Precidian Investments LLC

October 30, 2014

Kevin M. O'Neill
Deputy Secretary
Securities and Exchange Commission

Re: File No. SR-NASDAQ-2014-020

Dear Mr. O'Neill:

I am Daniel J. McCabe, CEO of Precidian Investments LLC "Precidian"). We had not initially planned on commenting on the NASDAQ rule filing to list Eason Vance's actively managed exchange-traded product ("ETMF") since we are generally of the view that competition is the best arbiter of an investment product's merits. However, after being made aware of the commissions' heightened focus on issues related to the structural formations of actively-managed ETFs[1], we feel it is important to share some of our thoughts. This letter is intended to discuss some of the foundational flaws in this model proposed by the NASDAQ for "trading" relative to NAV on an exchange.

The most critical aspect of ETMFs is a new trading model, where bids, offers and trades are not based on actual current prices, but on a fund's NAV as calculated after the close of trading. You are probably not aware that my partner, Paul Kuhnle, and I are co-inventors of the intellectual property forming the foundation of NAV-based trading[2] and have a continuing economic interest in that intellectual property's success in the market place. We believe as currently formulated by NASDAQ this application would produce a product that creates a myriad of problems for the asset management and brokerage industry and, most importantly, is unsuitable for equity investors, unless modified to address some of these concerns.

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2 http://patents.justia.com/patent/7496531

The intellectual property behind the NAV-based trading model was originally intended to be used as a method for investors to trade relative to widely implemented trading strategies such as Trade Weighted Average Price (TWAP), Target Volume (TVOL) and Weighted Average Price (VWAP), something which we believe to have real value. In application of these methodologies, the portfolio is known while the price cannot be determined until sometime in the future.

As a starting point, it is important to recognize that ETMFs are not redeemable securities, although investors might reasonably assume that they are given the fact that trading is based on NAV. With a redeemable security the fund is the counter-party to each purchase and sale transaction and the fund has a fiduciary duty to protect fund shareholders. In NAV-based trading, market professionals and other investors are the counter-parties to each transaction and their economic interest is diametrically opposed to the investor. A market professional buying shares from an investor in this product has an economic interest in providing the worst price to the investor. Traders that accumulate large ETMF positions will be incentivized to move the NAV in their favor. Evidence of their ability to do this is apparent in the recent marking the close case brought by the SEC.[3]

Additionally, it is illusory to pretend that NAV-based trading permits an investor to acquire or dispose of ETMF shares intraday when the actual price is not determined until the end of the day. Intraday liquidity is a foundational principle of exchanges and the secondary market as a whole and its' importance should not be disregarded. The proposed rules would allow the listing of products on exchange that do not trade at current market pricing. Undoubtedly, confusion will arise because an investor may see the market falling and desire to liquidate his or her position before the market falls further. NAV-based trading does not permit an intraday exit point because the price will be based on the closing prices of the portfolio. Thus, NAV-based trading provides no discernable benefit to investors and is likely to add to investor confusion given that the published Intraday Indicative Value (IIV) may or may not have any relevance to the end of day NAV.

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[3] http://www.bloomberg.com/news/2014-10-16/athena-to-pay-1-million-in-sec-hft-manipulation-case.html

The unintended consequences created by the illusion of a secondary market, should not be underestimated. These transactions are not 'trades' in the conventional sense since price is a critical component of a trade and is not known until after the close of trading. The fact that price is not known can create significant problems for both brokers and investors. Typically, in a margin account, a broker will only permit a customer to purchase securities if it has sufficient buying power in its account. Suppose an investor had an account that was subject to Finra's 25% margin rule so the equity in the account must be at least 25% of the value of the positions. If the investor decides to purchase an ETMF during the day, the margin requirement would go to 50% but the broker would not know the price of the trade until at least the end of the day so it cannot calculate the amount of additional equity that would be required to fund the account. As a result, the broker cannot exercise reasonable judgment in setting the buying power of the account.

The impact is even worse in a cash account. Suppose an investor with a cash account wants to buy an ETMF at a time the IIV is $30. The customer has $3000 it wishes to invest so it buys 100 shares. By the close of the day, the NAV has risen to $40. The investor may not have the additional cash and if the broker sells out the position it will place the account in violation of the margin regulations.

This problem becomes untenable when the investor is an IRA or self-directed 401(k). Erisa rules prohibit the beneficiary of an IRA or 401(k) from making supplemental contributions to the plan. In the event there are not sufficient funds in the plan to pay for the ETMF shares, the plan fiduciary would be required to close out positions and place the plan in violation of the margin regulations.

The problems caused by NAV-based trading are exacerbated by the inclusion of foreign stocks in a portfolio. If a portfolio includes stocks that trade in a different time zone, it may be impossible to accurately set the NAV until the foreign market opens for trading. For example, suppose a fund contained a British stock that did not trade in the U.S. Trading commences in London at 1 AM in East Coast Time. The NAV could not reasonably be set until 1 AM. Valuing the foreign stock based on the last London closing price would invite market timing[4] and valuing the stock

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[4] See http://en.wikipedia.org/wiki/2003_mutual_fund_scandal.

based on tomorrow's opening price would mean that pricing could not be established until T+1. This would require NSCC to reduce the settlement cycle for these securities, would lessen the time in which brokers can prepare confirmations, delay their ability to calculated margin calls and a host of other time critical problems.

As a practical matter for ETMFs containing foreign securities, we assume they will use fair value pricing. However, fair value pricing is computed after the close and therefore the published IIV will be based on the closing price of the foreign securities. This means that the IIV for these funds will be even more unreliable because they are based on values that are hours old.[5] Issues raised by stale pricing of the IIV are exacerbated because in part there is no intraday price discovery on exchange. Mr. Gastineau in a recent comment letter states, "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."

As the Commission notes in the Release, implementation of NAV-based trading will require the brokerage community to make significant changes to their risk and compliance platforms to account for the fact that a firm or customer has a position that can't be valued. It needs to be ascertained how a firm that has acquired a large ETMF position during the day would calculate its net capital. The SEC has stated the brokers must be able to calculate their net capital at any moment during the day. A firm with ETMF positions cannot possibly determine their value during the day because quotes and last sales prices are based on a future price and the IIV is only published at 15 minute intervals.

By the same token, all brokerage firms, vendors, the consolidated tape and quote system operators will have to significantly alter their systems. In order to permit NAV-based trading in today's systems that are limited to numerical values, the applicant proposes using a proxy of $100 for purposes of disseminating trades and quotes. NASDAQ correctly recognizes that all member firms and all market data providers must convert the "proxy" price quotations to a "NAV -/NAV +"

[5] An ETMF that consists of foreign stocks would make the IIV essentially worthless.

notation in an effort to avoid investor confusion when transacting in ETMF shares. More importantly, all order entry, management, confirmation and portfolio management systems must also be modified to prevent confusion. Without these changes, an investor who enters a limit order to sell an ETMF share at $100.02 could reasonably expect to receive $100.02 at settlement verses a closing NAV which could be significantly different (e.g., $23.78). This action is further confused by an IIV being disseminated every 15 minutes, which will be significantly different (e.g., $24.04) than the closing NAV. Even with the extensive modifications, which will be required to support ETMFs, investors would have to sift through multiple valuations in order to determine their order and final execution value (Quotation price: NAV+$0.08, Order entry price: $100.08, IIV quotation: $24.04, End of day NAV: $23.78).

The Commission has made known its opinion that for periodically disclosed actively managed products the IIV must be reliable and disseminated frequently enough to support arbitrage and foster efficient markets. While we agree with this conclusion, the same analysis would lead one to conclude that an IIV disseminated every 15 minutes is less valuable than one disseminated every 15 seconds. Investment decisions regarding the cost of buying and selling ETMFs can only be made by reference to a stale IIV.

While applicants state the NAV-based trading takes away the need for arbitrage, it may not be the case. If market professionals acquire a large ETMF position during the day, which he or she intends to redeem, they will receive securities comprising the proxy portfolio in the redemption. In order to hedge the ETMF position during the day, the AP may short the proxy securities. However, the market professional has no way to know whether this proxy is tracking the NAV or not. With ETMFs the only way to adjust the hedge is by reference to the stale (and presumably inaccurate) IIV that is published every 15 minutes and may include prices for foreign securities that are completely inaccurate. In this regard, we note that NASDAQ is unwilling to validate the accuracy of the IIV or implement failsafe procedures. Even more remarkable is that NASDAQ will not guarantee the accuracy of the NAV upon which *all* "trades" during the day are to be priced.

The proposed structure will likely not provide the tax benefits and may cost more to operate than existing exchange-traded funds that investors are accustomed to today. ETMFs will use proxy portfolios that will comprise a portion of a fund's actual portfolio. This portfolio will be disseminated daily and will be used for the creation and redemption basket. The net effect of using a proxy portfolio is that every time there is a creation or redemption, the fund will be forced to rebalance its portfolio thereby incurring additional costs. The fewer securities contained in the proxy, the worse becomes the problem. Suppose the proxy only contains 25% of the securities in the actual portfolio. A large redemption could force the fund to actually go into the market to buy securities in order to deliver them in the redemption. By the same token, tax efficiency is reduced because the fund manager has a more limited number of choices in choosing tax lots.

I would be happy to discuss this in person should you find it helpful to do so.

Best Regards,

Daniel J McCabe
Chief Executive Officer
Precidian Investments LLC