

Securities and Exchange Commission
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Re: Self-Regulatory Organizations; NYSE Arca, Inc.; Notice of Filing of Proposed Rule Change to Adopt a New Policy Relating to Trade Reports for Exchange Traded Products

File SR-NYSEArca-2015-104

This is a bad proposal that should be rejected. The proposed change would reduce or eliminate most investors' ability to see important Market Data for existing exchange-traded securities.

It was interesting to read the discussion of ETF bid/ask spreads in the NYSEArca filing because the quoted bid/ask spread for an ETF *has almost nothing to do with the cost of trading an ETF*. The true cost of trading an ETF is the difference between the contemporaneous value of the underlying portfolio and the price actually paid or received when trading the ETF. James J. Angel, Todd J. Broms and I have written a paper entitled "ETF Transaction Costs Are Often Higher Than Investors Realize." The paper will appear in the Spring 2016 Issue of *The Journal of Portfolio Management*. I will refer to some of the topics the paper covers in these comments because they are relevant to the transaction cost disclosure that would be eliminated by the proposed rule.

We even use the iShares MSCI Emerging Markets ETF (EEM) and, to a lesser extent, the Vanguard Emerging Markets Stock Index Fund ETF (VWO) in our examples. In my judgment, the Exchange's discussion, like many discussions of ETF bid/ask spreads obscures the adverse impact on investor access to market data that will be the most significant effect of the proposed rule. The cost of an ETF trade is appropriately measured as the difference between the transaction price and the fund's contemporaneous net asset value (NAV). To demonstrate this, we used data and examples from a weighty but often misleading paper available on the iShares website: Golub, Ben, Barbara Novick, Ananth Madhavan, Ira Shapiro, Kristen Walters and Maurizio Ferconi, "EXCHANGE TRADED PRODUCTS: OVERVIEW, BENEFITS AND MYTHS, 2013." <https://www.blackrock.com/corporate/en-pl/literature/whitepaper/viewpoint-etps-overview-benefits-myths-062013.pdf>

The simplest and clearest way to explain why the cost of trading an ETF has nothing to do with the bid/ask spread is to look at a customer trade at the market close. The cost of trading an ETF is equal to ***the difference between the transaction price and the fund's contemporaneous net asset value***. Here is an example. I am writing this on November 19, 2015. If I had bought the iShares MSCI Emerging Markets ETF (EEM) at the market close on November 18, data on the iShares website shows that I would

have paid \$34.47 per share or \$.40 more than yesterday's closing NAV of \$34.07. Market makers in EEM offered shares to investors above the NAV of the shares. If the NAV is still \$34.07 a week from now and I sell the shares at the close for \$33.67 when other investors are also selling, my roundtrip trading cost would be \$0.80 per share. The value of the fund shares is unchanged and I have incurred trading costs of \$0.80 per share, neglecting any commissions. That is a transaction cost of more than 200 basis points on the purchase price – and a lot more than the 3 basis point spread used as an illustration for the “trading cost” of this fund in the filing. Not every round-trip transaction will cost as much as 200 basis points, but I doubt that many customer round-trip transactions will cost as little as 3 basis points.

Any reasonable assessment of the economics of serving as a market maker in a complex fund like EEM will conclude that the various costs associated with creation and redemption of fund shares, hedging position risks, and meeting operating costs, make an average net investor trading cost close to 3 basis points impossible. The reality is that when customer orders for an ETF are largely on the buy side, the market maker will price an offer to recover the costs of creating shares. When orders on the sell side dominate, the market maker will have to cover the costs of redeeming shares. Buy orders may dominate trading for hours or even days at times. Sellers will dominate at other times. If buyers dominate, as they did at the November 18 close, the quoted spread means nothing and the cost to trade at that moment is the difference between the closing price and the NAV. The quoted spread is not remotely useful as an indicator of the trading costs associated with ETFs with high creation and redemption costs.

The average absolute difference between the daily closing price and the day's NAV for EEM from the launch of the fund in 2003 through March 31, 2015 was 63 basis points. This measure is the only useful measure of the cost of a trade at the market close that we have for most ETFs. ETF share creations and redemptions often cause large swings in differences between an ETF's **portfolio value** and its **trading price**. It is safe to assume that most Aberrant Report Indicators will find an investor on the “undesirable” side of the trade. Most of the trades that will be assigned Aberrant Report Indicators by the proposed process will be the result of a market order entered by an incautious investor.

Contrary to the statement in the filing that the appropriate reference price for a fund holding securities not traded during U.S. trading hours is the next day's value on the primary market, the appropriate value is the fairest valuation available as near as possible to the time of the trade – during U.S. trading hours or at the close. It seems safe to assume that more happens to *change* the value of most Eastern Hemisphere portfolios between the close in New York and the next day's market opening in Europe than happens during U. S. trading hours. In addition, using a next-day value defers determination of a reference price to a calculation that cannot be made until many hours after the trade. Most mutual fund managements do an excellent job of calculating a Fair Valued Net Asset Value as of the close of trading in the U. S. These managers, including Vanguard, are proud of the mutual fund industry's Best Practice of Fair Value Pricing of their funds' NAVs. They have exchanged cash for fund shares at 4 pm Eastern Time each trading day for as long as two generations in some cases. Many index-based ETF managers have not invested enough in their NAV pricing operations to insure fair valuations in a stressful environment; but this short-coming can be fixed.

In the paper mentioned above, we compare the trading of the Vanguard Emerging Markets Stock Index Fund ETF (VWO) to the trading in EEM. The share prices on these funds, like the quoted spreads described in the filing, are nearly identical. Ironically, EEM is far more actively traded than VWO in spite of EEM's much higher trading costs, measured as the difference between the Closing Price and NAV. EEM's Assets have been declining, perhaps partly as a result of higher trading costs. Trading VWO shares costs an investor less than one-third the cost of trading EEM, measured as the average difference between the fund's closing price and its NAV.

I see no benefit to investors from this rule change. Removing trade reports that are away from an appropriately measured value of the portfolio will make the market appear fairer and more efficient than it is – without changing any investor's trading cost. The Exchange and its market makers might benefit initially from the apparent improvement in market quality that will be greatest in the products and on the markets that are the worst now and will probably still be the worst. I doubt this change will be a long-term benefit to anyone.

The strongest argument against this proposal is that it reduces the quality and quantity of trading information available to investors and their advisors. If the Exchange wants to provide high quality market information, it should not emphasize the publication of misleadingly tight bid/ask spreads that suggest, but do not deliver, low trading costs. I recognize that the sale of market data is an important source of exchange revenue, but making more trading information available to all investors at little or no cost would help investors and advisors evaluate ETFs, other ETPs – and their markets – more effectively.