Trading Costs and Cash Drag. Potentially significant sources of performance advantage for ETFs that issue and redeem their shares in kind over mutual funds that issue and redeem shares for cash are (a) the ETFs may avoid trading to put invested cash to work and to raise cash for redemptions and (b) the mutual funds may forego returns on excess cash held in connection with inflows and outflows. Because the Funds intend to issue Shares exclusively for cash and to meet redemptions under the Retail Redemption Facility in cash, the potential trading and cash drag advantages of in-kind transactions will be limited to redemptions by or through Authorized Participants that the Adviser elects to meet in kind.

As described in the below section, the Funds will seek to offset the costs of direct purchases and redemptions of Shares by imposing Transaction Fees. If (and only if) such fees are large enough, the Funds can, on a net basis, achieve pre-tax performance advantages[77] similar to funds that issue and redeem shares exclusively in kind.

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[75] *See* Exemptive Application at page 17.

[76] *ibid* at page 20.

[77] In "Tax Treatment of In-kind Redemptions" above, I address whether the Funds' use of in-kind redemptions in the manner proposed would incrementally enhance after-tax returns.

Transaction Fees. In connection with the purchase and redemption of Shares, the Fund may impose Transaction Fees that "will be determined by the Adviser but will not exceed 2%."[78] The purpose of the Transaction Fees is "to protect the continuing shareholders against possible dilutive transactional expenses, including operational processing and brokerage costs, associated with establishing and liquidating portfolio positions . . . in connection with the purchase and redemption of Shares. The Adviser believes that imposing Transaction Fees will best respond to market needs and help to defray certain costs that would otherwise be borne by the Trust, such as custodian transaction fees and various other Fund overhead costs and fund accounting costs."[79]

A consideration raised by the Funds' proposed Transaction Fees is whether payments of up to 2% of NAV to enter or exit a Fund through direct purchases or redemptions of Shares will be commercially acceptable and attractive to investors. Few, if any, mutual funds impose purchase and redemption fees that approach these levels.

Conversely, an issue with significant Fund performance implications is whether Transaction Fees limited to 2% of NAV will be sufficient to accomplish the intended purpose of protecting a Fund's continuing shareholders against dilution as a result of direct purchases and redemptions of Shares. As stated in the Registration Statement, "to the extent [direct Share] trades are effected in whole or in part in cash, . . . those trades could result in dilution to a Fund and increased transaction costs (a Fund may impose higher transaction fees to offset these increased costs), which could negatively impact the Fund's ability to achieve its investment objective."[80] Given my understanding of the share processing costs of ETFs, I believe it is unlikely that Transaction Fees limited to 2% of NAV will be sufficient to offset the costs to be incurred by the Funds to accommodate small direct purchases and redemptions of Shares. To use an extreme example, it will certainly be impossible for a Fund to process a direct purchase or redemption of a single Share for anything close to the $0.20 maximum amount on a single share at the expected average price (2% of $10) the Fund would be permitted to charge in Transaction Fees.

Like the Funds propose to do, existing ETFs charge transaction fees on purchases and redemptions of their shares to offset the associated processing costs and estimated fund trading costs. Most existing ETFs charge transaction fees that are flat dollar amounts *(e.g.*, $500), which do not vary with the number of ETF shares purchased or redeemed by an Authorized Participant on a given day. This reflects the fact that the costs to that fund of processing an in-kind purchase or redemption are essentially the same, irrespective of transaction size. Funds that issue and redeem shares in cash may charge additional, percentage-based amounts to offset associated fund trading costs. The lowest base processing charge of an existing ETF that I am aware of is $50,[81] and most ETFs charge a multiple of that amount. If the Funds' true cost to process a purchase or redemption of Shares were $50, all Share transactions under $2,500 would be dilutive to Fund returns, assuming the maximum 2% Transaction Fee were to apply. Lots of small direct purchases and redemptions will unavoidably cause dilution of a Fund's returns.

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[78] *See* Filing at page 23.

[79] *See* Filing at page 23-24 and Exemptive Application at page 7.

[80] *See* Registration Statement at page 22.

[81] This is the base transaction fee of the SPDR Blackstone / GSO Senior Loan ETF, which creates and redeems shares entirely in cash. The fund may impose an additional fixed charge of up to three times the base fee on transactions outside the normal clearing process. The fund may also charge an additional variable fee to offset related fund trading costs.

Direct Purchase and Redemption Processing Fees. Nowhere in the Proposal documents is there any discussion of processing fees that broker-dealers may charge their customers in connection with direct purchases and redemptions of Shares. I believe it is likely that broker-dealers will routinely charge processing fees on direct purchases and redemptions of Shares by their brokerage account customers. Moreover, I believe there is significant risk that, left unregulated, the processing fees on direct purchases and redemptions of Shares will be *significantly higher* than standard brokerage commissions for secondary market trades. As noted previously, I believe it should be a condition for approval of the Proposal that all broker-dealers trading Shares on the Exchange be required to represent to the Exchange that the processing fees they charge on direct purchases and redemptions of Shares will not exceed what they charge the same customers for secondary market trades.

Scope of Proposal

For the reasons discussed previously in this letter, I believe the Proposal should not be approved. If approved, however, I believe the Funds' permitted investments and the permitted trading in Shares should be curtailed as described in this section.

The Initial Funds. The Proposal provides for three initial Funds:[82] ActiveShares℠ Large-Cap Fund (Large-Cap Fund), ActiveShares℠ Mid-Cap Fund (Mid-Cap Fund), and ActiveShares℠ Multi-Cap Fund (Multi-Cap Fund). Large-Cap Fund will normally invest at least 80% of its assets in U.S. stocks included in the Russell 1000 Index[83] and ETFs that invest primarily in such stocks. Mid-Cap Fund will normally invest at least 80% of its assets in U.S. stocks included in the Russell 2000 Index[84] and ETFs that invest primarily in such stocks. Mid-Cap Fund will normally invest at least 80% of its assets in U.S. stocks included in the Russell 3000 Index[85] and ETFs that invest primarily in such stocks.

The Applicants assert that "the nature of the markets in the component securities . . . will be primarily determinant of premiums or discounts"[86] and note that "the large and medium capitalization exchange traded equity securities in which the Funds plan to invest will generally be highly liquid and actively traded."[87] Further, "because a Fund will generally invest in large and medium capitalization equity securities that are highly liquid and have pricing information readily available in the marketplace,

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[82] *See* Filing at pages 4 and 12-18 and Registration Statement at pages 2-13. The Exemptive Application lists 15 initial Funds (*see* Appendix A).

[83] The Russell 1000 Index is a large-cap U.S. stock market index, representing approximately the 1,000 largest stocks in the Russell 3000 Index, based on market capitalization at the time of the annual index reconstitution, with implementation rules designed to reduce index turnover. The median market cap of index companies is approximately $7.7 billion and the smallest company in the index has a market cap of approximately $750 million.

[84] The Russell 2000 Index is a small-cap U.S. stock market index, representing approximately the 2,000 smallest stocks in the Russell 3000 Index by market cap at index reconstitution, with implementation rules designed to reduce index turnover. The median market cap of index companies is approximately $750 million and the smallest company in the index has a market cap of approximately $50 million.

[85] The Russell 3000 Index is a broad-based U.S. stock market index. The median market cap of index companies is approximately $1.5 billion and the smallest company in the index has a market cap of approximately $50 million.

[86] *See* Exemptive Application at page 25.

[87] *ibid* at page 21.

the Fund is able to provide shareholders a reliable [PIV] calculation and therefore, an effective hedging mechanism."[88]

In evaluating the Funds' proposed investments and comparing them to the statements in the preceding paragraph, I note significant inconsistencies. First, as proposed, only Large-Cap Fund will normally invest primarily in "large and medium capitalization equity securities" as that term is generally understood. The Russell 2000 Index that is the benchmark for Mid-Cap Fund is generally considered a *small-cap* index, including stocks with market capitalizations currently as low as approximately $50 million. The Russell 3000 Index that is the benchmark for the Multi-Cap Fund is generally considered a multi-cap index, since it includes not only the stocks in the (large-cap) Russell 1000 Index but also the stocks in the (small-cap) Russell 2000 Index. In addition, the Funds' ability to invest up to 15% in illiquid assets is inconsistent with the description of the Funds' holdings as "highly liquid." I also note that the Funds' ability to employ investment leverage, hold short positions and invest in non-U.S. debt instruments could significantly interfere with the effectiveness of the Funds' proposed mechanism for maintaining close correspondence between market trading prices of Shares and underlying portfolio values.

If the Proposal is approved, I believe the Funds' permitted investments should be significantly curtailed. In particular, I recommend that the Funds: (a) be required to limit their equity investments to U.S.-listed stocks with market caps of $5 billion or greater (consistent with the general understanding of large- and medium-cap stocks; a universe of about 700 stocks currently); (b) not be permitted to invest in illiquid assets or debt instruments of non-U.S. issuers; and (c) not be permitted to employ investment leverage or hold short positions.

Market Trading Hours. The Filing provides that the Shares will trade on the Exchange from 4 a.m. to 8 p.m. Eastern Time each Business Day, during the Exchange's Opening, Core and Late Trading Sessions.[89] By contrast, the PIVs that form the basis for the Funds' arbitrage mechanism will be disseminated only during the Exchange's Core Trading Session (normally 9:30 a.m. to 4:00 p.m. Eastern Time). The Exchange proposes to address this mismatch by including in the Information Bulletin to be sent to Equity Trading Permit Holders prior to the commencement of trading, a discussion of the "risks involved in trading the Shares during the Opening and Late Trading Sessions when an updated PIV will not be calculated."[90]

In my judgment, the proposed disclosure is not sufficient to address the significant risk that the prices of Shares bought or sold in the Opening and Late Trading Sessions will vary widely from underlying portfolio values because updated PIVs are not available then. If approved, I believe trading in Shares should be limited to the Exchange's Core Trading Session. I see no rationale for permitting Shares to trade at times when *neither* the *contents* nor any estimates of current *values* of the Fund's holdings are known in the marketplace.

Trading by Broker-Dealers for their Customers. As described under "Direct Share Purchases and Retail Redemption Facility," I believe the Exchange should be required to limit trading in Shares to brokers-dealers that have represented to the Exchange that they have systems in place (a) to

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[88] *ibid*.

[89] *See* Filing at page 36.

[90] *ibid* at page 38.

accommodate direct purchases and redemptions of Shares on terms no less favorable than their secondary market trading in Shares and (b) to ensure best execution of transactions in Shares, considering both secondary market trading and direct purchase and redemption options. Unless these conditions are in place, whatever protections the Funds' direct Share purchase and Retail Redemption Facility features provide will exist only on paper, and not in the real world.

Adequacy of Investor Information and Potentially Misleading Statements

Access to PIVs. The Proposal provides that, at least every 15 seconds during the Exchange's Core Trading Session, PIVs will be "widely disseminated by one or more major market data vendors."[91] The proposed frequency and means of dissemination of intraday values is, as I understand, consistent with the current requirement for most ETFs.[92] Compared to existing ETFs, however, access to timely and accurate PIVs will be of greater importance to investors in the Funds in two critical respects: (a) the role that PIVs provided to market makers play in seeking to ensure that market trading prices of Shares do not stray far from underlying portfolio values; and (b) the role of PIVs in enabling investors to make informed decisions whether to trade in the secondary market or in direct transactions with the Fund when they seek to buy and sell Shares. I addressed the first of these under "Secondary Market Trading Efficiency - Reliance on PIVs" above, and focus here on the second.

Similar to the intraday values disseminated by other ETFs, the PIVs are intended to provide Fund investors with information about the relationship between current market trading prices of Shares and the underlying value of Fund assets at approximately the same time, addressing the question: "do current Share prices represent a fair deal?" The Funds would differ from current ETFs in offering all investors the ability to purchase Shares for cash and Retail Investors the ability to redeem sub-Redemption Unit quantities of Shares for cash in transactions with the Fund at NAV-based prices, similar to mutual fund purchases and redemptions. The Funds' unique dual-liquidity features mean that investors contemplating buying or selling Shares will need to answer a second question: "should I buy or sell in the secondary market, or transact directly with the Fund?"

Given the greater importance of PIVs to the decision-making process of current and prospective Fund investors, I believe it is essential that all Fund investors have ongoing access to current PIV values. I do not believe that the proposed dissemination of PIVs "by one or more major market data vendors" is sufficient or appropriate for this purpose. Market data vendors do not necessarily make their services available for free, and it would be an unreasonable burden on small, self-directed investors to require them to subscribe to commercial data services to make informed investment decisions regarding a Fund. I believe it should be a requirement for approval of the Proposal that each Fund's current PIVs are *provided* at no charge on a public website and *made available* to the public no later than available to any other market participant.

Website Information. The Proposal represents[93] that the Funds will maintain a free public website through which a Fund's prospectus may be downloaded and including various Fund trading information that is updated daily. I understand that the Funds' proposed website disclosures are

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[91] *ibid* at page 34.

[92] Certain ETF sponsors provide real-time intraday fund values on their public website or support dissemination of intraday fund values through other public websites.

[93] *See* Filing at page 33 and Exemptive Application at pages 16 and 35.

consistent with the current practices of many existing ETFs. Given the heightened importance of PIVs for Fund investors, the likelihood that the Funds will trade at wider spreads and more volatile premiums/discounts, and the special considerations introduced by the Funds' dual-liquidity features, I believe additional Fund trading information should be required as a condition for approval. In particular, I recommend that each Fund's website disclosures be required to include the following:

PIVs

a. Real-time PIVs updated continuously throughout the Exchange's Core Trading Session on each Business Day (as discussed in the prior section);

b. Updated daily, complete intraday PIV history for at least the twenty most recent trading days (allowing buyers and sellers of Shares to compare their executed prices to reported PIVs at the time of their trade execution);

c. Updated daily, prior Business Day's closing PIV and a calculation showing relationship of closing PIV to NAV (allowing investors to evaluate PIV to NAV correspondence); and

d. Updated daily, a chart and tables showing the frequency distribution and range of the closing PIV-to-NAV ratios for each calendar quarter over the life of the Fund.

Closing Price Premiums/Discounts

a. Updated daily, prior Business Day's closing market price and premium/discount (expressed as a percentage) based on the relationship of closing market price to NAV; and

b. Updated daily, a chart showing the frequency distribution and range of daily closing price premiums/discounts (expressed as percentages) for each calendar quarter over the life of the Fund.

Intraday Estimated Premiums/Discounts

a. Updated daily, prior Business Day's average, minimum and maximum intraday estimated premiums/discounts (expressed as percentages) based on PIVs and bid-ask midpoints at each PIV publication time; and

b. Updated daily, a chart showing the frequency distribution and range of daily average, minimum and maximum intraday estimated premium/discounts (expressed as percentages) for each calendar quarter over the life of the Fund.

Bid-Ask Spreads

a. Updated daily, prior Business Day's closing bid-ask spread and average, minimum and maximum intraday bid-ask spreads (expressed as percentages) during the Exchange's Core Trading Session; and

b. Updated daily, a chart showing the frequency distribution and range of daily closing bid-ask spreads and intraday average, minimum and maximum bid-ask spreads (expressed as percentages) for each calendar quarter over the life of the Fund.

Fund Market Exposure and Leverage

a. Updated daily, prior Business Day's net long or short equity market exposure and amount of investment leverage employed, each expressed as a percentage of Fund net assets; and

b. Updated daily, a chart showing the frequency distribution and range of the Fund's daily net market exposure and leverage percentages for each calendar quarter over the life of the Fund.

Purchase and Redemption Transaction Fees

a. Updated daily, Transaction Fees currently applicable to direct purchases of Shares, redemptions through the Retail Redemption Facility and Redemption Unit redemptions; and

b. Updated daily, a chart showing the frequency distribution and range of Transaction Fees applicable to direct purchases of Shares, redemptions through the Retail Redemption Facility and Redemption Unit redemptions for each calendar quarter over the life of the Fund.

Prospectus Disclosures. The Funds' primary disclosure documents will be the summary and full prospectus (collectively, the Prospectus) as set forth in the Registration Statement.[94] In reviewing the Registration Statement, I identified a number of material omissions and misstatements in the Prospectus whose correction should be a condition for approval.

In-kind Redemptions. As described above under "Tax Treatment of In-kind Distributions," I see a significant risk that the Funds' in-kind distributions will be treated as sales of the securities by the Fund for tax purposes. If, contrary to my recommendation, the SEC approves the Proposal without the Funds receiving a Private Letter Ruling, I believe the tax discussion and tax risk disclosures in the Prospectus are grossly inadequate.

The Prospectus limits its discussion of the tax treatment of the Funds' in-kind distributions to the statements that "a regulated investment company is not required to recognize gain upon the distribution of appreciated securities to a shareholder in redemption of its stock upon the demand of the shareholder" and "each Fund believes that the distribution of securities in redemption of Redemption Units of Authorized Participants will qualify for this exception."[95]

Tax risk is not identified in the Prospectus as a principal risk of investing in the Funds.[96] The tax discussion in the Prospectus includes only the general statements that "the Funds have not requested and will not request an advance ruling from the [IRS] as to the federal income tax matters described" and "the IRS could adopt positions contrary to those [of the Funds] and such positions could be sustained."[97] These disclosures lead me to conclude that the Applicants have not fully considered the tax implications of the Funds' distinctive in-kind redemption features.

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[94] *See* Registration Statement at pages 2-13 for summary and pages 14-29.

[95] *See* Registration Statement at page 24.

[96] *ibid* at pages 3-5, 7-9, 11-16.

[97] *ibid* at page 24.

Direct Purchases and Redemptions. The Prospectus represents that "most investors will buy and sell Shares of the Funds in Secondary Market transactions" and that "the vast majority of trading in a Fund's Shares occurs on the Secondary Market."[98] I believe these statements are not only potentially false, but may be designed to influence investors to buy and sell Shares in the secondary market, rather than in direct transactions with the Fund to the extent they are entitled to do so.

As described above under "Direct Share Purchases and Retail Redemption Facility" and "Cost Considerations," I believe the Funds' direct purchase and redemption features raise significant operational challenges for broker-dealers, and will reduce secondary market trading liquidity and significantly increase Fund costs if large numbers of shareholders elect to take advantage of them. For these reasons, I believe the Applicants would like to see very few direct purchases and redemptions by small investors. As a condition for approval, I believe the Prospectus should be required to include a fair and balanced presentation of shareholders' liquidity options and to remove all ambiguous and potentially prejudicial statements relating to shareholder liquidity options.

Also relating to the need for a more balanced presentation of shareholder liquidity options, I believe the Prospectus discussion under "Creation and Redemption of Shares"[99] should be supplemented to include a more complete discussion of the considerations in direct purchases and redemptions of Shares, including the applicable Order Cut-off Times, Transaction Fees, processing fees they may be charged by broker-dealers in connection with a direct purchase or redemption of Shares, and, for redemptions through the Retail Redemption Facility, the limits on such redemptions (eligible shareholders and daily Share amounts) that currently apply. Last on this list, but not least, the Prospectus should be required to include a plain English discussion of the factors that an investor should consider in determining whether to buy or sell Shares in the secondary market or in direct transactions with the Fund.

Description of Funds as ETFs. The Proposal specifies that "the Applicants will take appropriate steps as may be necessary to avoid confusion in the public's mind between a Fund and a conventional "open-end investment company" or "mutual fund.""[100] The Proposal represents that "each Fund will be marketed as an "actively-managed exchange traded fund" or "actively-managed ETF.""[101]

Given the fundamental differences in how Shares may be bought or sold versus how mutual funds provide liquidity, I agree that it is not appropriate for the Funds to be advertised or marketed as mutual funds. For the same reason, however, I believe it should be a condition for approval that the Funds represent that they will not describe themselves as "ETFs" or "exchange-traded funds,"[102] and will take appropriate steps to ensure that the Exchange, broker-dealers and market data providers similarly will not describe the Funds as ETFs.

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[98] *See* Registration Statement at page 25.

[99] *ibid* at page 17.

[100] *See* Exemptive Application at page 13.

[101] *ibid* at page 13.

[102] I understand that, because the Shares could be bought and sold on an exchange, the Funds will literally be "exchange-traded funds," but the Funds' dual-liquidity features are very different from what investors have come to expect from an exchange-traded fund. It is not clear that even a majority of the Shares traded will trade on the Exchange. In the same literal sense, the Funds are also "open-end investment companies," but will not represent themselves as such to avoid potential investor confusion.

Trading in the Funds would differ from trading in existing actively managed ETFs in two important respects: (a) the Funds' direct purchase and redemption features; and (b) the different mechanism employed to maintain efficient secondary market trading (likely resulting in wider bid-ask spreads and more volatile premiums/discounts). Permitting the Funds to describe themselves as ETFs would raise significant potential for investor confusion and create false assumptions about how Shares may be bought and sold and the degree of expected correspondence between market trading prices of Shares and underlying portfolio values.

Fund Claims. The Applicants represent that the Funds' structure and method of operation will offer significant investor benefits relating to cost and tax efficiency, shareholder liquidity and Fund trading confidentiality. As detailed above, my analysis concludes that the Proposal has a number of serious flaws that undermine the claimed benefits and recommend against approval. If, contrary to my recommendation, the SEC moves forward with the Proposal, I believe it should be a condition for approval that all false, misleading and unsubstantiated claims relating to the Funds are removed from the Prospectus and all Fund marketing and advertising materials. Among other claims, I believe the Funds should not be permitted to represent that:

a. the Funds are more cost efficient or lower cost than mutual funds (unless substantiated by Fund expense ratios that are below the average of mutual funds with similar investment practices and comparable distribution and service fee (*i.e.*, 12b-1) structures);

b. the Funds are more tax efficient than mutual funds (unless Funds receive a Private Letter Ruling affirming the asserted tax treatment of the Funds' in-kind distributions);

c. the Shares will not trade on the secondary market at large discounts or premiums to NAV (unless and until documented by actual trading experience through a range of market conditions to show that the premiums/discounts of Shares based on closing bid-ask midpoints to NAV average less than 0.25% and have a standard deviation of less than 0.50%);

d. the Shares may be directly purchased for cash at NAV by all investors and redeemed for cash at NAV by Retail Investors (unless the Transaction Fees applicable to direct purchases and redemptions of small Share quantities have been (or are required by the Prospectus to be) consistently less than 0.25% and customary broker-dealer charges on direct purchases and redemptions of Shares are no higher than for secondary market purchases or sales of Shares); and

e. the Funds provide protection against front running and free riding (until the Funds have instituted, and have demonstrated the effectiveness of, policies to ensure that Fund holdings cannot be reverse engineered using PIVs and other disseminated Fund information).

Conclusion

My principal conclusion is that the Proposal should not be approved. In my judgment, approval would not be in the public interest or consistent with the protection of investors. Among the reasons are:

1. The significant risk that the IRS will deny the purported tax benefits of the Funds' distinctive in-kind redemption program.

2. The unreliability of the Funds' proposed method for ensuring secondary market trading efficiency, and the likelihood that the Shares will trade at significantly wider bid-ask spreads and/or more variable premiums/discounts than most existing ETFs.

3. The likely incidence of erroneous Share trades because of erroneous PIVs.

4. Policy considerations relating to the indirect selective disclosure of Fund information through PIV dissemination and time-series analysis of PIV data by market makers and other professional traders.

5. Potential reverse engineering risk.

6. Policy considerations relating to mandatory early Order Cut-off Times for Share redemptions.

7. Limitations of the proposed Retail Redemption Facility redemption privileges to specified types of shareholders, rather than treating all shareholders equally.

8. Potential for investor confusion introduced by the Funds' direct purchase and redemption options as alternatives to secondary market purchases and sales, and the likelihood of inadequate information for investors to determine how best to buy and sell Shares.

9. Substantial challenges to broker-dealers of ensuring best execution of Share transactions for their customers given the Fund's dual-liquidity features and the choice of venue opportunities they present.

10. Substantial operational challenges and costs for broker-dealers to accommodate the Fund's dual-liquidity features and implement direct Share purchases and redemptions.

Should the Proposal move forward, I believe its scope should be reduced by:

1. Restricting the Funds' investments to include only U.S.-listed large-cap and mid-cap stocks and cash instruments.

2. Not permitting the Funds to hold illiquid or non-U.S. assets, use leverage or enter into short positions.

3. Restricting trading in Shares to the Exchange's Core Trading Session hours.

4. Restricting trading in Shares to broker-dealers that have represented to the Exchange that they have systems in place to accommodate direct Share transactions on terms no less favorable than their market trading of Shares and to ensure best execution.

Should the Proposal move forward, I believe the information available to investors should be modified as follows:

1. Real-time dissemination of PIVs on a free public website, updated continuously throughout the Exchange's Core Trading Session each Business Day.

2. Daily updated statistics on the Funds' website showing historical PIVs, closing price/NAV ratios, PIV/NAV ratios, intraday price/PIV ratios, bid-ask spreads, leverage ratios, net long and short market exposures, and Transaction Fees applicable to direct purchases and redemptions of Shares.

3. Enhanced Prospectus disclosure of in-kind redemption tax risks.

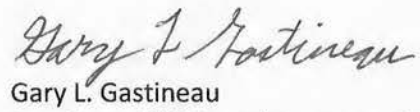
4. Enhanced Prospectus disclosure of the costs and risks of direct purchase and redemptions, and discussion of the relevant factors in an investor's decision-making on how to buy and sell Shares.

5. Funds should not be permitted to describe themselves as ETFs or exchange-traded funds.

6. Claims regarding Fund cost and tax efficiency, the Shares' secondary market trading efficiency, investors' ability to purchase and redeem Shares at NAV in transactions with the Fund, and the Funds' protection against front running and free riding should not be permitted until substantiated.

In closing, I wish to thank the commissioners and staff of the SEC for consideration of the views and information presented in this letter.

Sincerely,



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