

June 13, 2016

Brent J. Fields  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Adopt NYSE Arca Equities Rule 8.900 to Permit Listing and Trading of Managed Portfolio Shares and to Permit Listing and Trading of Shares of Fifteen Issues of the Precidian ETFs Trust (Order) (Release No. 34-77845; File No. SR-NYSEARCA-2016-08)**

Dear Mr. Fields:

I am writing in response to the request for comment set forth in the Order, which addresses the above-referenced filing (Filing) by NYSE Arca, Inc. (the Exchange) to permit the listing and trading of Managed Portfolio Shares (Shares) and the listing and trading of Shares of 15 series (Funds) of the Precidian ETFs Trust (Trust).<sup>1</sup> This letter restates and amplifies my views on the Filing stated in the comment letter I submitted on March 10, 2016 (March Letter), and should be read in conjunction with the earlier letter. Unless otherwise noted, the capitalized terms used herein have the same meanings as in the March Letter.

The Filing relates to a request<sup>2</sup> by the Trust and other parties for exemptive relief from various provisions of the Investment Company Act of 1940, as amended (Exemptive Application), and a registration statement filed<sup>3</sup> by the Trust on Form N-1A under the Securities Act of 1933, as amended

<sup>1</sup> As background, I am the author of The Exchange-Traded Funds Manual (Second Edition, Wiley, 2010) and numerous other publications on the topic of exchange-traded products. Most recently, and relevant to the Filing, I am a co-author with James J. Angel and Todd J. Broms of "ETF Transaction Costs Are Often Higher Than Investors Realize," published in *The Journal of Portfolio Management*, Spring 2016, pp. 65-75. This paper discusses the high costs of trading ETFs, an issue that will continue to be important as new types of ETFs are proposed. I am also the principal of ETF Consultants.com, inc. and a managing member of Managed ETFs™ LLC (Managed ETFs). Intellectual property developed by Managed ETFs and subsequently sold to an affiliate of Eaton Vance Corp. (Eaton Vance) forms much of the basis for NextShares™ exchange-traded managed funds (NextShares), a new type of actively managed exchange-traded product, the first of which were launched by Eaton Vance in the first quarter of 2016. Eaton Vance staff assisted in the preparation of this letter. Because NextShares may be competitive with the Shares and because I have a retained economic interest, my views may be considered subject to a conflict of interest. My comments are made in the public interest and, to the best of my ability, are not influenced by any conflict.

<sup>2</sup> See File No. 812-14405 (September 21, 2015).

<sup>3</sup> See File Nos. 333-171987 and 811-22524 (January 22, 2014) and Partial Amendment No. 1 (Amendment) to the Filing. The Amendment corrected the Filing to eliminate erroneous references to a registration statement covering the 15 subject Funds that does not exist. In the Amendment, the Exchange represents that the Trust will amend the Registration Statement prior to commencement of trading in Shares to include reference to the Funds.

(Registration Statement). In this letter, the Filing and the Exemptive Application are treated as elements of a single proposal (Proposal) and the various filing parties are referred to as the “Applicants.” For a more complete description of the Proposal, please refer to the Filing and the Exemptive Application.

### **Summary of the Proposal**

The Funds are a proposed new type of actively managed exchange-traded fund (ETF). Compared to actively managed ETFs as approved to date, the Funds’ principal distinguishing features are: (a) restricting Fund investments to U.S.-listed securities and short-term instruments; (b) disclosing portfolio holdings quarterly with a lag, rather than on a current daily basis; (c) limiting purchases and redemptions of Creation Units of Shares to transactions through Confidential Accounts established with Trusted Agents; (d) disseminating Verified Intraday Indicative Values (VIIVs) based on the bid-offer midpoint of the Fund’s current holdings at one-second intervals throughout the Exchange’s Core Trading Session; and (e) relying on dissemination of VIIVs and transactions by Authorized Participants and Non-Authorized Participant Market Makers through Confidential Accounts, rather than daily holdings disclosures and transactions directly by Authorized Participants and Non-Authorized Participant Market Makers, as the primary basis for seeking to ensure the Shares’ secondary market trading efficiency.

The Applicants assert their belief that the Funds will bring “significant advantages” over investments in actively managed mutual funds, including lower operating costs, enhanced tax efficiency and enabling investors to buy and sell Shares intraday on an Exchange.<sup>4</sup> The Adviser represents that, unlike fully transparent ETFs, the Funds’ proposed method of operation “will preserve the integrity of the active investment strategy and eliminate the potential for “free riding” or “front-running” of the Fund’s portfolio trades.<sup>5</sup> In the secondary market trading of Shares, the Applicants assert that the Funds’ manner of trading “will not lead to significant deviations between the shares’ Bid/Ask Price and NAV.”<sup>6</sup>

### **Assessment of the Proposal**

I believe the Proposal has a number of fatal flaws that, individually and collectively, *mandate its rejection or withdrawal*. As described below and in the March Letter, the Proposal *violates federal securities law* and has defects that (a) undermine the Proposal’s objectives, (b) diminish or call into question the Proposal’s purported benefits, and (c) expose Fund investors to potential harm. The Proposal falls far short of meeting the statutory standard that approval is necessary or appropriate in the public interest and consistent with the protection of investors.

Over the balance of this letter, I first respond to the six categories of questions set forth in the Order for which the Commission has requested comment and then summarize other important considerations that I raised in the March Letter, none of which have been addressed by the Applicants and therefore remain outstanding.

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<sup>4</sup> See Exemptive Application at page 5.

<sup>5</sup> See Filing at page 48.

<sup>6</sup> See Filing at page 46.

**Secondary market trading efficiency.<sup>7</sup>**

1. *Do commenters believe that market makers will be able to engage in effective and efficient arbitrage in the Shares without knowledge of the contents of the Funds' portfolios?*

*Do commenters believe that market makers will be able to engage in effective and efficient arbitrage in the Shares while delegating trading in the portfolio securities to an intermediary, rather than trading in those securities directly?*

*Do commenters believe that the Shares of a Fund will trade at secondary market prices that are closely aligned with the value of the Fund's portfolio?*

Market makers will face significant impediments to successfully arbitraging the Funds' Shares. Different from existing ETFs, a Fund's market makers must rely on VILIIs calculated and disseminated by third parties to estimate intraday Fund values. The Funds' proposed VILIIs would offer market makers far less, and far less useful, intraday valuation information than is available for existing ETFs. Compared to the internal valuations that ETF market makers now generate from daily fund holdings disclosures, the proposed VILIIs would provide intraday valuations that are significantly less precise, less robust, less continuous, less timely, more prone to errors, more subject to agency risks and would expose market makers to potentially unrecoverable losses in the event of erroneous VILIIs.<sup>8</sup>

In addition to the challenges to efficient market making raised by the proposed reliance on VILIIs as the only available intraday valuation metric, the Proposal would remove market makers' ability to control their own trading in underlying Fund assets in connection with their creations and redemptions, and force them to use either transactions through third parties or self-directed hedging trades subject to unknown and potentially significant basis risk to manage their intraday Share exposures and engage in arbitrage. Compared to the usual manner in which market makers in existing ETFs engage in arbitrage and buy and sell Creation Basket instruments, the proposed Confidential Account arrangement through Trusted Agents imposes significant costs and risks on market makers and limits their opportunities for profitable trading. Because market makers would not know a Fund's current holdings, any hedging transactions that they enter on a direct basis would be especially prone to basis risk during periods of market stress or volatility.

Taken together, the deficiencies of VILIIs as intraday price signals and the limitation that market makers can trade in Creation Basket instruments only on a blind basis through Confidential Accounts overseen by third parties will significantly curtail effective market making in the Funds' Shares. Reflecting the impediments to effective market making, the Funds are likely to attract less market maker interest and any market makers that do become involved will impose high profit hurdles to compensate for their added costs and risks. As a result, the Funds will trade at notably wider bid-ask spreads and more variable premiums and discounts than otherwise similar ETFs whose holdings are fully transparent. In addition, during periods of market stress and volatility, the Funds' lack of transparency will invariably

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<sup>7</sup> My response to this section summarizes information and analysis presented on pages 9-17 of the March Letter. Please refer to the March Letter for more detail.

<sup>8</sup> See my response to Question 3 below for more information regarding VILIIV-related challenges to Share trading efficiency.

cause bid-ask spreads and premiums/discounts to NAV to widen disproportionately in relation to ETFs that provide daily holdings disclosure.

**Comparability of trading characteristics to fully transparent ETFs.<sup>9</sup>**

2. *Do commenters believe that the trading characteristics—such as bid/ask spread and premium or discount to NAV—of a Fund will be comparable to the trading characteristics of a fully transparent ETF with similar assets and a similar strategy?*

Due to the challenges of efficient arbitrage, the Funds will certainly trade worse than existing fully transparent active equity ETFs,<sup>10</sup> which themselves demonstrate significant trading deficiencies.<sup>11</sup> The Funds can be expected, with a high degree of confidence, to trade at meaningfully wider bid-ask spreads and more variable premiums and discounts than fully transparent ETFs that hold similar assets and follow a similar strategy. The Funds' trading performance versus otherwise similar ETFs that provide daily holdings disclosure is highly likely to be especially poor during periods of market stress and volatility. The costs and risks to market makers imposed by the lack of transparency and loss of market-maker control embedded in the Proposal will undoubtedly be even more detrimental to the Funds' trading efficiency during stressed market conditions.

**Proposed use of VILIvs.<sup>12</sup>**

3. *What are commenters' views concerning the proposed use of a VILI as opposed to the IIV commonly used by other ETFs?*

*Do commenters believe that the VILI will provide sufficient information to market participants to ensure that the Funds are appropriately priced in secondary trading?*

*Do commenters believe that the VILI will provide sufficient information to market participants in periods of market volatility, including periods in which securities underlying a Fund's portfolio encounter trading halts or pauses?*

*Do commenters believe that the proposed parameters that apply to the accuracy of the VILI—i.e., the requirement that the two independent calculations not disagree by more than 25 basis points for 60 seconds or more—are appropriate?*

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<sup>9</sup> The views expressed in this section are supported by information and analysis presented on pages 9-17 of the March Letter. Please refer to the March Letter for more detail.

<sup>10</sup> This is consistent with the understanding expressed in the Staff Letter responding to the Applicants' Second Proposal that "an ETF which has something less than full portfolio transparency will *always* [emphasis added] exhibit a greater and more persistent premium or discount and wider intraday price spread than an identical product with full portfolio transparency." (see footnote 20 on page 5 of the Staff Letter available at [http://www.nextshares.com/regulatory-and-technical-documents.php#other\\_structures.](http://www.nextshares.com/regulatory-and-technical-documents.php#other_structures.))

<sup>11</sup> See discussion of the trading performance characteristics of existing equity ETFs at pages 6-8 and in Exhibit 1 of the March Letter.

<sup>12</sup> My response to this section summarizes information and analysis presented on pages 10-14 of the March Letter. Please refer to the March Letter for more detail.

In comparing the proposed VIIVs to existing ETF IIVs, it is important to understand the dramatic difference in the role of the disseminated intraday values: for the Funds, disseminating timely and accurate VIIVs is a key requirement for market trading efficiency; for existing ETFs, IIVs have little or no relevance to Fund trading efficiency and limited overall utility to investors. The relevant comparison for VIIVs is not versus the IIVs of existing ETFs, but rather the independently derived real-time estimates of underlying fund value that ETF market makers use to identify arbitrage opportunities and manage their risk of holding ETF positions today. Because existing actively managed ETFs (and most index ETFs) provide full daily disclosure of their current portfolio, their market makers have access to *far better information about the current value of Fund holdings* than the proposed VIIVs would provide.

Compared to the Fund's proposed VIIVs, the intraday Fund valuations that market makers routinely generate internally and employ in their market making have the following significant advantages:

- *Internal market maker valuations are significantly more precise than the proposed VIIVs.* As proposed, the Funds would disclose VIIVs to the nearest whole cent and maintain NAVs in a range of \$20 to \$30. One cent on \$20 is 5 bps; one cent on \$30 is 3.3 bps. ETF market makers generally calculate their internal valuations to a precision of a *fraction of a basis point*. Truncating the precision of the Fund's VIIIV disclosures to a range of 3.3 to 5 bps provides market makers with far less detailed valuations than they are accustomed to having.
- *Internal valuations of ETF market makers include significant information not reflected in VIIVs.* In calculating VIIVs, Applicants propose to value Fund securities based on the midpoint between the current national best bid and offer quotations. The bid-ask midpoint is a fairly crude valuation metric that does not capture important trading information that market makers frequently incorporate in their internal valuations: among others, the current bid-ask spread, the depth of the current order book on the bid and offer sides of the market, and the predominance of current trading between bid-side and offer-side transactions. As an example of how this information is useful, a market maker that is selling short an ETF's shares against net market demand is primarily interested in knowing the offer-side prices of the fund's underlying securities, since that is the side of the market on which the market maker would likely transact to hedge its fund share position or to purchase underlying securities to be delivered in a creation. Conversely, a market maker that is accumulating a long position in an ETF's shares will want to know the bid-side prices of the fund's underlying securities, since the market maker would likely transact on the bid side to hedge its long fund share position or sell the individual securities to be received in a redemption. In either case, the depth of market on the relevant side is at least as important as the best bid or best offer, since best bids and offers may not be representative of market prices to move larger blocks of shares. Whereas a market maker in an existing ETF can incorporate the full complement of current market data into its internal valuations, the Funds' market makers would only know the midpoint values reflected in the VIIVs.
- *The proposed VIIVs are not continuously available and may update with economically meaningful delays.* Although dissemination of VIIVs at one-second intervals may seem sufficient, the reality of current markets is that securities prices often adjust significantly in fractions of a second (milliseconds or microseconds). The internal valuations used by

ETF market makers update continuously, at frequencies often much higher than once per second. In addition to discontinuous dissemination, a concern market makers will have about the proposed VIIVs not addressed in the Filing or Exemptive Application is *latency* – the time lag over which changes in a Fund's underlying securities prices are reflected in the next disseminated VIIV. The number of participating parties and steps involved in computing, verifying and disseminating the VIIVs raises suspicion that Fund VIIVs may routinely update with economically meaningful delays.<sup>13</sup>

- *The proposed VIIV verification process leaves significant room for dissemination of erroneous values.* As proposed, a Fund's Pricing Verification Agent would take no action to address observed discrepancies in VIIV input prices until the calculated Fund values differ by at least 25 bps for 60 seconds. That's a huge disparity – 5 to 8 cents a share on a \$20 to \$30 NAV – far wider than the customary bid-ask spread of most domestic equity ETFs. No ETF market maker's internal valuation process would ignore price disparities of that magnitude. Whatever comfort the Funds' proposed VIIV "verification" process seeks to provide is significantly compromised by the wide tolerance band on observed price deviations.
- *The Fund's VIIV process does not address a number of potential intraday valuation errors.* As described in the Exemptive Application, a Fund's Custodian would be responsible for determining, and providing to each Independent Pricing Agent prior to the beginning of market trading each Business Day, a "constituent basket file" consisting of all the Fund's investments, other assets and liabilities that will be reflected in the Fund's NAV for that day.<sup>14</sup> Because each Independent Pricing Agent would utilize the same constituent basket file to determine intraday values, valuation discrepancies caused by errors in the constituent basket file could not be detected by the Pricing Verification Agent using the proposed verification process. If the constituent basket file for a Fund includes material inaccuracies, the Fund will disseminate erroneous VIIVs. Corporate actions (mergers, stock splits, spinoffs, dividends and the like) in Fund securities are a source of potential error in the constituent basket files disseminated by Fund Custodians. Because, in practice, *each corporate action must be reflected in constituent basket files the evening before the corporate action becomes effective*, it can be challenging for Fund Custodians to consistently account for them correctly. One of the advantages to an ETF market maker of calculating intraday fund valuations internally is that this allows the market maker to perform its own accounting of corporate actions or to check the Fund Custodian's accounting. The lack of holdings transparency makes this impossible for the Funds. Market makers' inability to verify that corporate actions are appropriately reflected in Fund VIIVs is a source of incremental risk for them compared to making markets in existing ETFs.

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<sup>13</sup> A further potential cause of economically meaningful delays in VIIVs versus market makers' interval valuations is that, in calculating their internal valuations, market makers may source pricing data directly from trading venues through proprietary data feeds, whereas the Funds will source their pricing data from the Consolidated Quotation System and UTP Plan Securities Information Processor (SIP). Proprietary data feeds routinely update faster than the SIP.

<sup>14</sup> See Exemptive Application at page 10. The IIVs of existing ETFs are also calculated using constituent basket files determined by Custodians and disseminated to IIV calculation agents.

- *The Fund's proposed process for adjusting VIIVs in the event of trading halts in portfolio securities is cumbersome and likely to result in errors in disseminated VIIVs.* The Funds' proposed procedures provide that "should a portfolio security stop trading, the Pricing Verification Agent will immediately notify an officer of the Adviser, who will in turn notify the Fund's Fair Valuation Committee. The Fair Value Committee will then make a good faith pricing determination using a methodology approved by the Board of the Fund. In cases where the fair value price of the security is materially different from the pricing data provided by the Independent Pricing Sources and the Adviser determined that the ongoing pricing information is not likely to be reliable, the fair value will be used for calculation of the VIIV, and the Custodian will be instructed to disclose the identity and weight of the fair valued securities, as well as the fair value price being used for the security."<sup>15</sup> Left unsaid in this description is that, throughout this potentially protracted process, the Fund would continue to disseminate VIIVs at one-second intervals that *do not reflect fair values of the halted security*, and therefore may vary significantly from the Fund's true underlying value at that time. The internal valuation process of any existing ETF's market makers would almost certainly arrive at a fair estimate of the fund's current underlying value far faster than the cumbersome Fund process outlined above.
- *Reliance on faulty VIIVs may expose market makers to unrecoverable losses.* One of the significant constraints on the utility of the existing ETF IIV calculation and dissemination regime is that no responsible party stands behind the disseminated values – all parties involved disclaim liability. Buyer (and seller) beware is very much the rule of the day. The Filing and the Exemptive Application include statements attributing liability for the timeliness and accuracy of the VIIVs disseminated for each Fund variously to the Fund itself, the Independent Pricing Agents and the Pricing Verification Agent.<sup>16</sup> No similar liability appears to rest with the Exchange, its agents or the Reporting Authority responsible for disseminating the VIIVs.<sup>17</sup> Moreover, the circumstances under which the Independent Pricing Agents and the Pricing Verification Agent are legally liable are limited.<sup>18</sup> Whether a Fund could acquire insurance or otherwise make provisions to meet its legal liabilities in the event of a costly VIIV error is subject to doubt.<sup>19</sup> Taken as a whole, the ability of a market maker to successfully prosecute a claim for damages resulting from a VIIV error is substantially unclear. This is likely not very comforting to a potential market maker trying to assess whether a valid claim against a Fund or service provider due to losses based on reliance on faulty VIIVs would be successful. If VIIVs are not viewed as supported by responsible parties, market makers either won't participate in the Funds or will make markets only at spreads and premiums/discounts that are wide enough to cover the risks assumed.

On an overall basis, the proposed VIIVs would fail to provide a consistently reliable, real-time measure of intraday Fund values. As stated above, the Funds' proposed VIIVs would offer market

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<sup>15</sup> See Exemptive Application at page 22.

<sup>16</sup> See Exemptive Application at page 11.

<sup>17</sup> See Filing at page 7.

<sup>18</sup> See Exemptive Application at page 11.

<sup>19</sup> *ibid.*

makers far less, and far less useful, intraday valuation information than they have for existing ETFs. Compared to the internal valuations that ETF market makers now generate from daily fund holdings disclosures, the proposed VIIVs would provide intraday valuations that are significantly less precise, less robust, less continuous, less timely, more prone to errors, more subject to agency risks and would expose market makers to potentially unrecoverable losses in the event of erroneous VIIVs. Fund market makers' forced reliance on VIIVs to determine intraday Fund valuations is a source of significant incremental risk that will surely translate into the Funds trading at wider bid-ask spreads and more variable premiums and discounts to NAV than similar existing ETFs. The lack of transparency of Fund holdings and the resulting loss of market maker control over their internal valuation process will also make the Funds especially prone to poor trading performance during periods of market stress and volatility.

**Reverse engineering of portfolio holdings.<sup>20</sup>**

4. *What are commenters views regarding whether market participants will be able to use the VIIV—by itself or in conjunction with other public data—to reverse engineer a Fund's portfolio holdings?*

*What factors might affect the susceptibility of a Fund to such reverse engineering?*

*If such reverse engineering were possible, what effect would it have on the Fund?*

*What effect would reverse engineering have on shareholders in the Fund?*

Both the Notice issued by the Commission in response to the Applicants' First Proposal and the Staff Letter responding to the Applicants' Second Proposal highlighted<sup>21</sup> the potential damage to Fund shareholders that could arise if the Fund's holdings and trading activity can be discerned by market participants. If a Fund's holdings could be reverse engineered, 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.

The Applicants assert that they "have carefully sought to provide a level of access and precision for the VIIV that would both facilitate arbitrage, yet protect a Fund from "front running" and "free riding" by other investors and/or managers which could otherwise harm, and result in substantial costs to the Funds. Applicants believe it highly unlikely, and have sought to confirm mathematically, that a VIIV calculated as described herein and provided at one second intervals would not allow others to reverse engineer a Fund's investment strategy for purposes of front running."<sup>22</sup> The Exemptive Application includes an analysis (the Ricky Cooper Study) concluding that "it seems rather unlikely that the Precidian ETF construction methodology will result in a product that can be reverse engineered for purposes of front running."<sup>23</sup>

Among the factors that would determine a Fund's susceptibility to reverse engineering (RE) through time-series analysis of VIIVs are: (a) the number of Fund holdings (fewer makes RE easier); (b)

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<sup>20</sup> See pages 22-24 of the March Letter for additional discussion.

<sup>21</sup> See Notice footnote 33 at page 16 and footnote 36 at page 17 and Staff Letter at page 4.

<sup>22</sup> See Exemptive Application at page 23.

<sup>23</sup> See Exemptive Application at page 63.

the number of potential Fund investments (fewer makes RE easier); (c) the current Fund NAV within the indicated \$20-30 range (higher makes RE easier); (d) the average price range of the Fund's holdings and eligible investments (higher makes RE easier); (e) the intraday price volatility of the Fund's holdings and eligible investments (higher makes RE easier); (f) the correlation of intraday price movements of the Fund holdings and eligible investments (lower makes RE easier); (g) Fund portfolio turnover rates (lower makes RE easier); (h) the statistical method employed in the RE process (there are several options); and (i) other Fund information incorporated in the RE process (such as previously disclosed holdings) that constrains or biases the RE process to increase the odds of a successful RE result.

Recent research<sup>24</sup> addressing the potential to reverse engineer the holdings of a Fund operating as described in the Proposal demonstrates that significant improvements in RE results over the Ricky Cooper Study can be achieved by using a different statistical method and altering some of the study conditions. This research demonstrates that match rates between estimated and actual portfolio weightings above 99% can be achieved during volatile market periods using the same portfolio parameters as in the Ricky Cooper Study. Because actual portfolios are not randomly selected and a determined reverse engineer<sup>25</sup> could come to know a great deal about a given Fund's likely holdings based on inputs other than VIIV analysis alone, in actual practice reverse engineering a Fund may not be nearly as difficult as the Ricky Cooper Study suggests. On an overall basis, *it is far from a settled question that the Funds would not ever be susceptible to reverse engineering.*

As a condition for approval, the Applicants should be required to conduct, and publicly report, additional research studies that demonstrate to the Commission's satisfaction that reverse engineering of the Funds is not possible over any reasonably foreseeable circumstances.

**Selective disclosure of portfolio holdings.**

**5. What are commenters views about the selective disclosure of portfolio holdings to the Trusted Agents, as described above?**

The proposed selective disclosure of the Funds' portfolio holdings to Trusted Agents trading on behalf of Confidential Account holders conflicts with the purposes of the amendments to Form N-1A adopted by the Commission in 2004 (Form N-1A Amendments) and applicable to ETFs and other open-end funds. In proposing the Form N1-A Amendments, the Commission expressed concern about "the misuse of material, nonpublic information that may occur when [an open-end] fund's portfolio holdings are selectively disclosed and professional traders are given the opportunity to use this information to their advantage to the detriment of fund shareholders."<sup>26</sup> In the release adopting the amendments, the Commission stated that "divulging nonpublic portfolio holdings to selected third parties is permissible

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<sup>24</sup> Conducted by a research consulting firm engaged by Eaton Vance.

<sup>25</sup> To increase the efficiency of their arbitrage trading, market makers and other arbitrageurs would be highly motivated to reverse engineer a Fund's holdings. As stated in footnote 16 on page 4 of the Staff Letter, "it is the staff's understanding that, in their quest for pricing precision, market makers or other market participants likely will seek to reconstruct the underlying portfolio as much as possible using any and all available information, even if the ETF is nominally non-transparent." The resources and determination a market maker could bring to this endeavor could far exceed the simple academic test demonstrated in the Ricky Cooper Study. See, for example, the *New York Times* article "A New Breed of Trader on Wall Street: Coders with a Ph.D." (February 22, 2016) available at [http://www.nytimes.com/2016/02/23/business/dealbook/a-new-breed-of-trader-on-wall-street-coders-with-a-phd.html?\\_r=0](http://www.nytimes.com/2016/02/23/business/dealbook/a-new-breed-of-trader-on-wall-street-coders-with-a-phd.html?_r=0).

<sup>26</sup> See Investment Company Act Release No. 26287 (December 11, 2003).

only when the fund has legitimate business purposes for doing so and the recipients are subject to a duty of confidentiality, *including a duty not to trade on the nonpublic information* [emphasis added].<sup>27</sup>

In the adopting release of the Form N1-A Amendments, the Commission drew connections<sup>28</sup> between the obligations of open-end funds and their advisers to protect confidential portfolio holdings information and the selective disclosure and insider trading rules applicable to publicly traded securities adopted by the Commission in October 2000,<sup>29</sup> including Rule 10b5-1. Rule 10b5-1 interprets the antifraud provisions under Section 10(b) of the Exchange Act and Rule 10b-5 generally to prohibit the trading of securities “on the basis of” material nonpublic information “if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.”<sup>30</sup>

The Proposal makes clear that the nonpublic portfolio holdings of the Funds are provided to Trusted Agents for the express purpose of enabling the Trusted Agents to trade on the nonpublic information on behalf of Authorized Participants and market makers holding Confidential Accounts. On its face, the proposed arrangement violates the provisions of Rule 10b5-1 and the purposes of the N1-A Amendments.

In the Staff Letter responding to the Applicants’ Second Proposal, the Commission’s staff expressed significant reservations regarding the proposed private communication of confidential Fund information to support trading in the Fund’s underlying holdings on behalf of Authorized Participants. As stated in the Staff Letter, “this disclosure would seem to run afoul of a foundational federal securities laws principle. The Commission has consistently opposed the selective disclosure of non-public material information, in particular where the recipients of such information could use it to trade for their own profit. Selectively disclosing information to trustees of the blind trusts for the benefit of Authorized Participants, but no others, and allowing the Authorized Participants to continuously trade on that selective information, constitutes a major departure from this long-standing principle. . . . Moreover, as noted at length by the Commission in its Notice, section 22(d) and rule 22c-1 under the [1940] Act are designed to require that all fund shareholders be treated equitably when buying and selling fund shares. Applicants’ proposal would create asymmetry between market participants by providing confidential disclosures to the ETFs’ Authorized Participants but no other market participants.”<sup>31</sup>

Although the current Proposal (a) alters the arrangement through which Authorized Participants could, through an agent, trade using privately disclosed confidential Fund information and (b) expands the eligibility to participate in such an arrangement to also include Non-Authorized Participant Market Makers and other arbitrageurs, the concerns expressed in the Staff Letter are not fully resolved and remain an issue for this Proposal.

The Confidential Account arrangement that is at the core of the Proposal violates foundational principles of federal securities law, the provisions of Rule 10b5-1 and the purposes of the Form N1-A

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<sup>27</sup> See Investment Company Act Release No. 26418 (April 16, 2004).

<sup>28</sup> *Ibid* at footnote 42.

<sup>29</sup> See Investment Company Act Release No. 24599 (October 23, 2000).

<sup>30</sup> See <https://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol4/xml/CFR-2015-title17-vol4-sec240-10b5-1.xml>. Rule 10b5-1 establishes a set of “affirmative defenses” against a person’s purchases or sales of securities being treated as made “on the basis of” material nonpublic information, the conditions of which would not be met by the proposed trading in Fund securities by Trusted Agents on behalf of Confidential Account holders.

<sup>31</sup> See Staff Letter at page 4-5.

Amendments adopted by the Commission in 2004 and applicable to all ETFs and other open-end funds. Accordingly, the Confidential Account arrangement should not be permitted and the Proposal should not be approved.

**Compliance with broker-dealer net capital, books and records, and related requirements.**

6. *In light of the non-transparency of the basket of securities underlying the proposed Funds, the Commission seeks comment on how a broker-dealer authorized participant engaging in creation and redemption activity might fulfill its obligation to maintain a minimum level of net capital in compliance with Rule 15c3-1 under the Act and how such an authorized participant would comply with the books and records requirements of Rules 17a-3 and 17a-4 under the Act.*

*For example, how would an authorized participant that is a broker-dealer apply an appropriate haircut to positions included in the Creation Basket when the authorized participant is unaware of the securities included in the basket?*

*In addition, how would the authorized participant determine an appropriate price for such securities?*

*Moreover, how would such an authorized participant make and keep current the records required under Rule 17a-3, including the daily blotter and daily stock record required under paragraphs (a)(1) and (a)(5), respectively, of that rule?*

As suggested by the above questions, the proposed trading of securities by Fund Authorized Participants and market makers on a blind basis through Confidential Accounts can interfere with their broker-dealer compliance obligations.

**Rule 15c3-1.** Broker-dealers are required by Rule 15c3-1 under the Exchange Act to maintain at least a prescribed minimum amount of net capital at all times, including throughout each Business Day on a “moment-to-moment” basis. In computing net capital, the securities positions held by broker-dealers are subject to “haircuts” set forth in Rule 15c3-1(c)(2)(vi). Specified haircut percentages range from 0% to 100%, depending on the security type and maturity:

- Government securities: 0% - 6%
- Municipal securities: 0% - 7%
- Money market funds: 2% - 9%
- Commercial paper, bankers' acceptances, certificates of deposit: 0% - 6%
- Other nonconvertible debt securities: 2% - 9%
- Convertible debt securities: 2% - 15%
- Preferred stock: 10%
- All other securities, including equities: 15%
- Securities with a limited market: 15% - 40%
- Securities for which there is no ready market: 100%

To compute its net capital on a continuous intraday basis, a broker-dealer must be able to determine both the value of each securities position held and the appropriate haircut for the position pursuant to Rule 15c3-1(c)(2)(vi). There is no provision in the net capital rules or the Commission's interpretations thereof permitting a broker-dealer to rely on a third party to make these determinations

on the broker-dealer's behalf. Accordingly, in its intraday net capital calculations, a broker-dealer is required to apply a 100% haircut to any position for which the current value or appropriate haircut under Rule 15c3-1(c)(2)(vi) is not known to the broker-dealer.

For the Funds, the above requirements would have the effect of causing securities positions held by an Authorized Participant or market maker through a Confidential Account to be treated as non-allowable assets for purposes of computing its broker-dealer net capital. In other words, the Funds' Authorized Participants and market makers will not get the benefit of including the securities they hold through Confidential Accounts as part of their net worth in meeting broker-dealer capital requirements.

One of the most precious assets of any broker-dealer is its regulatory capital. Broker-dealers only expend regulatory capital when they expect to be rewarded commensurately. The fact that positions in underlying Fund portfolio securities held by Authorized Participants and market makers through Confidential Accounts would be valued at zero for purposes of meeting broker-dealer net capital requirements means that the Funds' Authorized Participants and market makers will be substantially less efficient users of regulatory capital than Authorized Participants and market makers in conventional ETFs. Because the capital charges to broker-dealers making markets in Shares will be substantially higher, the Funds must trade at sufficiently wider bid-ask spreads and more variable premiums/discounts to compensate market makers for the added costs.

**Rule 17a-3 and Rule 17a-4.** Pursuant to Rule 17a-3 under the Exchange Act, broker-dealers are required to maintain specified books and records, including: (a) blotters (or other records of original entry) containing an itemized daily record of all purchases, sales, receipts and deliveries of securities showing the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price, the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered; (b) ledger accounts (or other records) of each cash and margin account of every customer and of the broker-dealer, including all purchases, sales, receipts and deliveries of securities and commodities for such account and all other debits and credits to such account; (c) a securities record or ledger reflecting separately for each security as of the clearance dates all long or short positions carried by the broker-dealer for its account or for the account of its customers showing the location of the positions and the name or designation of the account in which each position is carried; (d) a memorandum of each purchase and sale for the account of the broker-dealer showing the price and, to the extent feasible, the time of execution; and (e) record of all puts, calls, spreads, straddles and other options in which such broker-dealer has any direct or indirect interest. Rule 17a-4 under the Exchange Act sets forth the retention requirements for the broker-dealer information specified in Rule 17a-3.

For the Funds, the trading of securities by Authorized Participants and market makers through Confidential Accounts will, at a minimum, complicate their compliance with the broker-dealer books and recordkeeping requirements under Rule 17a-3 and Rule 17a-4. If customer books and recordkeeping compliance duties are included among the responsibilities of a Trusted Agent under the Confidential Account agreement, Authorized Participants and market makers may be able to use the Trusted Agent responsible for their account to satisfy the Rule 17a-3 and Rule 17a-4 requirements. Care must be taken to ensure that the requirements are satisfied in a manner that avoids disclosing any confidential Fund information to the Confidential Account holder. The added complications, costs and risks of ensuring compliance by Authorized Participants and market makers with the requirements under Rule 17a-3 and Rule 17a-4 without disclosure to them of confidential Fund information will contribute incrementally to the Funds trading less efficiently than fully transparent ETFs.

As a condition for approval, the Applicants should be required to specify how they expect Authorized Participants and market makers to satisfy the Rule 17a-3 and Rule 17a-4 books and records requirements for securities traded on their behalf through Confidential Accounts, while ensuring that no confidential Fund information is disclosed to any Authorized Participant or market maker in connection with meeting these requirements.

**FINRA Rules 2241 and 2242.** Not mentioned in the Order but raising similar issues are the FINRA rules applicable to investment research published by broker-dealers. Under FINRA Rules 2241 and 2242, broker-dealers publishing research reports are required to disclose in each report whether, at the time of publication or distribution of the reports: (a) the broker-dealer or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company (Rule 2241); and (b) the broker-dealer trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of a debt research report (Rule 2242).

For the Funds, compliance with the FINRA research rules would appear to require the research departments of broker-dealers acting as Authorized Participants or market makers and holding securities positions through a Confidential Account to know the specific positions held in the account. How this could be accomplished without compromising the confidentiality of a Fund's portfolio holdings is unclear.

As a condition for approval, the Applicants should be required to specify how they expect broker-dealers publishing investment research reports to satisfy the requirements of FINRA Rules 2241 and 2242 with respect to securities they may hold through a Confidential Account in connection with serving as an Authorized Participant or market maker for one or more Funds, while ensuring that no confidential Fund information is disclosed to any Authorized Participant or market maker in connection with meeting these requirements.

**FINRA Rule 5320.** Also not mentioned in the Order but, again, raising similar issues is the FINRA rule prohibiting a FINRA member from trading ahead of customer orders. FINRA Rule 5320 provides that a FINRA member that accepts and holds an order in an equity security from its own customer or a customer of another broker-dealer without immediately executing the order is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

For the Funds, compliance with FINRA Rule 5320 would appear to be problematic for any FINRA-member broker-dealer acting as a Fund Authorized Participant or market maker that trades equity securities through its Confidential Account. Compliance would appear to require the broker-dealer to have visibility into the trades being executed in its Confidential Account on a real-time basis. Without knowing the exact time and identity of the equity trades made on its behalf through its Confidential Account, a Fund Authorized Participant or market maker could not assure compliance. Accordingly, FINRA Rule 5320 appears to raise irresolvable conflicts for any Fund Authorized Participant or market maker that is a FINRA member and accepts and holds customer orders in equity securities that are not immediately executed.

As a condition for approval, the Applicants should be required to specify how they expect broker-dealers to comply with FINRA Rule 5320 with respect to equity securities for which they execute

customer orders and may also buy and sell through a Confidential Account in connection with serving as an Authorized Participant or market maker for one or more Funds, while ensuring that no confidential Fund information is disclosed to any Authorized Participant or market maker in connection with meeting these requirements.

**Additional considerations.**

In addition to the six categories of questions for which the Order requested comment, the March Letter raised a number of additional concerns and made recommendations regarding the Proposal that the Applicants have not addressed and which remain unresolved. These are:

**Portfolio Data Security Concerns.**<sup>32</sup> The dissemination of a Fund's confidential portfolio information across the network of Trusted Agents, affiliated broker-dealers and other service providers involved in managing and implementing trades on behalf of Confidential Account holders raises significant portfolio data securities concerns. If the Funds' confidential data is not secure, the claim that the Funds' proposed method of operation will preserve the integrity of their active investment strategies and eliminate the potential for free riding and front-running of the Funds' portfolio trades is invalid. Neither the Filing nor the Exemptive Application addresses concerns about portfolio data security or describes meaningful steps the Applicants will take to ensure against misappropriation or misuse.

As a condition for approval, the Applicants should be required to develop a comprehensive data security compliance and monitoring program and prospectively demonstrate its effectiveness. Unless the security of the Funds' confidential portfolio information can be assured, these Funds serve little or no useful purpose.

**Fund Costs and Potential Liabilities.**<sup>33</sup> One of the asserted benefits of the Funds over existing actively managed mutual funds is the potential to lower operating costs by reducing transfer agency fees and associated account maintenance expenses based on the Funds' use of an exchange-traded structure. Among the features of the Proposal offsetting these identified savings are the costs and risks to the Fund in connection with the calculation, verification and dissemination of VIIVs at one-second intervals throughout the Exchange's Core Trading Session each Business Day.

Comparing the Funds' proposed VIIV methodology to the IIV practices of existing ETFs, there seems little doubt that the Funds' approach will be significantly more costly than what ETFs customarily pay to calculate and disseminate IIVs. In addition, the Proposal indicates that the Funds will assume legal liability for potential claims in connection with dissemination of inaccurate or untimely VIIVs. Although the Applicants assert that each Fund will have appropriate errors and omissions insurance, it is far from clear that a Fund would be able to acquire comprehensive coverage against claims arising from trading losses and other damages that may be incurred by market participants that rely on VIIVs that prove untimely or inaccurate, which damages may be quite significant.

As conditions for approval, the Applicants should be required to (a) provide the Commission with detailed estimates of the VIIV-associated Fund costs and demonstrate that the asserted cost-related benefits of the Proposal are likely to be achieved on a net basis, (b) demonstrate to the

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<sup>32</sup> See March Letter at pages 18-19 for more detail.

<sup>33</sup> See March Letter at pages 19-21 for more detail.

Commission that they have secured commitments from at least one creditworthy insurer to provide errors and omissions insurance to the Funds and (c) provide the Commission with assurances regarding the reasonableness of Fund insurance costs. Given the potential magnitude of the liabilities that a Fund's shareholders could face, the Funds should not be permitted to operate without appropriate insurance coverage.

Share Trading Halts.<sup>34</sup> The Filing provides that the Exchange would halt trading in a Fund's Shares intraday whenever (a) the Fund's VIIVs are not being priced and disseminated in one-second intervals or (b) the Exchange receives notice that the Fund's Pricing Verification Agent has determined that the two Independent Pricing Source valuations vary by more than 25 bps for 60 seconds. A trading halt would continue until the cause of the trading halt is successfully resolved. If trading in a Fund's shares is frequently interrupted by trading halts, severe damage to the Fund's ongoing liquidity and trading efficiency would result.

As a condition for approval, the Applicants should be required to complete, and publicly report, the results of a study that examines the reliability of the VIIV calculation and dissemination process and the estimated frequency of circuit breaker-imposed trading halts for each proposed Fund strategy. The study should include consideration of both normal market conditions and periods of heightened market stress and volatility. If the study does not demonstrate that intraday trading in Shares will be virtually continuous and trading halts minimal, the Proposal should not be approved.

Erroneous Share Trades.<sup>35</sup> It appears inevitable that VIIV errors will occur from time to time, given the challenges to the accurate calculation and timely dissemination of VIIVs at one-second intervals throughout each Business Day's Core Trading Session. Due to the central role of VIIVs in determining market prices of Shares, material errors in disseminated VIIVs 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 VIIVs.

As a condition for approval, the Exchange should be required to institute a comprehensive program to monitor the timeliness and accuracy of disseminated VIIVs and to adopt appropriate procedures for the treatment of Share trades executed during periods when erroneous VIIVs are determined to have been disseminated. Rather than addressing the appropriate treatment of erroneous Share trades on an ad hoc basis after the fact, the Exchange should be obligated to do so in advance of the Funds' launch as a condition for listing and trading approval.

Tax Treatment of In-kind Redemptions.<sup>36</sup> The Applicants represent that the Funds offer potential tax advantages over traditional mutual funds derived from the proposed use of distributions of portfolio securities to effect redemptions in a tax-favorable manner. The Funds' process for in-kind redemptions would differ significantly from how existing ETFs redeem shares in kind, which could change the resulting tax treatment. Whereas Authorized Participants and other redeeming shareholders of an existing ETF know the contents of the Creation Basket instruments that will be used to effect the redemption and have complete control over the receipt, holding and disposition of those assets, the Funds' redeeming shareholders are not permitted to receive the assets directly and are

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<sup>34</sup> See March Letter at pages 21-22 for more detail.

<sup>35</sup> See March Letter at page 22 for more detail.

<sup>36</sup> See March Letter at pages 25-27 for more detail.

intentionally kept ignorant of the contents of the Creation Basket. While in form a redeeming shareholder would instruct the Trusted Agent as to the disposition of the distributed assets, in substance the shareholder would exercise little meaningful choice. Accordingly, 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 ETF tax advantages of redeeming in kind.

Given the importance of tax efficiency to the Proposal's claimed investor benefits and the strong possibility that the Funds' asserted tax benefits will be denied, 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. If the IRS will not grant a favorable Private Letter Ruling, the Proposal should not be permitted to move forward.

Order Cut-off Times for Creation Unit Transactions.<sup>37</sup> The proposal is ambiguous as to whether Order Cut-Off Times for Fund creations and redemptions on a given Business Day would be prior to the close of market trading on that day. Imposing early Order Cut-off Times for redemptions would violate 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. Mandatory early Order Cut-off Times for direct purchases and redemptions of Shares also raise Exchange Act issues due to the potential impact on secondary market trading after the designated Order Cut-off Time.

As a condition for approval, the Applicants should be required to represent that the Funds will establish and maintain Order Cut-off Times for creations and redemptions at the close of market trading each Business Day.

Scope of Proposal.<sup>38</sup> The 15 Funds included in the Proposal appear to encompass a broad spectrum of U.S. equity strategies, including large-cap, mid-cap and small-cap strategies, some of which would maintain significant short positions on an ongoing basis. Each Fund may hold all types of U.S.-listed ETFs other than leveraged ETFs, and may invest up to 15% of its net assets in illiquid assets, as determined at the time of investment. Because a Fund's trading efficiency is substantially uncertain and will depend critically on the liquidity and level of trading activity in its underlying holdings, the Funds' permitted non-cash investments should be restricted to include only highly liquid U.S. stocks and ETFs that invest in such assets.

As conditions for approval, the Funds should: (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); (b) be required to limit their ETF investments to U.S.-listed domestic equity ETFs; (c) not be permitted to invest in illiquid assets; and (d) not be permitted to hold short positions.

Adequacy of Investor Information.<sup>39</sup> The Proposal provides that Fund VIVs will be disseminated by one or more major market data vendors in a manner consistent with how ETF IIVs are normally

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<sup>37</sup> See March Letter at page 28 for more detail.

<sup>38</sup> See March Letter at pages 28-29 for more detail.

<sup>39</sup> See March Letter at pages 30-32 for more detail.

disseminated, and represents that each Fund will maintain a free public website including daily Fund trading information consistent with the current requirements of existing ETFs. Given the heightened importance of VIIVs for Fund investors and the likelihood that the Funds will trade at wider spreads and more variable premiums/discounts than existing ETFs, the Fund trading information available to investors should be significantly expanded.

As conditions for approval, each Fund should be required to provide on a free public website: (a) real-time VIIVs made available on a continuous intraday basis no later than available to any other market participant; and (b) daily updated statistics showing prior day and historical VIIVs, closing price/NAV ratios, closing VIIV/NAV ratios, intraday price/VIIV ratios, the Fund's net long and short market exposures, and Transaction Fees applicable to the Fund's creation and redemption transactions.

**Fund Claims.**<sup>40</sup> In the Filing and Exemptive Application, the Applicants represent that the Funds' structure and proposed method of operation will offer significant investor benefits relating to cost and tax efficiency, shareholder trading costs and portfolio confidentiality, many of which asserted benefits my analysis calls into question.

As conditions for approval, the Applicants should be required to represent that the Funds' Registration Statements and marketing and advertising materials will not make any claims regarding Fund cost and tax efficiency, the Shares' trading performance or the Funds' protection against front running and free riding until such claims are substantiated.

### **Conclusion**

As stated above and in the March Letter, I conclude that the Proposal is fundamentally and fatally flawed and should not be approved. Among the principal reasons are: (a) the proposed selective disclosure of confidential Fund holdings information to Trusted Agents for trading on behalf of Confidential Account holders in violation of federal securities law; (b) 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 existing ETFs that themselves demonstrate trading deficiencies; (c) the likelihood that the Funds' trading performance will be especially poor during periods of market stress and volatility; (d) concerns that the security of confidential Fund information disseminated to Trusted Agents and other Confidential Account service providers cannot be assured; (e) potentially significant added Fund costs and risks in connection with the calculation, verification and dissemination of VIIVs and associated Fund warranties; (f) the potential for frequent Share trading halts; (g) the likely incidence of erroneous Share trades and the absence of an Exchange program to detect and appropriately remediate erroneous trades; (h) the potential for reverse engineering of a Fund's portfolio holdings through analysis of VIIVs and other Fund information; (i) the significant risk that the IRS will deny the purported tax benefits of the Funds' distinctive in-kind redemption program; and (j) the costs, risks and uncertainties of broker-dealers serving as Fund Authorized Participants and market makers in meeting their compliance obligations with respect to securities traded on their behalf through Confidential Accounts.

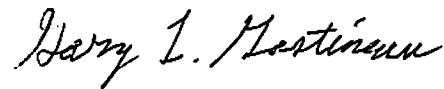
In my estimation, the Proposal falls far short of meeting the statutory standard that approval is necessary or appropriate in the public interest and consistent with the protection of investors.

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<sup>40</sup> See March Letter at page 32 for more detail.

I wish to thank the Commissioners and staff of the SEC for consideration of the views and information presented here and in the March Letter.

Sincerely,



Gary L. Gastineau  
President, ETF Consultants.com, inc.